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PUSHING THE FRONTIERS OF ISLAMIC FINANCE
THROUGH SOCIALLY RESPONSIBLE INVESTMENT
SUKUK

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Adam Abdullah*

Abstract

This study explores the potentials of SRI sukuk as a source of financing for projects that address community and social issues, thus giving positive impact to the society. Focusing on several cases of SRI sukuk in critical yet not so commercially-attractive for profit-motivated financial institutions to participate in such as education, environment and health sectors, this study highlights the mechanisms and challenges as well as potentials of SRI sukuk as a source of financing for these projects. Since the field of SRI sukuk is still in its infancy stage especially in Islamic finance, this study hopes to contribute towards enriching the literature as well as exploring the potentials for further applications in other areas in the Islamic finance industry.

Keywords: Socially Responsible Investment, *sukuk*, ethical investment, Islamic finance

1. Introduction

Despite the remarkable growth of the Islamic finance industry since its inception in the 1960s, many have raised doubts if the current model of Islamic banking and finance would lead to the achievement of the socio-economic objectives as envisaged in Islamic economics. Several studies have argued that most of the Islamic financial institutions are mainly being profit-motivated with rather minimal inclination towards solving social issues, thus being less socially-oriented¹. Consequently, continuous and concerted efforts are needed in order to refine the Islamic finance industry through innovative financial propositions that could steer the industry towards contributing to the socio-economic development agenda. This effort will not only expand the frontiers of the Islamic finance industry through the introduction of innovative products, but would also help in sustaining its growth by participating in a wider sectoral portfolio.

In this regard, Socially Responsible Investment (SRI) *sukuk* has a high potential to be developed as an innovative Islamic financial instrument that can be used to address specific community and social issues such as poverty, illiteracy, and lack of housing. This obviously would help to enhance Islamic finance prospect towards realizing its underlying philosophy of economic justice and social balance. To a certain extent, SRI helps to fulfill the financing demand for projects that are not so commercially viable yet with high social impact such as affordable housing, social enterprises, financial inclusion, waste management, renewable energy and water treatment². The rise of Social Impact Bonds (SIB) and green bonds in conventional finance has gained traction in recent years due to the perceived benefits in accomplishing social change goals. Green bonds specifically fund projects that are environmentally friendly, focusing mainly on sustainable projects that protect natural resources, while SIBs have been instrumental in financing social projects such

¹ M. O. Mohammad and S. Shahwan, "The Objective of Islamic Economic and Islamic Banking in Light of *Maqasid Al-Shari'ah*: A Critical Review", *Middle East Journal of Scientific Research*, 13, (2013), 75-84.

² M. Chamberlain, "Socially Responsible Investing: What You Need To Know", (*Forbes*, April 24, 2013).

as affordable housing particularly in developed countries such as Canada, the UK and the US.

Among others, the SRI bond provides financial support to build infrastructure schemes and projects, which are targeted for economic growth and improvement in underdeveloped places and societies. The SRI bond cumulates both the objectives of maximizing social and commercial activities by taking active duration and credit investment interpretations and views, while providing for the economic and social growth and development. Furthermore, the SRI strives to make a contribution to social and economic development through investments in a well defined portfolios and instruments, whereby these strategies would help to optimise the return to the investors' based on their risk-return appetite confined within the scope of projects that would simultaneously benefit the society. In essence, SRIs provide long-term capital enhancement instead of short-term, give steady and stable investment income, and encourage and promote sustainable and responsible investing.

The SRI avoids investing funds in businesses and firms that involve in the production or trading of activities that give detrimental effects to the society such as drugs, alcohol, and gambling, all of which result in addiction and negatively affecting the health of the consumers. It seeks out business activities that are beneficial as well as improving the socio-economic standing of the society such as companies involving in environmental sustainability and other clean technology efforts. Thus, SRI *sukuk* in essence has similar qualities, characteristics and objectives to SRI bonds. SRI *sukuk* has the potentials of being further applied in a wide range of areas of Islamic finance since generally *sukuk* itself already involves screening to exclude activities that possess danger to human being (not *Shari'ah*-compliant) and only select activities that are wholesome and benefitting the society at large. In view of this, the SRI *sukuk* can offer an additional platform in the Islamic finance industry to providing the needed social impact that is presently missing from the industry.

In the context of Islamic finance, all *Shari'ah*-compliant social impact investing are categorized under the SRI label which has various descriptions attached to it such as “sustainable”, “socially

conscious”, and “ethical” investing³. Generally, socially responsible investors are inclined towards moral or ethical considerations for environmental, social and governance (ESG) investments. Among the financial tools that have been developed through the SRI policies are SIBs along with SRI *sukuks*. Through SRIs, the Islamic finance industry can cater for the growing number of investors looking to invest in ethically and socially responsible *Shari’ah*-compliant projects.

This study aims to explore the potentials of SRI *sukuk* as a financial instrument that can be used to provide an economic safety-net for the community and society by addressing social issues such as poverty and lack of financial access by the low income segment of the society which often lack the attention of commercial entities. By highlighting the cases of several SRI *sukuk* issuances in sectors that have high social impact such as healthcare, environment and education, this study highlights the roles of each of the SRI *sukuk* models in contributing to the socio-economic improvement of the society.

2. SRI: A Review of Concept, Mechanisms and Performance

SRI can generally be defined as the type of investment that depends on personal values or value-based investment as opposed to the conventional profit-based investment that depends very much solely on financial considerations. It is an umbrella concept for investment strategies aiming to maximize social benefit and minimize environmental damage, create positive social change and incorporate ethical or religious beliefs, which in essence, related to investment activities that positively affect the society⁴. Consequently, SRI as a value-based investment can be referred to as sustainable, responsible, and impactful, economically and socially. It seems that the various literatures could not agree on a fixed term⁵, such as ‘socially

³ S. M. Syed Azman and E. R. A. Engku Ali, “Sustainable and Responsible Investment (SRI): Trends and Prospects”, paper presented during *Muzakarah Penasihat Syariah Kewangan Islam 2015 kali ke-10*, (2015).

