ESG INTEGRATION AND ISLAMIC FINANCE: COMPLEMENTARY INVESTMENT APPROACHES
ESG Integration and Islamic Finance: Complementary Investment Approaches
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EXECUTIVE SUMMARY

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

For instance, Islamic finance prohibits security lending and shorting, which ensures that voting rights remain the responsibility of the shareholder. ESG integration and stewardship practices are more widespread among ESG investing strategies, although they are consistent with the fundamental principles of shariah.

CFA Institute and Principles for Responsible Investment (PRI) published this report to offer guidance on the principles and characteristics of Islamic finance and to compare them to ESG investing. It explains the common and unique characteristics of both investment approaches when applied to equity and fixed-income investments. There is also a case study by SEDCO Capital on how they apply a shariah screening and integrate ESG factors into their active portfolio, and a case study by Hawkamah on how to incorporate ESG factors into a Pan-Arab Index.

In addition, the report includes insights on the current state of Islamic finance and ESG investing in the Middle East. This information was collected through:

- a workshop in Dubai organized by the Dubai Financial Market, and
- a roundtable discussion on Islamic finance and ESG investing with members of the Gulf Bond and Sukuk Association (GBSA).

We hope that investors find this report useful and that it provides a deeper understanding of Islamic finance and ESG investing and their associated investment products.
CHAPTER 1

COMPARISON BETWEEN ISLAMIC FINANCE AND ESG INVESTING

Modern Islamic finance and environmental, social, and governance (ESG) investing both emerged in the 1970s with a history of practices that predate the 20th century. Currently, in the Middle East, both investment approaches are growing separately and at different rates, although the potential for significant overlap across these product areas exists.

Islamic finance and ESG investing are complementary capital-raising and investment approaches with many shared principles, such as being a good steward to society and the environment. With many more similarities than differences, both offer products that serve Muslim and non-Muslim investors alike and both possess strong practices and policies that each can learn from the other. Some of their common practices extend as well to conventional investment products (Figure 1).

WHAT IS ISLAMIC FINANCE?

Islamic finance refers to the banking products and investment industry in which capital is raised and invested in accordance with shariah. The concepts of social justice and inclusion underpin Islamic finance. Its overarching principles are that interest-based transactions (riba) are prohibited, risk and reward are shared, and underlying assets related to transactions are owned (Figure 2).

Some Islamic investors view riba as negatively affecting society. As wealth and assets are required to generate riba, the poor are less likely to be able to earn riba and therefore accumulate wealth, while the rich can generate wealth on wealth through riba. It is also thought that riba is a disincentive to performing charitable deeds, as interest earners are more motivated by riba and wealth creation and less motivated by building a cohesive society that benefits all. In addition, a growing literature argues that interest based finance leads to several sorts of inefficiencies—significant amounts of debt and risk trading in financial markets expose economies to instability, and contagion and downturn in economies can affect jobs and societies.

Sharing risk and reward allows the parties to a transaction to minimize risk and to benefit mutually from profit. The premise is that all parties are exposed to the risk of default and therefore are likely to work toward a common goal of protecting each other’s interests and capital. This protects the parties, and in turn, society, from fraudulent activities and social tensions.
### FIGURE 1: COMPARISON OF THE LEVEL OF APPLICATION OF ESG, ISLAMIC, AND CONVENTIONAL FINANCE INVESTMENT PRACTICES

<table>
<thead>
<tr>
<th>PRACTICE</th>
<th>ESG INVESTING</th>
<th>ISLAMIC FINANCE</th>
<th>CONVENTIONAL FINANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systematic ESG integration</td>
<td>Medium levels</td>
<td>Low levels</td>
<td>Low levels</td>
</tr>
<tr>
<td>Screening</td>
<td>High levels based on client-specific/fund-specific screening policies</td>
<td>100% application based on shariah</td>
<td>Low levels</td>
</tr>
<tr>
<td>Company engagement on environmental and social issues</td>
<td>High levels</td>
<td>Low levels</td>
<td>Low levels</td>
</tr>
<tr>
<td>Voting</td>
<td>High levels</td>
<td>Low levels</td>
<td>Medium levels</td>
</tr>
<tr>
<td>Dividends</td>
<td>No restrictions</td>
<td>100% of dividends are subject to a “purification” process</td>
<td>No restrictions</td>
</tr>
<tr>
<td>Interest/riba earned</td>
<td>No restrictions</td>
<td>No riba permitted</td>
<td>No restrictions</td>
</tr>
<tr>
<td>Security lending</td>
<td>High levels with leading practitioners applying rules that ensure they can vote</td>
<td>No security lending permitted, assets must be owned, and riba is prohibited</td>
<td>High levels</td>
</tr>
<tr>
<td>Shorting</td>
<td>Low levels</td>
<td>No shorting permitted and assets must be owned</td>
<td>Low levels</td>
</tr>
<tr>
<td>Restriction on high leverage</td>
<td>No restrictions</td>
<td>100% application to avoid earning riba directly and indirectly through exposure to high-interest earning companies</td>
<td>No restrictions</td>
</tr>
</tbody>
</table>

*Note: Riba refers to interest-based transactions, which are prohibited within Islamic finance.*

### Shared Characteristic of Islamic Finance and ESG Investing: Screening

Another important pillar of Islamic finance is the prohibition of investments in certain industries, such as tobacco, alcohol, pork, pornography, weapons, gambling, human trafficking, and other products and activities that are deemed unlawful (*haram*). *Shariah*-compliant products are screened to avoid these industries, a practice that closely parallels ESG investing. Like investors in *shariah*-compliant products, investors using ESG investing strategies avoid certain activities and products so their portfolios align with the values of the beneficiaries/clients, align with the goal of developing a sustainable and fair society, and do no harm to people or damage to the environment. ESG products may employ a screening policy that contains one or more of the following criteria:
1. Apply absolute rules (e.g., exclude tobacco, cluster munitions, alcohol, pornography, weapons, gambling).
2. Apply relative rules (e.g., exclude companies that produce 10% or more of their revenues from tobacco).
3. Prohibit companies/issuers that violate international norms, such as the UN Guiding Principles on Business and Human Rights.
4. Exclude companies/issuers with poor ESG performance.

