Shariah Investing Dialogue Series 2021

IslamicMarkets®

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Series 1 – Sustainable and Responsible Investing (SRI) within the Notion of Maqasid al-Shariah

- **Shariah investing is an investment avenue for both Muslims and non-Muslims, with Shariah compliance, ESG principles and SDGs all sharing the same objective of sustainable and responsible investment to promote ethical investing.**
- **Sustainability is meeting our own needs without compromising the ability of our future generations to meet their needs, taking into consideration the consequences and impact of our actions.**
- **As sustainable finance globally shifts capital towards sustainable assets, Islamic finance may become a haven for unsustainable assets.**
- **ESG fund managers look religiously into companies' ESG disclosures and score them based on their ESG disclosures.**

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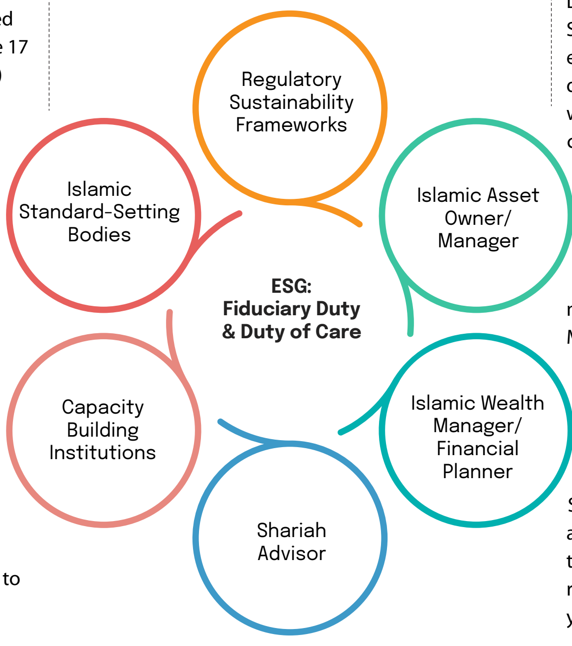
Maqasid al-Shariah from an SRI Perspective: Prof. Dr. Ashraf Md. Hashim commenced his presentation by providing an overview of Maqasid al-Shariah from an SRI perspective. He explained that this topic is equally important to Muslims and non-Muslims alike, as it relates to our well-being and the roles we can play to better our lives. Prof. Hashim went on to mention several macroeconomic concerns such as large scale conflicts and wars, inequality of income discrimination, corruption, food and water security, and the lack of education. Whilst these issues seem monumental to an individual, Prof. Hashim urged everyone to consider the major impact we can create if we were to take action collectively. He cited the example of the large number of small retail investors contributing to the resilience of the stock market during the global pandemic. Prof. Hashim emphasised that we are all equally responsible to contribute to the betterment of our environment and community and he shared several excerpts from the Quran that call upon mankind to be mindful of the consequences of their actions. He also highlighted that in terms of investing, profit must not be earned whilst causing harm to others.

Prof. Hashim explained that Maqasid al-Shariah refers to the objectives of the Islamic law which serves the interests of all living beings (jalb al-masalih) and where harm is prevented (daf' al-mafasid). Prof. Hashim drew a parallel between the 17 United Nations Sustainable Development Goals (UNSDGs) and the Maqasid al-Shariah, where they are very similar in terms of their end goals. Several of the UNSDGs exclude harmful sectors such as weaponry, alcohol, gambling and adult entertainment. This is in line with the prohibited economic activities in Islamic economy. Furthermore, the five essentials of Maqasid al-Shariah (the protection of religion, life, intellect, lineage and property) are all aligned with the widely accepted environmental, social and governance (ESG) principles, which translates into a Shariah-compliant investor being an ESG-compliant investor as well. With regards to Malaysia's SDG fulfilment, the country has made significant progress in three SDGs as of 2019, namely good health and well-being, industry, innovation and infrastructure, quality education, but is yet to reach commendable rates in others.

Prof. Hashim also discussed Bursa Malaysia's commitment to a sustainable future. Primarily, Bursa Malaysia's Strategic Roadmap 2021-2023 which focuses on positioning Malaysia as the global hub for Islamic capital markets, that are compliant with ESG principles and the UNSDGs, by embedding sustainability in its organisation and marketplace. Bursa Malaysia aims to become the preferred marketplace for SRI by embedding high standards of sustainability practices and disclosure in both, its organisation and in Bursa Malaysia as a public listed company. Prof. Hashim echoed Bursa Malaysia's objective to support the growing demand for sustainability, and continuing to strengthen and broaden their Shariah-compliant offerings with the aim of increasing investors' participation and allowing them to fulfil their social responsibility of contributing wealth towards economic growth and society's welfare. This includes using Islamic social funding instruments such as Qard al-Hasan, Sukuk, Waqf, and Zakat as sustainable means for equitable distribution of wealth to help companies and individuals economically affected by the pandemic.