⁴ H. Fung, S. A. Law and J. Yau, *Socially Responsible Investment in a Global Environment*, (Cheltenham, Edward Elgar, 2010).

⁵ S. M. Syed Azman and E. R. A. Engku Ali, op.cit.

responsible investment’ or ‘socially impact investment’ and the list goes on. The term ‘SRI’ has been widely used and often described as an investment that considers the social, ethical and environmental aspects, while some defined it as ethical, social and sustainable investment⁶. As the name suggests, sustainable investment is a more general definition of the two, with sustainable investing refers to an investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management⁷.

While it has been in existence since a very long time, the SRI has just lately captured investors’ interests and gained more importance in the investment industry. Amid the growing interest among investors in ethical investing, SRI instruments such as green *sukuk* and bonds⁸ in particular have experienced rapid growth in the quantity of assets and resources under management, as well as the number of investors in the past few years. As the current generation is apparently more expressive and critical on the governance and transparency in investments, SRI instruments will be able to meet these additional requirements of the investors, in which they need to adhere to in order to attain the SRI status set by the relevant regulatory body.

To encourage the SRI, the Securities Commission of Malaysia issued guidelines and principles to facilitate the investment in the SRI sector. The *Islamic Fund and Wealth Management Blueprint for Sustainable Investment* describes the method and long-term strategies for Malaysia’s Islamic fund for the Muslims investors who are ready to invest their money in Islamic products mainly to generate and create a favorable and helpful ecosystem that fulfill the increasing and growing needs of the global market⁹. The Blueprint specifies the trading and business circumstances for sustainable

⁶ A. A. Adam and E. R. Shauki, “Socially Responsible Investment in Malaysia: Behavioral Framework in Evaluating Investors’ Decision Making Process”, *Journal of Cleaner Production*, 80(1), (2012), 224-240

⁷ Global Sustainable Investment Alliance, *Global Sustainable Investment Review 2016*.

⁸ S. M. Syed Azman and E. R. A. Engku Ali, op.cit.

⁹ Securities Commission, Malaysia, “Development of Sustainable and Responsible Investment in Malaysia”, *Islamic Fund and Wealth Management Blueprint for Sustainable Investment*, (SCM, 2017), 26-28.

investing and inspects investment actions and activities that can be altered and modified to achieve the sustainable investment plan.

2.1 Historical Development of Ethical Investment

Historically known as ‘ethical investment’, the origin of SRI may be dated back to the middle of the 18th century, possibly in 1758¹⁰. Despite this, only in the 20th century especially during the last two decades that it developed significantly in size and was considered a recognised investment strategy. It started when members of a religious society named as “Quakers or Friends of Church” started to invest in selective activities by prohibiting participation in slave trading since it contradicts with their values and ethics. From there onwards, the movement of this ideology continued and became a trend in certain periods. Few years later, religious movement highlights this issue but in more detailed way. In his sermon on “the use of money” John Wesley, one of the founders of Methodism (a Christian Protestant denomination) highlighted that one should not harm another through business practices and to avoid industries that engage in chemical production which can harm the health of workers. Subsequently, members of this denomination further generalized the instruction to exclude all “sinful” companies such as weapons, liquor and tobacco.

The 20th century saw the decision of the Methodist church to selectively invest in the stock market in investment activities being further extended to include gambling and weapon manufacturing. In the 1970’s, there was a public demand for ethical investment vehicles with the establishment of the Pax Fund in 1971 as a reaction to the Vietnamese War¹¹. This was the first public mutual fund using both social and financial criteria in the investment decision-making process. As the movement continued to expand and became even more popular in the investment field, this type of investment was named as socially responsible investment – SRI since this name has an even broader dimension than “ethical investment”. The historical

¹⁰ M. Q. Alhadi, “Introducing Social Responsible Investment (SRI) Sukuk Funds in Malaysian Market”, (Universiti Teknologi MARA, 2015).

¹¹ Malaysia International Financial Centre and Centre for Islamic Wealth Management, *SRI & the Case for Islamic Investment Funds*, (MIFC, 2015).

development has highlighted religion as being the biggest motive for this type of investment, hence the guidelines for ethical investment emanate from religious principles and values. Coincided with the start of Islamic finance industry in the 1970s, today the SRI continues to grow significantly and show bright prospects for growth.

2.2 A Review of Performance of the SRI Industry

Generally, global *sukuk* issuance has reached USD74.8 billion at the end of the year 2016 with Malaysia being among the highest *sukuk* issuers at USD34 billion, which represents 46.4% of the global *sukuk* market, followed by Gulf Cooperation Council (GCC) countries (USD19.6 billion), Indonesia (USD7.4 billion) and Turkey (USD4.1 billion)¹². In the specific context of SRI *sukuk*, there has been a growing interest in the global market towards SRI instruments¹³, which has shown an upward growth over the past decade. In the U.S., the estimated total assets of SRI instruments has reached USD6.7 trillion, while it reached USD90 billion in the U.K.¹⁴. The issuance of SRI *sukuk* also adds new requirements to the existing *sukuk* framework, in order to achieve its objective.

Reflecting the remarkable growth of SRIs due to increasing interest in the global market towards value-based investment, total asset managed in SRI globally has reached USD22.9 trillion in 2016 (Table 1), representing 26.3% of total managed funds globally¹⁵. According to industry estimates, global SRI assets under management could reach USD34-53 trillion by 2025¹⁶, with popular areas that are normally associated with SRI include the environment and its preservation¹⁷.

Table 1 shows the different growth rates of SRI in terms of regions from 2014 to 2016. Europe still leads in terms of total asset of SRI at USD12,040 billion in 2016. This is followed by United

¹² Malaysia International Financial Centre, "SRI and Green Sukuk: Challenges & Prospects", *New Insights*, (MIFC, 29 January 2016).

¹³ Malaysia International Financial Centre, op.cit.

¹⁴ S. M. Syed Azman and E. R. A. Engku Ali, op.cit.

¹⁵ Global Sustainable Investment Alliance, op.cit.

¹⁶ Barclays Research, *Sustainable Investing and Bond Returns*, (2014).