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

ESG integration and active ownership activities are less common in Islamic finance. Although a focus on social issues characterizes both Islamic and ESG investment approaches, environmental considerations currently seem to be less of a focus in the Islamic finance industry. However, ESG integration and active ownership practices complement Islamic finance practices, and environmental issues are consistent with the fundamental principles of *shariah*. As Islamic investors pursue sustainable risk-adjusted investment returns, more are likely to integrate ESG factors into their decision making and engage in active ownership activities to improve investment performance while aligning financial objectives with social and environmental goals. As an example of this direction toward more active ownership practices, some Islamic economists call for allowing investment account holders in banks to vote in the General Assembly and sit on boards in proportion to their share of total invested

**FIGURE 2: THE PRINCIPLES OF ISLAMIC FINANCE**

1. Transactions should promote equality, social justice and inclusion, and economic prosperity. They must demonstrate accountability, transparency, and legal protection for all parties.
2. Investment in certain industries, products, and services (*haram*) is prohibited.
3. Interest (*riba*), uncertainty (*gharar*), and gambling (*maysir* and *qimar*) are prohibited.
   a. The prohibition of *riba* stems from the notion that money is only a means of exchange with no intrinsic utility and that financial transactions should ultimately be tied to real assets and cater to the real economy.
   b. *Gharar* is believed to feed fraudulent and antisocial behavior by encouraging excessive risk taking. This rule prohibits the finance of risk trade.
   c. *Maysir* and *qimar* are transactions that involve gambling and are based on uncertainty. *Maysir* refers to the acquisition of assets by chance; *qimar* refers to a game of chance.
4. All parties are participants in the transaction and share the risk and reward.
5. The underlying asset, project, or joint venture is owned by one or more of the parties to the transaction.
funds. This innovation is based on the fact that investment account holders face the same risks as bank shareholders.

**Unique Characteristic of Islamic Finance: Contracts**

To adhere to the overarching principles of *shariah*, Islamic products are constructed through the use of different types of contracts. These contracts ensure that the earning of interest is avoided, risk and reward are shared, and ownership in the underlying asset is present (i.e., no shorting or security lending is allowed).

**Table 1** categorizes the different types of contracts as equity-based contracts and debt-based contracts. Islamic products that use equity-based contracts create partnerships among the parties and require the sharing of risk. In contrast, debt-based contracts are asset backed, transfer assets on initiation or on a future date, and have a predetermined price. These contracts can be applied to equity products and fixed-income products. Islamic unit trusts and mutual funds generally apply one of three contracts: *mudharabah*, *ijarah*, or *murabahah*.

**ISLAMIC FINANCE ASSETS**

As of the end of 2017, global Islamic finance assets reached $2.05 trillion.¹ Seventy-six percent of global Islamic finance assets are related to Islamic banking (*Table 2*). The second largest asset class is *sukuk*, which is 5.9 times bigger than the Islamic fund market. The most common Islamic investment funds are equity funds, which account for 42% of global Islamic fund assets. Islamic fixed-income funds account for 10% of global Islamic fund assets (*Table 3*).

The majority of global Islamic finance assets are located in Saudi Arabia and Malaysia (37.1% and 31.7%, respectively) (*Table 4*). A significant percentage of Islamic finance assets are also found outside of the Middle East and Southeast Asia, specifically in Ireland (8.6%), the United States (5.3%), and Luxembourg (4.8%).

**Equity Investing**

Equity investment products that are *shariah*-compliant apply two screens that restrict the investment universe: 1) a business screen and 2) a capital structure screen.

The business screen relates to the area or core business of the securities in the investment universe. Securities that have been identified as exposed to *haram* products and activities are excluded from the portfolio and investment universe. The process is the same as the negative screening deployed by many ESG investors. Although the rationale underlying these choices might not stem from the same source (religion/ethics), both Islamic and ESG practices are seeking to avoid investing in businesses that are considered harmful.

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TABLE 1: EQUITY-BASED AND DEBT-BASED CONTRACTS USED TO CONSTRUCT ISLAMIC FINANCE PRODUCTS

<table>
<thead>
<tr>
<th>DESCRIPTION</th>
</tr>
</thead>
</table>

**EQUITY-BASED CONTRACTS***

*Mudharabah*
- All partners to a project contribute capital and have the right to manage the project.
- Profit and loss are distributed based on a pre-agreed ratio.
- It is often used with mutual funds and structuring *sukuk*.
- It is used as a basis for investment accounts (deposits) with Islamic banks.
- *Mudharabah* is suitable for joint ventures and project financing.

*Musharakah*
- A partner (or partners) contributes all the capital while one partner manages the project.
- Profit distribution is based on a pre-agreed ratio. Losses are borne by the capital provider.
- *Musharakah* is suitable for joint ventures and project financing.

**DEBT-BASED CONTRACTS**

*Murabahah* (sale term)
- One party buys an asset and then sells it to another party for a predetermined higher price.
- The predetermined higher price is paid in regular instalments.
- *Murabahah* is often used for consumer credit and short- to medium-term financing.
- The resulting debt is not salable except at face value.
- It is also used with mutual funds and structuring *sukuk*. (*Murabahah* use in *sukuk* must be safeguarded against debt trading.)

*Ijarah* (leasing)
- One party buys and owns an asset, then leases it to another party. The lease is equivalent to the sale of the right to use the good and is thus considered “asset-backed.”
- The lessor charges a rental fee to the other party. Some contracts including the right of final purchase.
- *Ijarah* is often used for consumer credit and short- to medium-term financing.
- It is also used with mutual funds and structuring *sukuk*.

*Istisna’a*
- One party pays in advance for an asset under construction to be delivered on an agreed-upon date.
- *Istisna’a* is often used for consumer credit and short- to medium-term financing, and for structuring *sukuk*.

* Profit and loss-sharing (PLS) contracts (aka participatory financing or contract of partnerships).
** Non-PLS contracts (aka nonparticipatory financing or contracts of exchange).

To society and the environment. In that sense, Islamic finance could be understood as a socially responsible paradigm rooted in religious tenets.