Developing Holistic Shariah SRI Investment Products: When probed on how investors perceive the value proposition of Shariah-compliant SRI, and if Shariah-compliant SRI companies influence the investment decision of investors, Najmuddin Mohd Lutfi shared that BIMB Investment Management Berhad's (BIMB) journey in this space began in 2015 when it was overhauling its investment strategy. Working closely with global ESG pioneers such as Arabesque Asset Management, BIMB launched the first global Shariah ESG equity fund which, after six years, is now the largest global Shariah equity fund in Malaysia. He mentioned that Malaysia's Shariah fund space is very crowded with around 300 Shariah-compliant funds currently, emphasising that ESG-integrated funds need to perform on par or better than the other Shariah-compliant funds in addition to competing with conventional funds. Lutfi said that, even with the integration of Shariah and ESG principles, retail investors are mostly concerned with the fund performance which BIMB has been able to deliver on through the use of technology in the form of machine learning and artificial intelligence in stock selections, and using big data technology to ensure a robust ESG compliance assessment. Focusing on SRI funds in particular, Lutfi highlighted that there are currently 20 SRI funds in Malaysia with assets under management (AuM) of MYR2.5 billion (about USD600 million), compared to MYR131.7 billion (about USD31.7 billion) for Shariah funds, indicating further work needs to be done to gain more market acceptance of SRI funds.

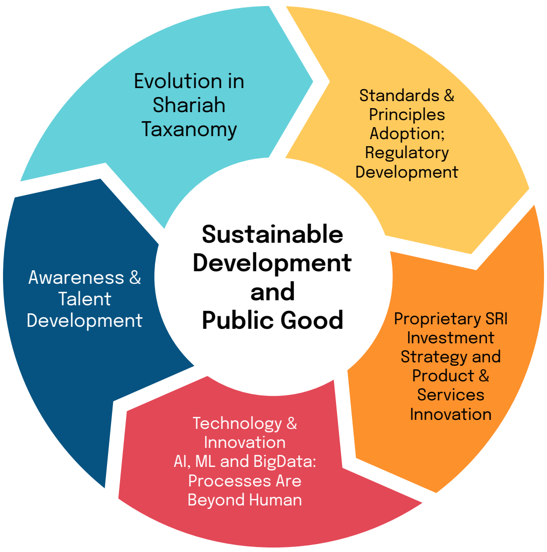


Lutfi then set out some recommendations to help grow SRI funds in the asset management space. Firstly, to encourage companies that have low ESG ratings to disclose additional information, which will ensure a wider investible ESG universe so that fund managers can look at a bigger pool of options when constructing an ESG portfolio. Secondly, capacity building can be done by setting up research centres on ESG and sustainability whilst providing grants to attract global houses to set up such centres. Thirdly, there should be a concerted effort to drive talent acquisition and management to attract more ESG and SRI experts to Malaysia. Fourthly, it is also crucial to obtain the support of institutional investors. The fifth recommendation is to offer incentives to banks and other investors to focus on SRI/ESG wealth management. Sixth, tax relief can also be introduced to encourage robo-advisors to focus on ESG/SRI investment. Seventh, to expand the green and sustainable financing asset class. The eighth recommendation is to speed up the approval of ESG/SRI EPF-approved funds from requiring a three-year track record to only requiring a year. Lastly, incentives can be rolled out to encourage more fund managers to become signatories of the United Nations Principles for Responsible Investment (UNPRI).

Mohd Radzuan Ahmad Tajuddin then started speaking on Shariah and SRI as catalysts for economic growth. Sustainability means meeting our own needs without compromising the ability of our future generations to meet their needs, thus this necessitates taking into consideration the consequences and impact of our actions today. During his presentation from the perspective of risk and seizing opportunities in the SRI space, Tajuddin focused on the importance of preventing current Islamic markets from becoming a safe haven for unsustainable assets, by applying and integrating Shariah and ESG principles as a catalyst for the transition towards sustainability, and to tap the available SRI opportunities. Tajuddin noted that the sustainable finance market has developed rapidly and is witnessing a shift from traditional investments to sustainable investments. As an example, he pointed out that global sustainable investment AuM now account for over 30% of the total professionally managed assets, around USD103 trillion in 2018, with expectations to grow further in 2021. There has also been an uptake in the UNPRI signatories from only 60 signatories in 2006 to over 3000 signatories today. The AuM of global Islamic funds is only around USD100 billion in 2020 in comparison, which is a fraction of the total professionally managed assets globally. This data shows that Islamic capital markets are lagging behind in sustainable investments from the perspective of ESG, resulting in the widening of sustainability gaps between Islamic capital markets (ICM) and the SRI space.