¹⁷ Malaysia International Financial Centre, op.cit.

States and Canada at USD8,723 billion and USD1,086 billion, respectively. In terms of growth, Japan is the world fastest growing country in SRI, which recorded a compounded annual growth rate of 724% from USD7 billion in 2014 to USD474 billion in 2016. An interesting trend of the SRI in Japan is that the proportion of individual (retail) investors' participation outweighed that of institutional investors in which the sustainable investment balance of Japanese institutional investors in 2016 was ¥56.25 trillion, while the total sustainable investment balance of individual investors was ¥57.05 trillion¹⁸.

Table 1. Growth of SRI Assets by Region 2014-2016

Region	2014	2016	Growth over period	Compounded Annual Growth Rate
	(in USD billion)			(in %)
Europe	10,775	12,040	11.7	5.7
US	6,572	8,723	32.7	15.2
Canada	729	1,086	49.0	22.0
Australia/New Zealand	148	516	247.5	86.4
Asia ex-Japan	45	52	15.7	7.6
Japan	7	474	6,689.6	724.0
Total	18,276	22,890	25.2	11.9

Source: Global Sustainable Investment Alliance *Annual Report 2016*.

Of the total assets managed globally, 26.3% of them are SRI assets (Table 2). There is a clear shift towards SRI instruments in Australia/New Zealand where the proportion of the SRI of the total managed asset increased substantially from only 16.6% in 2014 to 50.6% in 2016. Europe has the highest percentage of SRI assets relative to the total managed assets at 52.6% in 2016, followed by

¹⁸ Japan Sustainable Investment Forum, *Survey on Sustainable/ESG Investment in Japan*, (2015).

Australia/New Zealand at 50.6%, Canada at 37.8%, the US at 21.6%, Japan at 3.4%, and Asia at merely 0.8%.

Table 2. Proportion of SRI Relative to Total Managed Assets

Region	2014 (%)	2016 (%)
Europe	58.8	52.6
US	17.9	21.6
Canada	31.3	37.8
Australia/New Zealand	16.6	50.6
Asia ex-Japan	0.8	0.8
Japan	-	3.4
Total	30.2	26.3

Source: Global Sustainable Investment Alliance *Annual Report 2016*.

Based on the Global Sustainable Investment Alliance, the SRI can be classified into six different investment strategies as shown in Table 3. The negative/exclusionary screening is the highest strategy adopted by investors totaling USD15,023 billion in 2016. Through this strategy, stocks or instruments, which are not related to sustainability of environment, social and education are excluded such as alcohol, pornography and gambling activities. Next is the ESG integration strategy where it combines environmental, social and governance factor in making investment decisions, rather than focusing just into one of the factors. This strategy has reached USD10,369 billion in 2016, being the second most adopted strategy. The impact/community investing strategy, although the least adopted strategy, has gained the highest growth of 146%, followed by sustainability-themed investing strategy, which has recorded a growth of 140% for the past two years. It is evident that investors are shifting their investment strategy to impact/community investing as well as sustainability-themed investing from the more straightforward types of screening (such as positive/best-in-class-screening and negative/exclusionary screening) as shown by the triple-digit growth rates in these investment strategies.

Table 3. Growth of Strategies 2014-2016

Strategy	2014	2016	Growth over Period	Compounded Annual Growth Rate
	(in USD billion)		(in %)	
Impact/community investing	101	248	146	56.8
Sustainable themed investing	137	331	140	55.1
Positive/best-in-class-screening	890	1,030	16	7.6
Norms-based screening	4,385	6,210	42	19.0
Corporate engagement and shareholder action	5,919	8,362	41	18.9
ESG integration	7,527	10,369	38	17.4
Negative/exclusionary screening	12,046	15,023	25	11.7

Source: Global Sustainable Investment Alliance *Annual Report 2016*.

2.3 Investor Trends towards SRI

Although there is a tremendous growth of the SRI industry, it is still dominated by institutional investors rather than retail investors¹⁹ (Figure 1). This finding is in line with the study conducted by Eurosif in 2014, which ranks “Demand from Institutional Investors” as being the single largest driver of market growth for SRIs²⁰. However, there is an increase in the growth of retail investors’ asset from 13.1% in 2014 to 25.7% in 2016 in terms of total asset in the SRI industry. In 2016, institutional investor still dominates the industry by owning 74.3% of total asset in the industry²¹.

¹⁹ KPMG, *European Responsible Investing Fund Survey*, (2015).

²⁰ Eurosif, *European SRI Study* (2016).

²¹ Global Sustainable Investment Alliance, op.cit.

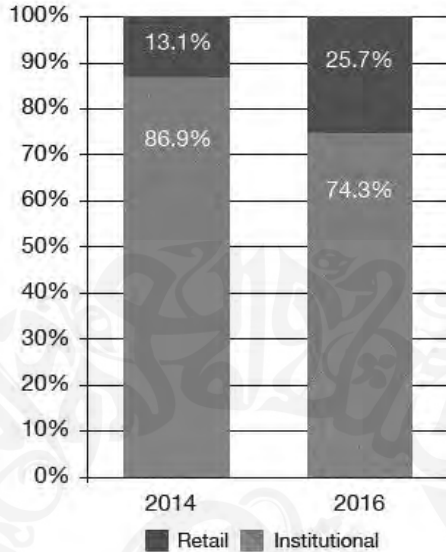


Figure 1. Total Asset Managed by Retail and Institutional Investors

Source: GSIA Annual Report 2016

Investors' behavior is evolving as reflected by their priorities and way of thinking. Apart from being very critical and vocal in addressing the issues of unethical behavior and bad governance, investors have also begun to expect social and ethical responsibility in all aspects of corporate practices. Many institutional investors are no longer prepared to work with asset managers who do not offer SRI products. A survey done by KPMG in 2014 found several cases where investors withdrawing mandates from asset managers with limited or no responsible investing policy and process²².

Diversity aspect is also given priority in SRI investments. In 2014, diversity was ranked 6th in the rankings of ESG issues and this has led to the growth in the number of female investors in the SRI industry. Among other factors that attracted women to invest in the SRI market is the feminine messaging²³. As of 2011, just over half of

²² KPMG, op.cit.