Islamic investors are concerned not only with the kinds of activities they finance but also with the manner in which those activities are financed. Thus, the second screen of equity investing in Islamic finance concerns the capital structure of companies. A company financed primarily through debt rather than equity may be problematic for
### TABLE 2: ISLAMIC FINANCE ASSETS BY ASSET CLASS (YEAR END 2017)

<table>
<thead>
<tr>
<th>ASSET TYPE</th>
<th>PERCENTAGE OF GLOBAL ISLAMIC FINANCE ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic banking</td>
<td>76%</td>
</tr>
<tr>
<td>Outstanding <em>sukuk</em></td>
<td>19.5%</td>
</tr>
<tr>
<td>Islamic funds</td>
<td>3.3%</td>
</tr>
<tr>
<td><em>Takaful</em> (insurance)</td>
<td>1.3%</td>
</tr>
</tbody>
</table>


### TABLE 3: DISTRIBUTION OF GLOBAL ISLAMIC FUND ASSETS IN 2017, BY ASSET CLASS

<table>
<thead>
<tr>
<th>INVESTMENT FUND</th>
<th>PERCENTAGE OF GLOBAL ISLAMIC FINANCE ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>42%</td>
</tr>
<tr>
<td>Money market</td>
<td>26%</td>
</tr>
<tr>
<td>Commodity</td>
<td>14%</td>
</tr>
<tr>
<td>Fixed income/<em>sukuk</em></td>
<td>10%</td>
</tr>
<tr>
<td>Mixed allocation</td>
<td>7%</td>
</tr>
<tr>
<td>Real estate</td>
<td>1%</td>
</tr>
</tbody>
</table>


### TABLE 4: ISLAMIC FINANCE ASSETS BY COUNTRY (YEAR END 2017)

<table>
<thead>
<tr>
<th>DOMICILE</th>
<th>PERCENTAGE OF GLOBAL ISLAMIC FINANCE ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>37.1%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>31.66%</td>
</tr>
<tr>
<td>Ireland</td>
<td>8.62%</td>
</tr>
<tr>
<td>United States</td>
<td>5.25%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>4.76%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2.96%</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2.49%</td>
</tr>
<tr>
<td>South Africa</td>
<td>2.4%</td>
</tr>
<tr>
<td>Pakistan</td>
<td>2.32%</td>
</tr>
</tbody>
</table>

Islamic investors, insofar as debt in the capital structure of a company is interest based. Nevertheless, cognizant of the difficulty in finding businesses that are financed solely through equity, Islamic investors may set parameters and seek out for investment those companies in which the following financial ratios fall below a certain threshold:

- debt-to-equity ratio,
- accounts receivable to total assets ratio, and
- interest income from cash and interest-bearing securities to total income ratio.

The main concern of the Islamic “ethical” investor remains the source of the income and therefore the area or core business of the securities, that is, the securities’ earnings must always come from halal sources. When shariah-compliant investments receive company dividends generated as part of a company’s normal business operations, a purification process takes place. For example, a large diversified corporation may be shariah compliant but may own a small finance subsidiary deemed noncompliant; in such a case, any proportion of income received from noncompliant activities would be paid to charity and thereby “purified.”

Shariah screens are distinguished from ESG responsible investment screens because of their assessment of capital structure. In addition, shariah-compliant products are generally certified by shariah boards to demonstrate compliance with shariah, an action that some Middle Eastern countries (e.g., Bahrain, Oman) have made compulsory. Shariah boards are categorized as:

- international shariah boards, such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board, Islamic Development Bank, and International Development Bank;
- national shariah boards, which have overall authority of shariah governance in a country; and
- institutional shariah boards, also known as shariah supervisory boards, formed by financial institutions that offer Islamic products.

After Islamic investors screen the investment universe and exclude haram securities, some apply ESG integration techniques that assess the financial impact of ESG factors on securities in the portfolio and on the reduced investment universe. They may also engage with companies and vote at annual general meetings, including voting on shareholder resolutions related to environmental, social, and governance issues (see Chapter 5, “Case Study by SEDCO Capital”).

**Fixed-Income Investing and Sukuk**

Conventional bonds are prohibited investments under Islamic finance due to their payment of riba and their use as instruments of debt trade, which amounts to trading present for future money. As an alternative to conventional bonds, corporate and sovereign issuers are issuing sukuk, a shariah-compliant Islamic bond option. Sukuk benefit issuers by providing access to a wider investor base; companies and countries often issue green bonds for similar reasons.
The Accounting and Auditing Organisation for Islamic Financial Institutions defines *sukuk* as “certificates of equal value representing undivided shares in ownership of tangible assets, usufructs, and services, or (in the ownership of) the assets of particular projects or special investment activity.” A number of *sukuk* structures deploy equity-based contracts or debt-based contracts, including *mudharabah sukuk*, *musharakah sukuk*, *murabahah sukuk*, *ijarah sukuk*, and *istikna’a sukuk*.

As with Islamic equity products, investors apply a *shariah* screen to *sukuk* investing. This again demonstrates the similarity between *ESG* fixed-income products and *shariah*-compliant fixed-income products. Both can also apply ESG integration techniques to identify ESG risks that can affect the creditworthiness of issuers and therefore negatively influence bond yields and portfolio returns.

These complementary approaches and analyses have given rise to the creation of green *sukuk*. The growing demand for green bonds led to the issuance of the Middle East’s first green bond in March 2017 by the National Bank of Abu Dhabi. A new market in green *sukuk* was created when Malaysia released the first green *sukuk* in 2016. Indonesia issued the first sovereign green *sukuk* in February 2018.

Both green bonds and green *sukuk* are asset-backed securities and derive income from green revenues. The capital is used to finance climate/green assets or projects, which addresses environmental protection concerns under *shariah*.

### Prohibition of Security Lending and Shorting

A major difference separating Islamic finance from ESG investing (and conventional investments) is the former’s prohibition of security lending and shorting. The principles of Islamic finance that prohibit *riba* and state that the security/asset/project/joint venture is owned by at least one partner to the transaction prevent the lending of securities to a third party. In the case of equities, this ensures that voting rights remain the responsibility of one or more partners to the transaction. Some investors running ESG investing strategies also will not partake in security lending and shorting, while others will apply rules that allow them to vote on shareholder resolutions (e.g., recalling all securities before annual general meetings or allowing the loaning of only a limited percentage of securities to a third party).

### NARROWING THE GAP BETWEEN ISLAMIC FINANCE AND ESG INVESTING

Islamic finance and ESG investing are distinct approaches that have many similarities. The cultural and religious differences that separate Islamic finance and ESG investing require unique products and practices that reflect the faith and values of the investors in the products.

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Although they will remain separate investment approaches, Islamic finance and ESG investing are converging. This is not surprising given the origins of each investment approach and their common underlying principles. A deeper understanding of Islamic finance and ESG investing by all investors and the increasing materiality of social and environmental issues will likely continue this trend toward the use of common techniques and analyses.
CHAPTER 2

CASE STUDY BY SEDCO CAPITAL: PRUDENT ETHICAL INVESTMENT—THE INTEGRATION OF RESPONSIBLE AND SHARIAH-COMPLIANT INVESTMENT IN SAUDI EQUITIES

Christian Gueckel and Khurram Shehzad

SEDCO Capital refers to its approach of integrating responsible and shariah-compliant investment as Prudent Ethical Investment (PEI). A common denominator between responsible investment and shariah-compliant strategies is the exclusion of so-called “sin sectors” (e.g., alcohol, tobacco, gambling, and so forth). Additionally, shariah compliance requires screening of balance sheet ratios such as leverage, cash and interest-bearing securities, and/or accounts receivable to market cap or total assets, whichever is greater. Further, PEI integrates assessment of environmental, social, and corporate governance (ESG) criteria (see Figure 3).

