

EDITORIAL

Bridging the Gap between Islamic Finance and Sustainable, Responsible, and Impact Investing

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In the realm of present-day economics and finance, two significant paradigms, Islamic Finance and Sustainable, Responsible and Impact (SRI) investing, have emerged as strong forces shaping investment ideologies and strategies. Although emerged as distinct fields in global finance, they potentially complement each other. Notably, the financial worth of Islamic Finance is around USD 4.5 trillion globally with an annual growth of 11 to 12 percent, while the financial worth of SRI investing is almost 10 times higher than that of Islamic finance. They have a joint core value proposition that aligns financial decisions with ethical principles while emphasizing a positive impact on society and the environment. Even though their origins and operational structure differ, it is worthwhile to explore the intersection and potential bridges between them.

The roots of Islamic finance go back to the 7th century AD based upon the religious principles given by Islamic law. The formal Islamic banking and finance evolved over the last six decades with a primary focus on distributive justice by providing value-based financial intermediation based on the principles of Shariah. This system is expected to provide financial intermediation throughout the hierarchies in society, including the unprivileged ones. Islam considers the supply of resources to all according to their capacity as important to society as blood is important to the human body. SRI investing also emerged in 1970s primarily incorporating concerns about justice in society and environmental protection. SRI, also termed “ethical investment” – refers to the practice of integrating social, environmental, or ethical criteria into financial investment decisions. While focusing on ethical dimensions, it pertains to a wide range of environmental, social, and governance (ESG) factors.

There are several commonalities between Islamic finance and the SRI such as ethical underpinning (both systems are driven by ethical considerations), and application of screening filters. Both systems apply certain screening criteria to filter ethical investments such as SRI filters out businesses involving tobacco, gambling, alcohol, projects damaging the environment, human rights violations, and so on. Going forward, SRI funds have been developed based on positive screening, like sound environmental management and the

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promotion of ethical labor practices. This is what Islamic finance requires as its basic feature; it not only considers most of the filters identified by SRI but also extends the list by adding some more critically important filters such as businesses involved in interest (*ribā*) and trading in risk and excessive uncertainty like financial derivatives and separating risk from the ownership.

Islam has an ethically committed stance on *Ribā* and classifies it as a root cause of injustice and exploitation in the financial system. It has been proved empirically that the increasingly wide divide between the rich and the poor is by dint of interest and the short selling. Moreover, Islamic finance filters do not approve the companies involved in selling liquor, pork, haram meat, gambling, operating night clubs, disseminating pornographic content, prostitution, etc. It further emphasizes on risk-sharing, asset-backed securitization, and justice in the distribution of wealth as per value addition and taking business risk in the light of Islamic law of contracts. Overall, both systems emphasize promoting positive societal impact through effective financial intermediation for broad-based welfare and sustainability.

Islamic ethical values are especially based on human dignity, equity, justice, freedom of enterprise, and moderation in all social, economic, and even belief-based activities. The objectives of Islamic ethical finance are serving the community through some systematic checks on financial services providers; restraining consumer indebtedness; CSR initiatives and responsible investment not involving exploitation and harm to the environment. Therefore, due to its nature of being ethical, sharing risk equitably, and being asset-backed, Islamic finance has an inherent crossover with the SDGs and the SRI. By linking finance with the real economy, it would promote entrepreneurship and widen the ownership base of society. As such, Islamic finance institutions (IFIs) are considered value-oriented financial institutions guided by the principles, morals, and ethical norms of Islam.

The VBI that emerged in global finance in the wake of the global financial crisis of 2008, tends to ensure an environment where social and governance aspects and the SDGs could be better served. Accordingly, a new approach is required with the bounds of moral economy, ethical finance and disciplined behaviour of all in the society.

In line with the United Nations Framework Convention on Climate Change (UNFCCC) and the SDGs, the Jeddah based IsDB is playing the role of an effective partner in supporting its member countries' transitions to increasingly resilient, green, sustainable and prosperous development pathways. The IsDB approved in 2019, its Climate Change Policy (CCP) with the overarching goal of deepening sustainable development imperatives for a better and safer planet. It broadens the role of Islamic ethical finance to social and environmental horizons. This broader agenda of financial intermediation would require a paradigm change in the regulatory approaches concerning the Islamic finance industry. Only then, the IFIs could perform ethically and responsibly.

Bridging a gap between Islamic finance and SRI investing can offer several potential benefits to reshape the financial landscape globally. Both approaches prioritize long-term sustainability with socially and environmentally responsible investments. SRI investing employs mainly the ESG criteria while Islamic finance complements and extends the list of compliance based on Shariah guidelines. It would be greatly impactful if investors combine

the screening methodologies in constructing their portfolios that not only meet the SRI investing ethical standards but also adhere to the Islamic finance principles. Moreover, the integration of Islamic finance and SRI investing can trigger innovations in financial products and services based on the principles of Islamic finance. Sukuk, for instance, offers a unique avenue to finance sustainable projects, which is also a core objective of ESG and SRI investing. By structuring Sukuk while incorporating ESG and VBI considerations the issuers can get the opportunity to tap into the growing market demand of ethical financial solutions.

The realization of the full potential of integrating SRI investing with Islamic finance requires concentrated efforts by all stakeholders of the financial ecosystem. The regulatory bodies need to provide clear standards and guidelines for the integration to achieve transparency and investor confidence. Accordingly, policymakers and banking and finance practitioners (more importantly IFIs) need to come forward to re-align the economics and finance at national and global levels to bridge the gap by moving to SRI and responsible finance. It requires a change in policy options to adopt the value-based system that conforms to the ethical principles of business and financial intermediation, and just and equitable distribution of resources. It is what the United Nations adopted as the 2015-30 agenda of SDGs. Likewise, financial institutions need to develop expertise in both fields to offer innovative solutions that fulfil emerging needs. Moreover, relevant education and awareness initiatives are required to improve the broader adoption process. It would bring a paradigm shift in the financial ecosystem for the long-term welfare of mankind.