²³ Barclays Research, "Women in Focus: Gender Diversity and Socially Responsible Investing", *Barclays Report*, (The Economist Intelligence Unit, 2014).

the wealth in the US was controlled by women, and by 2020 it is predicted to grow to two-thirds of total US wealth. Women are more inclined than men towards aligning their investments with certain social and environmental values. A survey of high net worth investors found that social, political or environmental impacts were considered “somewhat” or “extremely” important by 65% of women but only 42% of men²⁴. By 2030, it is expected that investors to be fully embracing the ESG factors which still seem to be optional today. Simplicity, transparency, honesty and integrity are likely to be regarded as more important buying criteria, maybe even at the expense of financial performance²⁵.

2.4 Types and Implications of SRI and SIB

With there being an urgent need to close the gap between theory and practice in Islamic finance industry, and shift of business priority from being too profit-driven to be more socio-economically inclined, the SRIs have the most potential to steer the industry towards fulfilling this objective. This refers to the SRIs ability to effectively alleviate the social problems, something that the Islamic finance industry is arguably lacking and has room for improvement in the future.

Among the financial tools that have been derived from the SRI concept are SIBs and SRI *sukuk*. However, the latter is set to be as a form of SIB that is arranged using a combination of *Shari'ah*-based contracts. Nonetheless, both SRI and SIB share the same commitments towards better social outcomes, as well as some commonalities such as the result-based approach since the returns are paid in accordance to the success of the programs. The relationship between SRI, SRI *sukuk* and SIB is shown in Figure 2 below.

²⁴ PAX World Management LLC, *Women Leading: Sallie Krawcheck on Investing in 2014*.

²⁵ KPMG, op.cit.

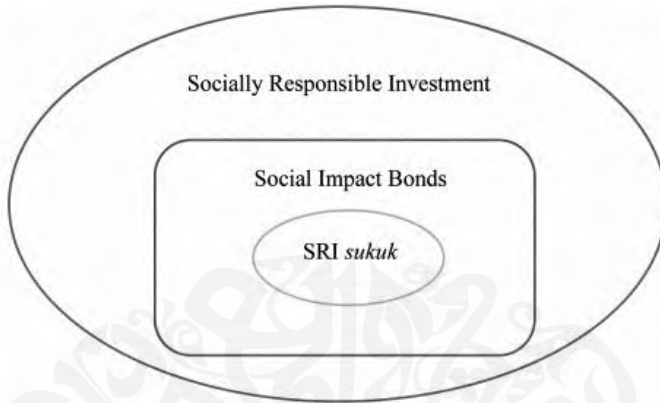


Figure 2. Relationship between SRI *Sukuk*, SIB and SRI

In general, SRI can be implemented as a structure of intervention programs against any form of socio-economic injustices and insecurities as long as it brings positive impact to the society. According to the International Capital Markets Association (ICMA), a distinction is needed to be made between two types of SRIs which essence are described below:

- Green bonds: which target sustainable projects designed to reduce the amount of carbon emissions and help preserving the environment for a more sustainable future. This type of bond is the most suitable tool to finance green projects such as renewable energy source, vaccines and immunization campaign, green farms and water purification facilities.
- Social bonds: which target a variety of social issues and alleviating social injustice, especially issues in dealing with the manifestation of poverty. Among the projects associated with social bonds include those addressing homelessness (social housing), unemployment, affordable health care and basic infrastructure, recidivism, quality education as well as providing microfinance for revenue generating activities intended for low income people.

In 2008, the World Bank pioneered the green bond initiative,

launching the *Strategic Framework for Development and Climate Change* as a step forward to combat and mitigate climate change. The World Bank green bond is an example of a way to provide investors with an innovative way of supporting clean energy and other low-carbon projects. Since then, financial instruments supporting green projects have witnessed increased interest from both issuers and investors resulting in total issuance of over USD10 billion equivalent in green bonds²⁶.

The Paris Agreement undertaken by the United Nations (UN) in 2015 on climate change, imposed many urgent rules as demonstrated in Article 6, to promote the mitigation of greenhouse gas emissions. It also fostered sustainable development and Article 2 made finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development with the hope of reducing of all gases that puts the future of this planet in danger²⁷. Many analysts see this initiative as a driver for the existence or advancement of environmental-friendly securities and financial instruments in general.

These initiatives are very much in line with the objective of the *Shari'ah* – the *maqasid al-Shari'ah*, which forms the foundation of Islamic finance. The first pillar of *maqasid al-Shari'ah* is the protection of human life, and protection of progeny and the environment also falls under this pillar. Moreover, Islam forbids willful destruction of the planet, as all creations of God, including animals and trees, are trustees on this earth (*amanah*). Islamic finance, which is ruled by the *Shari'ah* principles, therefore presents a tremendous opportunity to develop instruments that can support the global demand to initiate green projects that look for protecting the planet and providing a sustainable environment. Therefore, environmental protection fits well in the aspirations of Islamic finance that aims to enhance the general welfare of society.

In this regard, the Islamic declaration represented by Islamic Development Bank (IDB) at the United Nations Global Warming

²⁶ World Bank, *Green Bonds*, (n.d.) accessed from <http://treasury.worldbank.org/cmd/htm/WorldBankGreenBonds.html>

²⁷ European Commission (EC), *Paris Agreement*, (2016), accessed on May 7, 2017 http://ec.europa.eu/clima/policies/international/negotiations/paris/index_en.htm

Conference in Paris in 2015 has indicated its interest to issue green *sukuk* to finance climate-related projects and the commitment to develop a market to finance environmental projects²⁸. Furthermore, under the Climate Bonds Initiative in 2012, the Clean Energy Business Council of the Middle East and North Africa and the Gulf Bond and *sukuk* Association have formed a Green *Sukuk* Working Group (GSWG) which provides guidance and best practices pertaining to the issuance of *sukuk* for financing climate-related projects²⁹. This type of *sukuk* is called “green *sukuk*” which is the *Shari’ah*-compliant counterparty of a green bond that represents *Shari’ah*-compliant investments in green energy and environmental projects³⁰. The underlying projects in this type of *sukuk* may include solar parks, bio-gas plants and wind farms. The Islamic Research and Training Institute (IRTI)³¹ states the following tasks as the main missions of the GSWG:

- i. Identify green energy projects that fall under *Shari’ah*-compliant categories for potential investors;
- ii. Promote the concept of green *sukuk* and other green Islamic finance products to governments, private investors, product originators and other interested parties;
- iii. Engage with governments and development banks to support appropriate project development and the growth of a green *sukuk* market; and
- iv. Provide guidance and promote best practices into the market by convening industry forums and developing template models.