Research has shown that negative screens for sin stocks have led to a deterioration in expected performance. SEDCO Capital’s research shows that the balance sheet constraints of Islamic investors can improve risk-adjusted returns of conventional and responsible investment portfolios. Thus, PEI can deliver distinct return/risk characteristics relative to conventional as well as responsible investment strategies. SEDCO Capital regards PEI as value added and an evolution of responsible investment approaches (see Figure 4). The lower financial leverage and better cash conversion result in a bias to quality and growth, which adds the prudence element to the PEI approach. In the last years, the quality and growth factors have generally enhanced risk-adjusted performance of PEI relative to conventional portfolios. PEI can be regarded as an investment style due to its portfolio biases to quality and growth characteristics.

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For SEDCO Capital, being a prudent investor means avoiding undue risks and seeking sustainable investments with strong governance that comply with relevant regulation. PEI demands an understanding of the underlying risks, leverage, structure, and cash flows. SEDCO Capital believes that an ESG overlay can lead to long-term rewards in terms of risk reduction and potentially higher returns. SEDCO Capital aims to use the ESG assessment to incorporate nonfinancial information and to identify risk factors.
The key building blocks in the responsible investment process for SEDCO Capital’s listed equities business work at five distinct levels: (1) negative screening, (2) environmental factors, (3) social factors, (4) governance factors, and (5) active ownership through proxy voting.

**NEGATIVE SCREENING**

SEDCO Capital considers *shariah* compliance as a subset of responsible investing. Therefore, we apply the same Islamic investment guidelines and seek to restrict nonpermissible activities. SEDCO Capital does not make additional a priori exclusions in the sense of refusing to invest in companies with predefined activities deemed unethical.
ESG Integration and Islamic Finance: Complementary Investment Approaches

SEDCO Capital analyzes investments from an ESG perspective through its internal research as well as through external data and research providers. Our ESG analysis is integrated in the analysis of our target companies. We conduct ESG analysis focusing on the ultimate effect of quantitative and qualitative criteria on enterprise value. Thus, we analyze ESG considerations with regard to their effect on a company’s competitive advantage (e.g., revenue generation, cost savings, innovation), risk reduction (e.g., cost of financing, reduced volatility) and reputation building (e.g., governance, compliance with regulation, customer and workforce loyalty).

SEDCO Capital quantifies and aggregates its ESG assessment into scores to devise portfolios that can reward or penalize companies through dynamic portfolio weights in a recurring manner. Our goal is to minimize the human bias in the scoring process, which we can achieve through better access to more reliable data.

ENVIRONMENTAL FACTORS

As they forecast cash flows for investee company valuations, our analysts break down the revenue by each product and service, depending upon its materiality. As an example, products or services that have environmental concerns attached to them might be assumed to be phased out over our forecast horizon and cash flows would be adjusted accordingly, even if the products/services depict historically growing profitability and volumetric sales. In certain cases, costs for the retreat from the activity or regulatory costs may be considered. This integrates environmental concerns for the investee company in forecasted cash flows.

Moreover, we assign an Environmental Score for a target company. This score aggregates multiple data points and weights that are specific to the target company’s sector. Thus, the score allows comparison among sector peers as well as environmental performance across sectors. For example, a component of the Environmental Score is the Resource Efficiency Ratio—the cost per unit of production, which is not standardized across the industry. This helps us in rewarding those companies that ensure efficiency in resource utilization, thus championing the cause of conservation. Such companies also bear the potential of asymmetric expansion in margins that can help generate alpha.

SOCIAL FACTORS

Before we induct any company into our Conviction Stocks Inventory, one of the tasks the analyst completes is to assign a Social Score to the company. As with the Environmental Score, constituent data and weights are sector specific. For example, Corporate Social Responsibility Spending to Total Expenditure or R&D Expense to Total Expenditure are constituents of the Social Score. The information for these ratios is usually available from the company’s board of directors’ report and annual report.

GOVERNANCE FACTORS

The analyst assigns an idiosyncratic Governance Score that integrates factors such as number of board members and independent directors, the quality of and quantum of
disclosures in the board’s report, the company’s participation in analyst conferences, the responsiveness of the company’s investor relation personnel, and the availability of qualitative data through regular quarterly investor presentations.

Finally, the three scores are combined with the Fundamental, Event, and Technical Scores of every stock with predetermined weights. The policy weights of Environmental, Social, and Governance Scores tend to be more stable, while dynamic market conditions can affect the weights assigned among the other three categories.

Although the quality of ESG disclosure is not yet up to our expectations, it has been consistently improving over the last few years.

**ACTIVE OWNERSHIP THROUGH PROXY VOTING**

Active ownership in the Middle East markets is more difficult than in developed markets. Challenges include a less-developed infrastructure for proxy voting research and recommendation, the transparency of general meetings, and the execution of proxy votes and their ultimate impact, as many stocks have dominant shareholders. A key milestone in effective proxy voting is Saudi Arabia’s *Tadawulaty* system, which enables shareholders to execute votes. SEDCO Capital aims for high coverage of executed votes for its portfolio. We also try to have a constructive dialogue with listed companies. The goal of this dialog is to enhance disclosure of ESG data and to create awareness of risks resulting from a company’s respective ESG practices so that these risks can be abated.
Jointly developed by the Hawkamah Institute for Corporate Governance and S&P Dow Jones Indices, the S&P/Hawkamah ESG Pan Arab Index measures the performance of the 50 stocks with the highest score in the Middle East and North Africa region on environmental, social, and governance (ESG) factors. The index serves as an investment and benchmarking tool for both purely sustainable investors and for those who want to apply passive strategy with an ESG overlay.