Tajuddin opined that the Islamic equity market faces the challenge of having a negative screening taxonomy. Failure to integrate ESG factors into the existing Shariah taxonomy have now resulted in Shariah-compliant securities being designated as unsustainable in courts, from an ESG standpoint. In terms of Sukuk, the rule on the use of proceeds has not evolved, continuing to ensure that proceeds are merely used for Shariah-compliant purposes. Many United Nations-linked bodies such as the United Nations Global Compact and the PRI, have issued principles and standards to be observed by global stakeholders and market participants. Many in the ICM space, however, have yet to do so. Tajuddin added that the Islamic fund industry's advancement in this regard has been unimpressive, globally and in Malaysia. Tajuddin further stated that there is an obligation on the part of market participants such as regulators, Islamic asset owners, managers, Islamic wealth managers, financial planners, Shariah advisors, and Islamic standard-setting bodies to undertake the responsibility of integrating sustainability considerations, as well as ESG factors. He believes that it is their responsibility to develop the relevant sustainability framework such as the SRI super framework and Bursa Malaysia's own sustainability disclosure framework. He noted the absence of a single sustainability standard issued from Islamic standard-settings bodies like the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Tajuddin re-iterated that Islamic assets are already experiencing negative impacts due to the absence of ESG and sustainability considerations such as facing non-financial risks arising from environmental, social and governance risks. A stock may be designated as being Shariah-compliant but may not be entirely sustainable from an ESG standpoint whilst still being included in Islamic fund portfolios. This raises the risk of impairment, where the stock could potentially be devalued as SRI investors who value the integration of ESG principles will avoid this unsustainable asset, although it is Shariah-complaint. Tajuddin worries that Islamic finance investors are not on an equal footing with SRI investors who hold an advantage, as he believes Islamic investors do not possess the same capability as conventional SRI investors. As sustainable finance globally shifts capital towards sustainable assets, in a worst-case scenario, Islamic finance may become a haven for unsustainable assets.



SRI Agenda in Malaysia: On whether Shariah and SRI investing will continue to be major themes in the future, Shahariah Shaharudin believes that considering people, planet and profit in investments is important and therefore, SRI-centred investing will be around in the long run. Shaharudin mentioned that Malaysia has developed an Islamic finance ecosystem and has a long-term track record in Islamic finance. With that experience, the country should apply the lessons learned from 40 years in the Islamic finance industry into the SRI roadmap. She advised taking a holistic approach to increasing the Shariah SRI in Malaysia by analysing three main areas, namely, the demand side, the supply side and the regulatory side. In terms of the demand side, she encourages incentivising and educating consumers so that they can understand what Shariah SRI means, as well as keeping them informed through digital and social media advertisements. The supply side will be driven by the industry which has to look into greater Shariah-compliant

Challenges of Shariah SRI

product development and building human capital by training personnel to understand Shariah ESG completely. Technology and enablement must be developed, by having an online platform and digitalising the ESG disclosures and investment processes. With regards to the regulatory aspect, regulators need to standardise rules, guidelines and requirements whilst considering the cost implications of standardisation such as audits and third-party certification. Shaharudin outlined certain challenges that may present themselves, including setting precedents for potential lawsuits, educating investors to think ethically before considering profit and asset managers dealing with a reduced universe to consider investing in. She advocated investing in value stocks in times of rising inflation, but investing in growth stocks, like technology, when inflation is lower. She highlighted that Shariah SRI products are resilient and because of the in-built strategy in a Shariah SRI portfolio, they will have improved performance in the long run. Shaharudin continued by comparing ESG funds and Saturna's pure Shariah SRI fund to the market, as represented by the S&P 500, both of which have outperformed the market. She outlined the implications on the market outlook as a result of Joe Biden being elected as President of the United States, by way of higher taxes and a better climate plan with more energy saving that will benefit sustainable funds. Further considerations include US-China trade relations, fiscal and monetary policy, together with the rollout of the COVID-19 vaccinations. She singled out the technology, healthcare and consumer staples sectors as good performers in 2020, but stated that these may be worth less in 2021. She encouraged rebalancing portfolios to hold more investments in the industrials, materials and sustainable energy sectors.

On the best way of expediting the integration of global ESG standards and principles into Islamic capital markets, Tajuddin responded that it is to be aware of the risks associated with the non-integration of ESG principles. There is a risk that Islamic funds which do not incorporate ESG factors could be devalued or be illiquid given that other SRI investors have already disposed of such assets. Second, he advocated being more proactive in building the ESG ecosystem through the development of standards and principles where Islamic bodies like IFSB have to play a more meaningful role. In addition, the requirements of regulators can be proactive in identifying opportunities and mitigating risks by introducing SRI and ESG-related frameworks for the various capital market products and services based on the demand from the marketplace. Further, he urged a sustainability disclosure by regulators and stock exchanges. Bursa Malaysia having its own sustainability disclosure framework would encourage corporates to disclose their ESG performance as well, thereby accelerating the entire process of integrating ESG into all segments of the marketplace.

In conclusion, speakers were all in agreement that integrating SRI and ESG in Shariah investing is the way forward to grow the industry locally and globally. ESG disclosure remains a key point in assessing companies' ESG scores and enabling investors and asset managers to properly construct their ESG and SRI portfolios.

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