The prospects of green *sukuk* in the future are encouraging driven by several factors. First, the increase demand for energy supply due to the global population growth is one factor to foster the green *sukuk* market. For example, the GCC population is estimated to

²⁸ L. Irvine, M. P. Grifferty and A. Cowman, “Green *Sukuk*: The Race to be First”, *Islamic Finance News*, (5th November, 2014).

²⁹ D. Dey, T. Hussain and M. Hauman, *Green Bonds & Islamic Finance*, White & Case LLP, (22 November 2016), 1–7.

³⁰ Islamic Development Bank (IDB), “Climate Change Financing: Role of Islamic Finance”, (November, 2016).

³¹ IRTI, (IDB).

grow to over 53 million by 2020, while at the same year electricity demand is expected to be 84% higher than 2010 levels hence a significant rise in demand for water, electricity, transport and infrastructure is unavoidable³². Meanwhile, with the availability of clean energy comparative advantages production favoring wind and solar power generation, Arab countries are to increase renewable energy generation from 12 GWH in 2013 (representing only 6% of power generation) to about 75 GWH by 2030 to meet the energy gap that exists in these countries³³.

Second, the increase demand for energy financing is linked with the first mentioned factor of the energy demand. Due to the large scale financing needed for such projects, banks are reluctant to finance infrastructure especially given the stricter capital requirements under Basel supervisory and regulatory framework. Moreover, capital markets are willing to replace banks as the providers of financing for infrastructure thus providing even more space for green *sukuk* to play an important role of financing clean energy projects and infrastructure³⁴.

Third, the growing investor willingness toward investing in socially responsible investments. The global investors issued an investor statement declaring their commitment to the financing of climate change projects and infrastructures. Green *sukuk* will facilitate the participation by the conventional investor and attract Islamic funds to invest in such an underlying ethical and socially responsible project³⁵.

Despite the bright prospects of green *sukuk*, there are several challenges facing this financial instrument. This includes the absence of an assessment and green performance measurement standard and verification system and independent verification agencies to certify the green initiatives. Even though the Climate Bonds Initiatives

³² N. Mohammad, "SRI and Green Sukuk: Challenges & Prospects", (MIFC: January, 2016).

³³ Ibid.

³⁴ M. Bennet, "Islamic sukuk: A promising form of finance for green infrastructure projects", *Voices*, (World Bank, 2015). Accessed on May 7, 2017, <http://blogs.worldbank.org/voices/islamic-sukuk-promising-form-finance-green-infrastructure-projects>

³⁵ N. Mohammad, "SRI and Green Sukuk: Challenges & Prospects", op. cit.

(CBI) issued and developed guidelines pertaining to standardized green criteria and green assessment this process is still voluntary and the green investors still find difficulties following it. As such, they carry out their own due diligence of identifying and measuring the level of environment impact between the projects³⁶.

Second, the risk profile associated with green *sukuk* tends to be high, because environmental projects involve a highly sophisticated new technology due to construction and operation of green technologies. Thirdly, the small secondary market due to the small number of investors in this *sukuk* also poses a challenge, though this challenge is applicable to all types of *sukuk*.

2.5 Justification of Governments Compensation

A major characteristic of SRI is that the investors are reimbursed according to the degree of success of the program in achieving the agreed targets, and in case the program did not meet the set targets, stakeholders will only be partially compensated or none at all. From another perspective, the SRI is embedded with an excellent incentive system for the stakeholders to give out the best and deliver the project as planned.

The SRIs would reduce the high dependency on government's budget on addressing the social issues. From the government perspective, there are implicit costs of any social issue that are weighing on its budget, for example, homeless people are usually affected by alcoholism, drug abuse and both physical and mental health problems, These issues tend to escalate into a higher crime rate, vandalism and squatting public properties, all which need to be dealt with using tax-payers money to cover the costs of correctional institutions, hospitals, youth rehabilitation centers. All of these problems could be avoided by dealing with homelessness from the source, and in the long run, governments could spare a substantial amount of funds that could be otherwise wasted on fixing the damage rather than avoiding it in the first place, and this point alone justify the fact that governments is the one rewarding the SRI stakeholders.

³⁶ L. Irvine, M. P. Grifferty and A. Cowman, "Green *Sukuk*: The Race to be First", op.cit.

3. Cases of SRI *Sukuk* for Development of the Social Sector

3.1 *Ihsan Sukuk* by Khazanah Nasional Berhad for Education Sector

The first-ever SRI *sukuk* issued in the Islamic finance industry is the *Ihsan Sukuk* issued by Khazanah Nasional Berhad (KNB), the investment arm of the Malaysian government on the 18th of May in 2015. It is comprised of a RM100 million seven years *sukuk* issued via an independent Special Purpose Vehicle (SPV) known as *Ihsan Sukuk Berhad* for a RM1 billion *sukuk* program. The *sukuk* was issued in Malaysia and regulated by the Malaysian Securities Commission. Rated AAA by the RAM Rating Services Berhad, the *Ihsan Sukuk* was designed to drive private sector finding towards socially responsible programs, while adhering to Islamic financial principles and meeting the objectives of *Shari'ah*. All the proceeds from this *sukuk* were used to fund 20 Trusts Schools (public schools) under Yayasan Amir's Trust Schools Program for 2015. Yayasan Amir is a nonprofit foundation incorporated by KNB. The objective of this foundation is to improve the educational sector in the Malaysian public schools through a strategic partnership with the Ministry of Education, Malaysia. The details of the *Ihsan Sukuk*, containing the terms and conditions and general information are summarized in Table 4.