The S&P/Hawkamah ESG Pan Arab Index was the first index of its kind in the Pan Arab region. Its ESG methodology is based primarily on quantitative factors, bringing in qualitative analysis as an overlay. The index extensively quantifies ESG factors and translates them into a series of scores measuring securities in the universe of publicly traded Pan Arab companies. It not only ensures a selection of companies with the highest ESG scores, but it is also designed to be efficiently representative of the Pan Arab equity markets by excluding small and illiquid securities. Screened annually, the index uses an innovative ESG score-weighting scheme to ensure that stocks with higher ESG scores have a greater influence on the index than those with lower ESG scores.

The index constituents are selected from a universe of the top 150 Pan Arab companies (based on total market capitalization) listed on the national exchanges of Bahrain, Egypt, Jordan, Lebanon, Kuwait, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, and the United Arab Emirates, subject to a liquidity screen.

The index comprises the 50 highest-scoring stocks, according to their composite ESG scores from the selection universe, subject to a maximum individual country representation of 15 stocks. As a first step, the scoring process assesses companies’ levels of ESG transparency and disclosure on 197 indicators, including carbon emissions, water and energy consumption, employee health and safety, community investment, charitable giving, financial reporting, auditing, board independence, and executive remuneration. The scoring process includes looking at each company’s actual sustainability performance characteristics, based on independent sources of information, news stories, websites, and Corporate Social Responsibility (CSR) reports. Weighting of items differs by sector based on their impact. As a result of the scoring process, each company is assigned a composite ESG score, and the company’s weight in the index is determined as a function of its ESG score. Table 5 provides the index’s top 10 stocks and their weights. Table 6 shows the performance of the S&P/Hawkamah ESG Pan Arab Index versus its benchmark, the S&P Pan Arab Composite Index.
### TABLE 5: Top 10 Stocks in the S&P/Hawkamah ESG Pan Arab Index (As of 23 November 2018)

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>COUNTRY</th>
<th>WEIGHT</th>
</tr>
</thead>
<tbody>
<tr>
<td>DP World Ltd.</td>
<td>United Arab Emirates</td>
<td>2.983%</td>
</tr>
<tr>
<td>Saudi Basic Industries Corp.</td>
<td>Saudi Arabia</td>
<td>2.961%</td>
</tr>
<tr>
<td>Abu Dhabi Commercial Bank</td>
<td>United Arab Emirates</td>
<td>2.915%</td>
</tr>
<tr>
<td>Arab Bank</td>
<td>Jordan</td>
<td>2.687%</td>
</tr>
<tr>
<td>Saudi Investment Bank</td>
<td>Saudi Arabia</td>
<td>2.460%</td>
</tr>
<tr>
<td>Savola Group</td>
<td>Saudi Arabia</td>
<td>2.437%</td>
</tr>
<tr>
<td>Bank Audi S.A.L.</td>
<td>Lebanon</td>
<td>2.368%</td>
</tr>
<tr>
<td>Mobile Telecommunications Company</td>
<td>Kuwait</td>
<td>2.323%</td>
</tr>
<tr>
<td>Bank Muscat International</td>
<td>Oman</td>
<td>2.323%</td>
</tr>
<tr>
<td>Saudi Arabian Mining Company</td>
<td>Saudi Arabia</td>
<td>2.164%</td>
</tr>
</tbody>
</table>

Source: S&P Dow Jones Indices LLC.

### TABLE 6: Risk and Return of the S&P/Hawkamah ESG Pan Arab Index Versus the S&P Pan Arab Composite Index (As of 31 December 2018)

<table>
<thead>
<tr>
<th>PERIOD</th>
<th>S&amp;P Pan Arab Composite</th>
<th>S&amp;P/Hawkamah ESG Pan Arab Index</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ANNUALIZED RETURN (%)</td>
<td></td>
</tr>
<tr>
<td>1 year</td>
<td>10.34</td>
<td>3.51</td>
</tr>
<tr>
<td>3 year</td>
<td>7.56</td>
<td>6.37</td>
</tr>
<tr>
<td>5 year</td>
<td>1.63</td>
<td>3.44</td>
</tr>
<tr>
<td>10 year</td>
<td>6.20</td>
<td>9.24</td>
</tr>
</tbody>
</table>

|             | ANNUALIZED RISK (%)     |                                  |
|-------------|-------------------------|                                  |
| 3 year      | 11.08                   | 9.54                            |
| 5 year      | 14.67                   | 13.93                           |
| 10 year     | 14.98                   | 15.59                           |

Source: S&P Dow Jones Indices LLC.
CFA Institute and PRI thank Dubai Financial Market for its support in organizing our ESG Integration workshop in Dubai. With its assistance, we were able to work with investors and analysts to better understand the current state of ESG integration in the Middle East and to conduct a panel discussion, “A Practitioner’s View: ESG, Islamic Bonds, Green Bonds—What Investors Need to Know.”

THE STATE OF ESG INTEGRATION

ESG integration in the Middle East is in its early stages. Although several positive developments hint at an increased adoption of ESG integration practices by investors in the region, some challenges remain and will require the concurrence of different stakeholders to allow for a greater penetration of ESG in this market.

As in other regions, investors and companies are both still grappling with the concept of ESG integration, and the reporting of meaningful ESG data remains at an embryonic stage. Indeed, although pressing ESG issues have been identified for the entire region—notably water scarcity, climate change, governance reform, labor practices, and employment—the level of ESG uptake on the part of investors and regulators alike differs.

Of late, the focus of regulators has been on environmental issues. This might be due in part to the reform plans (e.g., UAE Energy Strategy 2050 and Saudi Vision 2030) launched by some of the region’s governments, which have grown increasingly aware of the need to tackle climate change as the region is particularly vulnerable to its effects given its scarce water sources and aridity. These plans also stem from the need for countries that are heavily reliant on the export of natural resources (e.g., oil and gas) to diversify their economies. They have also turned to renewable energies to cope with predicted increases in local energy consumption.

INTERNATIONAL CLIENTS DRIVE DEMAND FOR ESG IN THE REGION

In addition to the overarching political developments that should increasingly bring more investors to the region, local investors and practitioners highlighted a number of other elements that they consider to be driving ESG integration (Table 7). In particular, they highlighted increasing demand for ESG from international investors and clients as a powerful driving force. Indeed, participants mentioned that this increase in demand, from international clients to local investors, contributed to raised awareness around ESG in the market and that it could ultimately enhance the spread of an ESG culture across the investment chain. They noted that Nordic investors are not only asking investment managers and companies in the region about ESG but are also providing guidance on ESG. However, participants also noted that regulation should follow suit to provide incentives to issuers and sustain that demand.

In terms of local investor demand for ESG, participants felt that sovereign wealth funds were less focused on ESG than were life insurance and pension investors. Participants also mentioned that integration of ESG factors was predominantly happening in the equity space and that ESG was not talked about much in the fixed-income space, where investors were asking more questions about yields than about sustainability.

Other drivers of ESG integration that workshop participants brought up included the growth in investment opportunities and the availability and quality of ESG data. However, although participants insisted that these drivers were and would be crucial in driving the uptake in ESG integration in the region, they also pointed out that progress has been slow and that better ESG education and increased awareness were needed to accelerate that progress. The lack of understanding of ESG was reflected most clearly in the lack of substantial and consistent ESG reporting on the part of companies.

TABLE 7: DRIVERS OF AND BARRIERS TO ESG INTEGRATION IN THE MIDDLE EAST: FINDINGS FROM THE DUBAI WORKSHOP

<table>
<thead>
<tr>
<th>DRIVERS</th>
<th>BARRIERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor demand, especially international investors</td>
<td>Lack of standardization of ESG</td>
</tr>
<tr>
<td>Different ESG issues drive/impact different sectors</td>
<td>Lack of understanding of ESG</td>
</tr>
<tr>
<td>Investment opportunities</td>
<td>Limited understanding of how data are analyzed</td>
</tr>
<tr>
<td>Asset flows/client demands</td>
<td>Cost of ESG</td>
</tr>
<tr>
<td>Asset allocation</td>
<td>Lack of regulation/incentives</td>
</tr>
<tr>
<td>Regulation</td>
<td></td>
</tr>
</tbody>
</table>
MORE TRANSPARENCY AND BETTER REPORTING OF ESG DATA NEEDED

Participants stressed that although securities markets in the region have made some progress in terms of corporate governance regulations and disclosure requirements, those trends have yet to translate into substantial improvements in terms of ESG reporting by companies. Participants believed that the lack of standardization and understanding of ESG still stand in the way of meaningful reporting. Although some companies in the region report on some ESG indicators, ESG reporting remains at an embryonic stage and more often than not derives from a company’s desire to mitigate the reputational risk associated with poor ESG performance, notably in relation to adverse environmental impact. Workshop participants considered governance to be the most material pillar in terms of its impact on share prices, corporate bond prices, and sovereign debt prices.

As companies in the Middle East expand their activities and look for capital on the global market, their exposure to international investors will increase. The demands of these investors for ESG data and consideration of environmental, social, and governance issues will likely contribute to both valuation and reputation. Large sectors in the market—infrastructure, energy, real estate, and banking—are well suited to ESG integration. Companies in these sectors could learn from their peers in other regions on how best to tackle ESG risks to attract the growing number of international investors that integrate ESG considerations into their investment decisions.

A CENTRAL ROLE FOR REGULATORS AND STOCK EXCHANGES

Workshop participants cited regulation as both a driver of and a barrier to ESG integration in the Middle East and emphasized the need for it to be the former. They pointed out that although regulators in the Middle East might not be able to provide the same types of incentives found in other markets (e.g., tax reduction), regulators should focus their efforts on reducing the cost of ESG integration for issuers and investors alike. That is, regulators should work on getting rid of the disincentives that constitute barriers to the adoption of ESG strategies and products in the market.

One participant cited the example of regulation and green sukuk. Although the knowledge gap regarding such assets remains a challenge, the lack of investor appetite and the lack of regulation are the main reason for the low numbers of green issuances. When coupled with the cost for issuers, issuers do not perceive any incentive to green sukuk issuances other than the reputational benefit. Provided that regulators cannot incentivize ESG products through traditional levers (i.e., tax incentives), they should try to remove disincentives
(i.e., the extra cost). For example, regulators in the Middle East could look at Malaysia, where the cost of third-party checks for issuers of SRI green bonds is paid for by the government.

In relation to the lack of existing regulatory or economic incentives driving better practices in corporate ESG reporting in the region, participants noted that companies are slowly becoming more attuned to ESG requirements, particularly around the “E,” and that this might stem from a moral imperative or be motivated by a reputational incentive. If the inclusion of sustainable development in national strategic plans were to translate into increasing disclosure requirements for issuers on ESG and into the removal of the disincentives mentioned earlier, it would contribute to the creation of more fertile ground for ESG integration on the part of local investors.

Another driving force may come from stock markets in the region that have signed up to become partner exchanges with the Sustainable Stock Exchange (SSE) initiative, including the Dubai Financial Market (DFM) in the United Arab Emirates and the MENA (Middle East North Africa) exchanges of Bahrain, Egypt, Jordan, Kuwait, Morocco, and Qatar. The stock exchanges play an important role in driving more and better reporting on the part of the companies listed on them, as they can issue guidance on ESG reporting and organize trainings and workshops to raise awareness among issuers. These actions, in turn, contribute to investors—both local and foreign—having access to more standardized ESG data. Companies in the Middle East that demonstrate their commitment to ESG and comply with reporting requirements will surely gain greater attention from international investors as well as facilitated access to capital.

As well as developing reporting guidance, stock exchanges can create standards in listing requirements that cover ESG reporting. This approach has been taken by DFM, the first shariah-compliant exchange, which has updated its DFM Shari’a Standards to cater to investors’ growing interest in sustainability and a green economy. Based on feedback from shariah scholars, bankers, legal advisors, and Islamic finance experts, as well as regulatory institutions, the DFM Fatwa and Shari’a Supervisory Board updated the DFM Standards for Issuing, Acquiring and Trading Sukuk on the terms, conditions, and characteristics for green sukuk, which finances projects that protect the environment, adapt to climatic impact, reduce energy costs, substitute solar energy for dependence on oil, or reduce carbon emissions. The DFM standards state that the issuance prospectus of green sukuk shall include

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7 The SSE, launched in 2009 by the UN Secretary General, is a UN Partnership Programme of the UN Conference on Trade and Development, the UN Global Compact, the UN Environment Program Finance Initiative, and PRI. The SSE convenes Partner Exchanges from around the world who join the SSE by signing a voluntary public commitment. The SSE’s mission is to build the capacity of stock exchanges and securities market regulators to promote responsible investment in sustainable development and advance corporate performance on environmental, social, and governance issues. More information about the SSE is available at http://www.sseinitiative.org/.
“Disclosure whether these *sukuk* will finance a green project/projects along with an annex to the objectives and specifications of these projects (if applicable).”

**GREEN ISSUANCES: A PATHWAY TO GREATER ESG INTEGRATION**

Some participants perceived an uptake in the issuance of green bonds and green *sukuk* in the Middle East. The plans put forth by governments in the region, including goals to increase the contribution of clean energy in the total energy mix and to reduce the carbon footprint of power generation, provide substantial incentives to green issuers.