Table 4. General Information on Khazanah Nasional's *Ihsan Sukuk*

Issuer	<i>Ihsan Sukuk Berhad</i> (“ <i>Ihsan</i> ”), an SPV initiated by Khazanah
Obligor	Khazanah Nasional Berhad (“Khazanah”)
Facility	RM1.0 billion in nominal value <i>sukuk</i> for the whole <i>sukuk</i> programme
Facility tenure	Twenty five (25) years from the issuance date
Offering tenure	Seven (7) years
Issuing price	RM100 million
Type of contract	<i>Wakalah bil istithmar</i>
Rating	AAA

The *sukuk* is structured based on the “*Wakalah bil istithmar*” contract with the modus operandi being illustrated as follows³⁷:

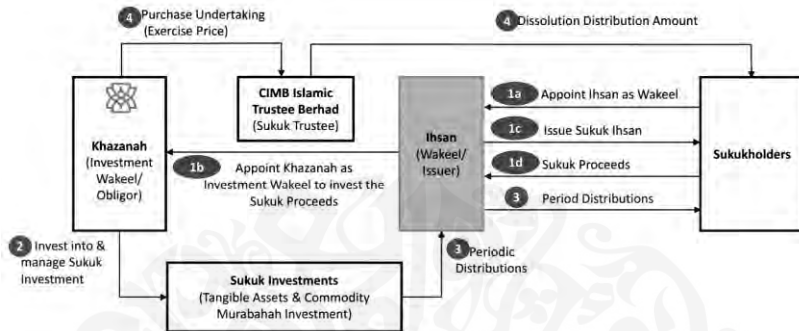


Figure 3. Structure of *Ihsan Sukuk* by Khazanah Nasional Berhad

The evaluation of how successful this SRI *sukuk* is done even earlier than the maturity date based on its flow and performance. The returns to investors are based on the success of the Trust Schools Program in meeting a set of predetermined key performance indicators (KPI). The KPI is a quantifiable measure to evaluate the success and social impact of the *Ihsan Sukuk* in meeting its objectives, with the KPIs covering four main areas³⁸, namely (i) Minimum number of schools rolled out under the Trust Schools Programme; (ii) Proficiency of the selected Trust Schools’ teachers; (iii) Proficiency of the selected Trust Schools’ senior leadership team; and (iv) Proficiency of the students, including set targets in relation to discipline, literacy and numeracy skills for the said students

The *sukuk* was priced at the price guidance of 4.30% per annum. If the KPIs mentioned above are successfully met by the 2015 Trust School Program at maturity, 6.22% per annum (annual) on the principles repayment will be payable to the *sukuk* holders. However, if any of the KPIs are not met, *sukuk* holders will be entitled to the nominal value of the SRI *sukuk* in full. Besides that,

³⁷ R. Haneef, “Retail *Sukuk* and SRI *Sukuk*: The Malaysian Experience”, CIMB Islamic during 1st Annual Islamic Finance Conference, (Jakarta: Indonesia, 2016).

³⁸ International Shariah Research Academy for Islamic Finance (ISRA), *Islamic Commercial Law*. (Kuala Lumpur: Malaysia, 2017)

sukuk holders are also entitled for tax vouchers of amount equal to the nominal amount of their *sukuk* holdings waived³⁹.

This *sukuk* was a success where it has attracted diverse investor base of asset management companies, banks, pension funds and foundations. In 2015, there were only 20 schools under Yayasan Amir's Trust Schools Program, but currently there are around 60 schools under this program. The year after the issuance date, RAM Rating's has reaffirmed the AAA/stable rating of the *Ihsan Sukuk* Berhad's *sukuk* program. Another prove of this success is that Khazanah won two awards for this issuance, the first being "The Social Impact Deal of the Year (2016)" and the second was "Most Innovative Deal of the Year". These awards illustrate the good performance of this *sukuk* and the obligor's role in contributing to the improvement of the education programs in Malaysia.

3.2 Orasis Sukuk for the Environmental Sector

A specific example of SRI *sukuk* for the environmental sector is the Orasis Green *sukuk*, which is the first green *sukuk* being issued in France in August 2012 by Legendre Patrimoine, a solar energy company. It was the first SRI *sukuk* structured in France whereby the subscription was opened for private investors as well as institutional investors. A series of legal and tax adjustments were introduced into the French financial system before the issuance of this *sukuk* to ensure tax neutrality. Furthermore, investment in the renewable energy sector accrued tax exemption benefits for the *Shari'ah*-compliant Orasis *sukuk* under the Industrial Law, Orasis investors would benefit from the maximum tax reduction if they hold the investment for 10 years, albeit an earlier exit is also possible but with a less competitive tax treatment⁴⁰.

The Orasis *sukuk* invested in photovoltaics as the underlying asset to convert solar energy into electricity. The underlying *Shari'ah* contacts that are used in the structure are *musharakah* and *ijarah* (equity and leasing) whereby the investors purchase Islamic certificates that are issued by a joint venture forming a partnership

³⁹ ISRA, op.cit.

⁴⁰ A. Hassoune, "Islamic financial solution for Green Energy in France", *Hassoune Conseil*, (October, 2012).

amongst them representing ownership rights green renewable energy investments (solar panel manufacturing plant), then the joint venture after acquiring the photovoltaic materials will lease it out to Photovoltaic operating companies which produce electricity and subsequently enters into a 20-year agreement to sell the green energy produced to Electricité de France (EDF), the French energy company, at a pre-agreed price. Finally, EDF can sell the energy produced to the final consumer through its existing distributional network⁴¹. The identity card of the Orasis *sukuk* is provided in Table 5, while the structure of the *sukuk* is depicted in Figure 4.

Table 5. General Information about Orasis *Sukuk*

Issuer	Joint venture and limited liability company
Obligor	Legendre Patrimoine
Tenure	15 years of leasing
Dividend and principal purchase	7% per annum and capital practically guaranteed at 87% after 10 years
Issuing price	5,425 euro
Type of contract	<i>Musharakah-Ijarah</i>
Underlying asset	Photovoltaic materials

⁴¹ N. Mohammad, “SRI and Green Sukuk: Challenges & Prospects”, op. cit.

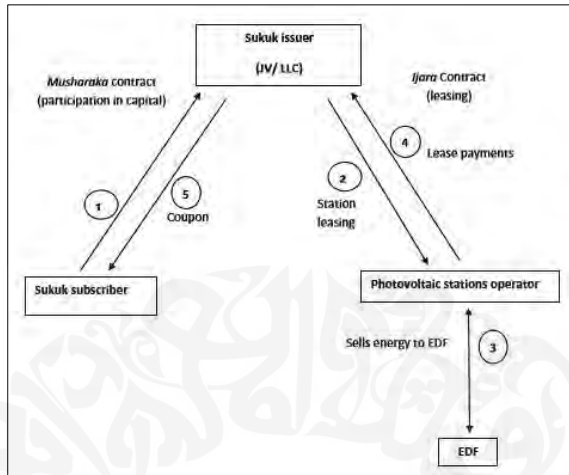


Figure 4. Structure of Orasis *Sukuk*

Despite its appeal, Orasis was not deemed successful after 2 years into its issuance due to many factors such as Europe was still under the aftermath of the global financial crisis and also because of the debt crisis that took place in Greece and some other parts of Europe. However, its structure may provide the basis for developing broader *Shari'ah*-compliant solutions to green investments⁴². It is estimated that the solar assets would have generated 1,000 megawatt (using 2,000 hectares of land and 5 million solar panel whereby according to the Solar Energy Industries Association, the number of homes powered by 1 MW of solar energy is on average 164 homes. This implies that for 1,000 MW it will cover 164,000 houses in terms of electricity consumption⁴³.

3.3 International Finance Facility for Immunization Sukuk for the Health Sector

Established as a charity in 2006, the International Finance Facility for Immunization (IFFIm) operates with no employees in the UK. It is a collaboration of four parties, namely donors, the IFFIm board, the

⁴² A. Hassoune, "Islamic financial solution for Green Energy in France", op. cit.

⁴³ Z. Hagadone, "Megawatt? How many homes can you power with a single megawatt?", *Note Boise Weekly* (Mar. 18, 2015). Accessed on May 26, 2017, <https://www.boiseweekly.com/boise/megawatt/Content?oid=3433953>

World Bank and Gavi – the vaccine alliance (a non-profit foundation based in Switzerland). IFFIm receives long-term legally binding pledges from donor countries and subsequently issues bonds backed by these pledges on international capital markets. Money raised from the bond issuances (termed ‘vaccine bonds’), provides funding in the form of immediate cash, a process known as “front-loading” to Gavi. The Gavi Alliance seeks to save children’s lives and protect people’s health through the widespread access and use of vaccines in poor countries. To date, IFFIm has disbursed \$2.5 billion to Gavi’s vaccination programmes in 73 countries, with approximately half in Muslim countries⁴⁴.

In November 2014, IFFIm’s inaugural *sukuk* raised \$500 million, with the *sukuk* being oversubscribed by 1.4 times. Participation of investors from the Middle East was 65% and 18% in Asia. It diversified the investor base, increased visibility and grew brand strength. The *sukuk* even captured the participation of conventional investors for the very first time, those who were strongly inclined to ethical and social investment. The three-year *sukuk* provided investors an opportunity to invest in a socially responsible manner that aims to protect children against preventable diseases⁴⁵. After the overwhelming positive response for the initial *sukuk* offering, a second *sukuk* was issued in September 2015, raising \$200 million, when it was 1.6 times oversubscribed with a similar regional distribution of investors as the initial *sukuk*⁴⁶.

While the overall objective of the *sukuk* ties into Gavi’s long-term strategy of supporting immunization programmes across the globe in developing countries, IFFIm has specific funding objectives. Gavi has strategy indicators to help measuring performance of ongoing program. Among the main objectives of the IFFIm’s funding program was to build a diverse user base, as means to managing risk. It also offered more opportunities to raise awareness of Gavi’s instrumental work in the field of vaccines⁴⁷. IFFIm’s three main objectives are: (i) Build a diverse investor base;

⁴⁴ IFFIm, *Resource Guide*, (2017).

⁴⁵ Gavi, *The Vaccine Alliance Annual Financial Report*, (2015).

⁴⁶ IFFIm (2015) Press Release, (2015).

⁴⁷ IFFIm, *Update*, (10 August, 2015).

(ii) Establish a benchmark for IFFIm in the international *sukuk* market; and (iii) Raise Islamic liquidity for sociable responsible purposes. Meanwhile, Gavi's mission statement is underpinned by a strategy that encompasses four key objectives: (i) To accelerate equitable access to and use of vaccines; (ii) To increase the effectiveness and efficiency of immunization delivery as an integrated part of strengthened health systems; (iii) To improve the sustainability of national immunization programmes; and (iv) To shape the markets for vaccines and other immunization products.

To measure the impact of a pledge, IFFIm provides an approximate breakdown of proceeds from IFFIm to Gavi by country using an agreed methodology. Based on commodity *murabahah*, the *sukuk* structure is an innovative one (Figure 5). However, the structure of this *sukuk* had the potential to align closer to *Shari'ah*-compliance ideals by embracing *mudarabah*. Thus, IFFIm could have issued *mudarabah* certificates to investors in the part of the deal where vaccines are purchased from Gavi using on the spot payment, to sell to the purchase order at a higher deferred price. Therefore, investors would have shared in the profits from the *mudarabah* profit. This would have linked the financing of the deal directly to the actual business rather than through a secondary layer. The added benefit of this method is that the *mudarabah* certificates could then be traded on the secondary market offering better liquidity and another incentive for investors. The opting of the *murabaha* structure was primarily down to it being easier to administer⁴⁸.

⁴⁸ World Bank Group. *Islamic Finance: A Catalyst for Shared Prosperity?* (2016).