Given the number of infrastructure and investment targets set by the Middle East countries in their plans, the local green bonds market will likely continue to develop. These developments could also potentially lead to a shift from green to sustainable bonds that would broaden the focus of these issuances from solely environmental sustainability to sustainable development, with the inclusion of socially responsible endeavors as well.

Participants mentioned that although the requirements for green *sukuk* and green bonds differ, growth potential exists for both instruments. Attempting to conflate the two would not be helpful, as investors should be given as many options as possible.

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CHAPTER 5

GBSA ROUNDTABLE DISCUSSION ON
ISLAMIC FINANCE AND ESG INVESTING IN
THE MIDDLE EAST

CFA Institute and PRI thank the Gulf Bond and Sukuk Association (GBSA) for supporting this study and organizing a conference call on “Islamic Finance and ESG in the Middle East.” GBSA members who participated on the call provided the following views on this topic.

How prevalent is Islamic finance and ESG investing in the Middle East?

**Daniele Vecchi, Investcorp:** What we are seeing here is not much traction for ESG investing, contrary to shariah-compliant products, with clients or competing firms. Investors tend to focus primarily on potential for higher returns, and the sensitivity to ESG topics is still limited as other issues, like geopolitics, are occupying their minds. Some Nordic investors are at the forefront of this trend; however, ESG is still a nascent discussion and embryonic.

The asset classes that we offer to our clients are private equity, real estate, and other institutional products in credit and absolute return. As mentioned above, currently, the specific demand for ESG investments with our regional client base is limited. However, the region is progressing on the topic and we would not be surprised if major regional institutional clients will soon request ESG-responsible investments.

**Iza Kamaludin, Natixis:** Coming from a debt capital market perspective and issuers’ interest, ESG and green are key words coming up. People are talking about it and people are looking into it. From this region, there is interest in learning how to implement it.

**Xuan Jin, White & Case:** Whilst there is an active market for Islamic finance in the Gulf countries, ESG is less of a consideration in these jurisdictions compared to other regions of the world such as the United States, Europe, and China. There are a number of reasons for the nascent state of development of ESG investments, chief among them being that although stakeholders in the Gulf countries (such as banks, sovereigns, and corporates) are aware of and are becoming more attuned to ESG requirements and trends and recognize that ESG is growing in importance, the Gulf region currently lacks the regulatory incentives that have driven the growth of ESG investments in other jurisdictions (for example, tax deductions or beneficial regulatory treatment of ESG investments).
Is Islamic finance considered a form of ESG investing?

Xuan Jin, White & Case: There is certainly plenty of similarity and overlap between these product areas, particularly in respect of the underlying rationales that drive these financial products.

At the moment, we see a lot of synergy between green finance and Islamic finance, in particular in respect of the concept of “use of proceeds.” Everything else being equal, ESG-compliant investments are also likely to be shariah compliant. For example, if you look at the Polish sovereign green bond, which was issued on the basis of a framework developed in line with International Capital Market Association’s (ICMA) Green Bond Principles, the “use of proceeds” parameters for such issuance specified a list of projects to be funded from the proceeds of the issuance that are largely consistent with shariah principles. Moreover, they specifically excluded certain products and industries that are also considered haram from a shariah perspective, namely, alcohol, gambling, weapons, and adult entertainment.

Another similarity is if you look at an Islamic finance transaction. A fatwa is provided by shariah scholars or the relevant shariah advisory board or committee in certain jurisdictions. A green or ESG finance transaction also typically involves obtaining a green certification of green/ESG compliance from an independent third-party verifier.

Mohamed Damak, S&P Global Ratings: At this stage, Islamic finance is not perceived as a form of ESG investing. People are starting to realize the potential that Islamic finance offers from an ESG perspective. If you look at the intersection between ESG investing, the United Nation’s Sustainable Development Goals, and Islamic finance, you can see a lot of commonality.

Abdullah Hidayat, Social Finance: Islamic finance overlaps a lot with ESG investing. With Islamic finance, you have to be shariah compliant, which also means you have to be ESG compliant. To be shariah compliant, you take the minimum standard that is required to adhere to ESG criteria. To be ESG-compliant, you have to meet additional ESG requirements. The question is, should Islamic finance be pushed up to the level of ESG investing or should we have intermediary endorsement of it?

The additional criteria to be met to be ESG compliant could impact the growth of Islamic finance. We have well-established governance around being shariah compliant, including committees in most of the banks that issue sukuk. To be ESG compliant, who is going to endorse that?

In Islamic finance, you would need to expand the shariah criteria to meet ESG criteria. It’s not in the terms of reference of shariah committees to look at how the company treats the staff and how the company treats the environment. If we want to push for convergence, should we push Islamic finance to that level, with shariah committees having more power to assess transactions for shariah compliance and ESG compliance?

Mohamed Damak, S&P Global Ratings: Shariah goes beyond the principles of prohibition of interest and profit sharing. Islamic finance really goes to the foundation of PRI and ESG investing.
Is it better to promote ESG through Islamic finance or as a separate approach and product?

Mohamed Damak, S&P Global Ratings: An interesting trend is the green sukuk. In our opinion, the opportunities are significant. If you look at the governments’ policies on energy mix—for example, Dubai’s target to reach 75% of its energy to be generated from renewable energy by 2050—that would require a lot of investments. There will be a natural preference for the issuance of sukuk that would speak not only to the Islamic investors but also to ESG investors.

Xuan Jin, White & Case: Both approaches are feasible. It really depends on the jurisdiction in which the ESG or Islamic finance product is being marketed and the target investor base/audience. The key point is that the development and growth of both ESG and Islamic finance products are a function of supply and demand across jurisdictions. ESG investments can be both Islamic and non-Islamic. Similarly, Islamic finance products can be linked to ESG initiatives or not. The various permutations that exist (and that have the potential of being developed) are designed to cater to a variety of investors who may have a range of investment criteria (which will typically prioritize the following features: i) financial return; ii) ESG impact; or iii) shariah compliance). Additionally, for borrowers and issuers, these permutations broaden the sources of funding available to them.

It is also important to note that both ESG and Islamic products do not need to align perfectly across all jurisdictions. There doesn’t have to be (nor is there) one agreed universal approach to define what is shariah compliant and/or what is ESG/green compliant. Although broadly accepted principles do exist, the specific interpretations of what constitutes an ESG- or shariah-compliant investment can and do vary from region to region and from investor to investor. For example, if you look at the fixed income issuances out of the Middle East, the types of shariah structures deemed shariah compliant are not always the same as the shariah structures adopted in Southeast Asian transactions.

Similarly, in the green bond space, different jurisdictions may apply different variations of the Green Bond Principles. A case in point is China, which has one of the largest green bond markets in the world, yet a large proportion of Chinese green bonds may not be considered sufficiently green by European investors’ standards or by a strict interpretation of the Green Bond Principles. Crucially, both of these examples demonstrate that provided there is a sufficient critical mass of demand in any particular market for a particular permutation of ESG/Islamic finance products, then such products are capable of flourishing.

Rupert Cadbury, State Street Global Advisors: Over the last 12 months especially, we have seen a significant increase in the level of interest and commitment investors are making to integrate ESG into their fixed-income investments, particularly from large pension funds. Prior to this, much of the focus had been on equity allocations only. The move is underpinned by new technology, big data, regulatory and policymaker initiatives, and the launch of the European Commission’s sustainable finance action plan.

When investors seek to incorporate ESG (aka Responsible Investing) options into their fixed-income investments, they often approach it from the perspective of a standard benchmark. This is because standard benchmarks are important for performance
ESG Integration and Islamic Finance: Complementary Investment Approaches

comparison, asset allocation decisions, security pricing transparency, risk monitoring, and so forth. Using the standard benchmark as a baseline universe, an investor can customize it to define a more ESG/responsible investment universe. Securities that are not included in common benchmarks (e.g., the Bloomberg Barclays Global Aggregate Bond Index or the J.P. Morgan Corporate EMBI Broad Diversified Composite) typically fall outside the scope for portfolio inclusion consideration.

Investment securities that remain within the eligible investment universe may then be further analyzed, scored, and ranked. For example, securities and issuers with a better ESG score may be allocated a greater weight than what they may have had in a standard market-weighted index. To ensure detailed and up-to-date analyses of ESG-related matters, data on the bond issuers from highly specialized ESG vendors such as Sustainalytics, ISS-Oekom, and Trucost must be available. Bond issuers not scored by companies such as the three mentioned here may also be removed from portfolios that require investments in bond issuers that monitor and control for ESG risks. Depending on the investment constraints, our research shows that it is possible to improve the ESG composition of a portfolio meaningfully while delivering a similar investment risk-return profile to that of a standard index relied on for financial risk and control-monitoring purposes.

The relatively recent inclusion of sukuk into standard benchmarks (e.g., the J.P. Morgan EMBI Global Diversified in October 2016), has helped raise their profile and potential for inclusion into ESG-focused portfolios. Likewise, as the investment community increasingly relies on big data, ensuring that a bond issuer is covered by ESG research and rating providers will also likely help raise the issuer’s profile. As is the case with ESG investing, Islamic finance can be promoted through inclusion into conventional investment vehicles and investable benchmark indices.

What are the barriers to and drivers of ESG investing in the Middle East?

Xuan Jin, White & Case: The ultimate driver for both ESG investments and Islamic finance in any jurisdiction, including the Middle East, is demand. Currently, in the Middle East, there is not yet the critical mass of demand for ESG products required to develop this into a mainstream product area, unlike Islamic finance, which has a more established market. The reasons for this include the lack of regulatory and/or tax incentives for investors to invest in ESG products. In other jurisdictions where ESG investment is more prevalent, incentives such as tax deductions and preferential regulatory treatment of green financial products exist that beneficially differentiate ESG investments from non-ESG investments. In the Middle East, this is currently not the case, so investors are hard pressed to find sufficient commercial rationales to invest in ESG products. Moreover, whereas in Europe and the United States several dedicated ESG/green investment funds exist, no such funds have yet been established in the Middle East.

Additionally, implementing ESG products, such as green bond issuances, will typically be a little more time consuming and involve higher costs for borrowers/issuers as compared to non-ESG products, given the additional layers of work required (e.g., to establish a “green use of proceeds” framework or obtain an external verification/opinion of green compliance). In certain jurisdictions, such practical disincentives are mitigated (e.g., both Malaysia and Singapore have implemented subsidy systems to defray the additional costs of
obtaining external green verifications for the issuance of green bonds/sukuk), but no such systems are currently in place in the Middle Eastern countries.

Related to the above, ESG/green investments as a product are at present less understood and standardized in the Middle East when compared to other jurisdictions. The fact that there has to date only been one green bond transaction in the region (the NBAD transaction mentioned above) is both a consequence of the low level of penetration of ESG/green finance and an indication of the level of demand/recognition for the product. That being said, Rome wasn’t built in a day. There’s a starting point for everything and the Middle East ESG market, although nascent, has the potential to develop into a mainstream product capable of catering to both Islamic and conventional investors, particularly when considering the vast array of sustainable infrastructure projects that are capable of being developed in the region and that require funding.

Mohamed Damak, S&P Global Ratings: The growth potential is definitely there. The government policies and targets for their energy mix provide opportunities for the sukuk market.

Green is the low-hanging fruit. However, there is a lack of shariah governance of green in Islamic finance. We also lack a mapping exercise between ESG and shariah principles.

Abdullah Hidayat, Social Finance: We have talked about demand being a key driver. Regulators should also provide incentives to drive ESG investing. Tax incentives are one of the main reasons for the growth of sukuk in Malaysia.

Hadi Melki, S&P Global Ratings: The knowledge gap is there but it is not the main barrier to green sukuk. In my opinion, the main obstacle for green issuances in the Middle East is the lack of appetite.

From a regulatory perspective, we don’t have the right regulations that promote green issuances. Green issuances can be more complex and costly than conventional ones, so without the right incentives, issuers may only value being labelled as caring or gaining reputational benefits. We will start seeing a growth in green issuances when issuers are really motivated to do so.

In addition, aligning investor views on what is “green” could be challenging. Improving the reporting standards for listed companies is a partial solution, as such reporting requirements won’t apply to privately owned companies. This is why S&P Global Ratings has launched the green evaluation, a point-in-time assessment of the relative environmental impact of a financing transaction or portfolio, for example, in the case of a labelled green bond.

Iza Kamaludin, Natixis: Key questions from the issuers are how do I determine which investors are interested in these types of issuances and what are the benefits for issuers who obtain capital from ESG and green issuances? It is still unclear for issuers how to implement ESG criteria in their bonds.

If we can’t show the additional benefits of ESG or green issuances, such as determination in pricing or additional liquidity, then it is always going to be a discussion.
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