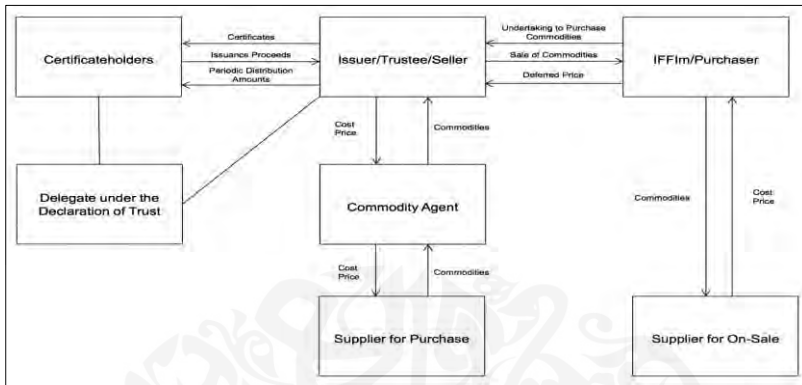


Figure 5. Structure of IFFIM Sukuk

Source: IFFIM 2014 Sukuk Memorandum

In terms of issuances, the IFFIM issuances since 2006 included bonds and *sukuks*. Other than the inaugural benchmark in 2006 and the two global benchmarks in 2013 and 2016, the first *sukuk* issued in 2014 raised more than all previous bond issuances. This provides an indicator to the amount of interest the *sukuk* managed to attract, particularly from new investors from the Middle East and Asia. Notable features of the IFFIM issuances are that they are well-rated by major rating agencies Fitch, Moody's and S&P, with AA+, Aa1 and AA respectively. The *sukuk* utilised a *murabahah sukuk* structure, whilst the global coordinator was Standard Chartered Bank, and this provided it with significant credentials.

The unique finance mechanism that drives the IFFIM vaccine *sukuk* is that it has performed strongly. Apart from the IFFIM, GAVI receives funding from pneumococcal Advance Market Commitment (AMC), a matching fund and direct donors. In AMC, donors commit funds to guarantee the price of vaccines once developed. This incentivizes the vaccine manufacturer to invest in research & development, expand manufacturing and offer vaccines at affordable prices to developing countries in the long term. The Gavi Matching Fund (GMF) is a public-private funding scheme designed to incentivize private sector investments in immunization programs.

Gavi's reports, however do not distinguish the *sukuk* funds from conventional bonds. Thus, the reported figures from IFFIM

contributions are a combination of both funds combined. If Gavi reported where *sukuk* funds were used in which immunization programmes, it would be more useful to *sukuk* investors to enable them to envisage a direct correlation of fund use and results on the ground. The front-loading mechanism has been assessed independently by several evaluations, with conclusions stating that it is highly cost-effective and provides strong financial returns for investors⁴⁹.

The IFFIm landmark *sukuk* is considered as a terrific success, with the introduction of a new supranational entity to the Islamic capital markets. IFFIm's objectives were accomplished, in terms of widening the investor base, with 85% of the order book coming from predominantly Islamic investors. While in terms of establishing a new benchmark in the *sukuk* market, the standard was set high after it pushed boundaries by being the largest ever *sukuk al-murabaha* and the largest inaugural *sukuk* from a supranational. The success of the *sukuk* led to the IFFIm receiving six prestigious awards, namely (i) The Financial Times' Achievement in Transformational Finance Award; (ii) Islamic Finance News' Social Impact Deal of the Year 2014; (iii) EMEA Finance's Best Supranational *Sukuk*; (iv) Euromoney's Innovation in Islamic Finance; (v) The Asset's Best *Sukuk* for Social Good; (vi) Global Finance's Islamic Deal of the Year.

From Gavi's perspective and the impact in the developing countries, it can also be classed a resounding success. The child mortality rate fell from 76 to 63 per 1,000 live births between 2010 and 2015 at a rate of 3.6% per year. Gavi exceeded its target of averting 3.9 million future deaths, by achieving over 4 million. Whilst for immunization, 277 million children had been immunized with Gavi-supported vaccines. This surpassed the target of 243 million⁵⁰. Gavi does not report results based on funding sources. Therefore, the results were realized through the combination of all funding sources, i.e. conventional vaccine bonds, direct donations, *sukuk* amongst others. The Health and Life Sciences Partnership

⁴⁹ G. Keohane, *Capital and the Common Good How Innovative Finance Is Tackling the World's Most Urgent Problems*, (Columbia University Press. 2016).

⁵⁰ Gavi, *The Vaccine Alliance Progress Report 2015*

(HLSP) conducted an independent evaluation of IFFIm noting that the model undertaken carried many risks. Plus, the operating costs and regulations were much higher than originally anticipated. However, the concept was regarded as a success with Gavi unable to reach its goals if it wasn't for the funding efforts from IFFIm⁵¹.

5. Conclusion

In conclusion, Islamic finance is taking the initiative and be ahead of its conventional counterpart, pertaining to achieving the social economic growth and the social welfare of the Muslim community. As it is one of the pillars of *maqasid al-Shari'ah*, along with safeguarding and protecting our environment for the next generations, this can be achieved through more Islamic financial instruments and innovative products such as SRI *sukuk* as well as green *sukuk* for environmental protection.

Moreover, on the demand side, there is a recognized increase in the demand for Islamic financial instruments that is related to social and ethical values both from institutional investors and sovereigns including non-Muslim investors. This is due to a change in their investment preferences and the increased awareness of the environmental and social issues that need an urgent solution. Hence many regulatory authorities started to work on that and Malaysia is a good example whereby the securities commission took the initiative and issued a blueprint for SRI *sukuk* to be a comprehensive guideline and a regulatory framework to enhance this specific type of financial instrument.

Despite that, there is still a lack of a comprehensive standardized impact assessment methodology that will boost the confidence among the different segments of investors and that gives the credibility and integrity for this particular type of investment and projects. Hence, efforts must be incorporated to come up with a comprehensive and efficient and standardized impact assessment framework of the SRI projects, in order to give more integrity and transparency to this newly emerging type of financial instrument.

⁵¹ Health and Life Sciences Partnership, *Evaluation of the International Finance Facility for Immunisation*, (June, 2011)