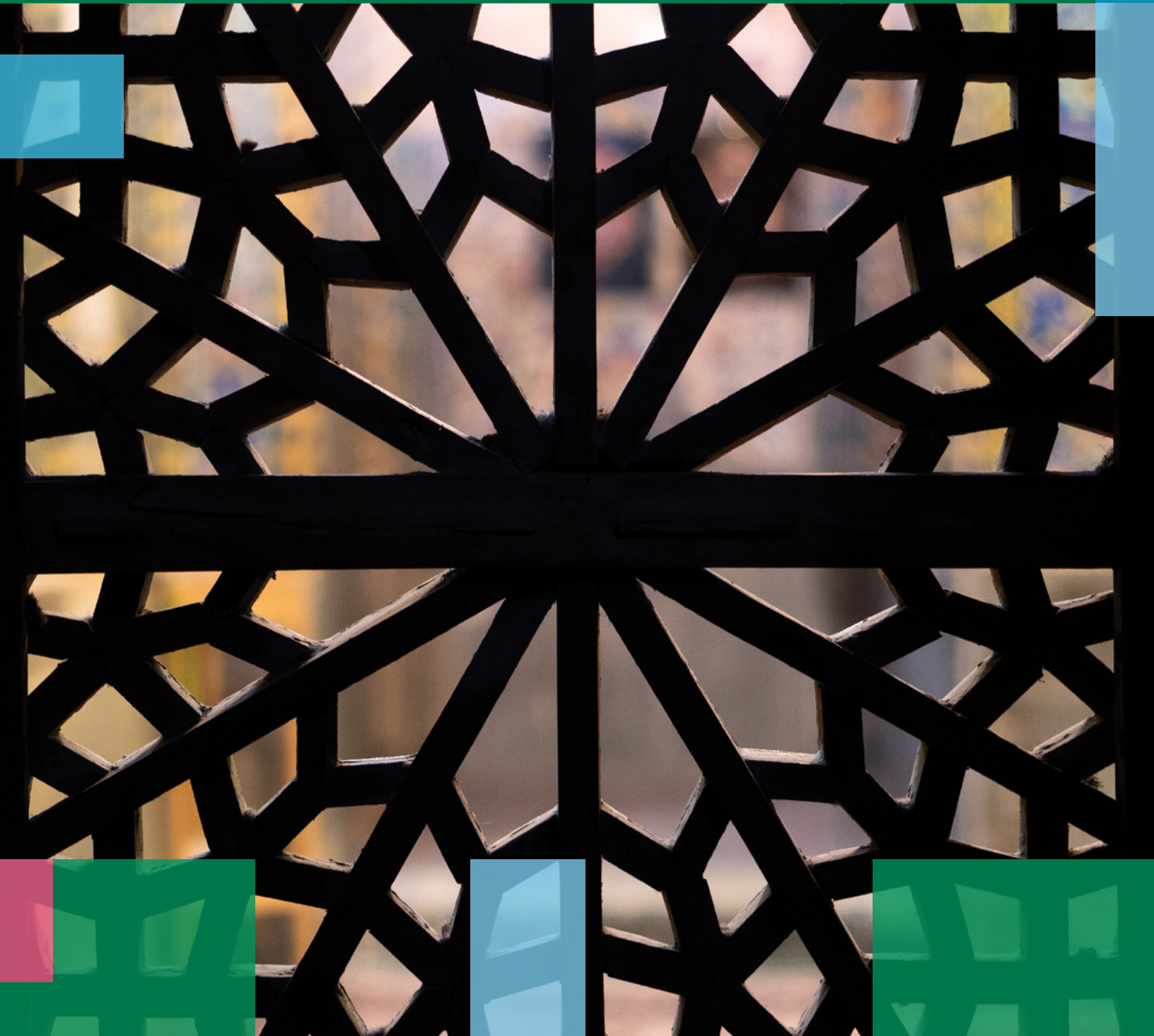




CFA Institute

**SUSTAINABLE, RESPONSIBLE, AND IMPACT  
INVESTING AND ISLAMIC FINANCE  
SIMILARITIES AND DIFFERENCES**



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# SUSTAINABLE, RESPONSIBLE, AND IMPACT INVESTING AND ISLAMIC FINANCE

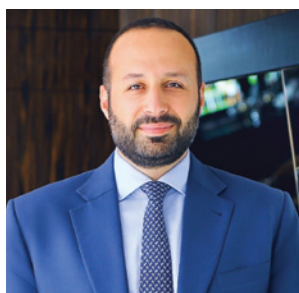
## SIMILARITIES AND DIFFERENCES

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## FOREWORD



Sustainable, responsible, and impact (SRI) investing and Islamic finance share similar origins and aspirations. Yet for the most part, these two modes of finance have existed as distinct approaches in parallel worlds.

Common to both is an ethical underpinning that puts stewardship and societal value creation at the forefront of finance.

With this research, CFA Institute aims to articulate the similarities—and differences—between SRI investing and Islamic finance. We trace the early origins of both schools of thought, identifying their historical connections, and identify the main concepts in each approach.

Central to any discussion of SRI investing are environmental, social, and governance (ESG) considerations—the core factors around which an SRI investment approach is developed, such as through screening, full integration into security valuation and portfolio management, and thematic and impact investing. Islamic finance is most commonly associated with the prohibitions of *riba* (lending money at interest) and excessive *gharar* (sale of risk). At face value, these restrictions imply a very different approach from SRI investing—one that is ill-fitting with conventional finance. Viewed through another lens, however, certain Islamic prohibitions can be seen

as consistent with a negative screening approach under ESG investing, for example. Moreover, at its core, Islamic finance embodies a responsible investing approach, such as through sustainable resource management.

In this report, we further articulate the ways in which these two modes of finance converge and diverge, in order to highlight the accessibility of each approach to prospective investors whilst acknowledging limitations in implementation. We conclude by articulating the ethical bridge that can straddle both modes of finance.

CFA Institute has developed this research in collaboration with our Islamic Finance Working Group, represented by several CFA member societies in the Middle East and North Africa (MENA) region, as well as in Asia Pacific. The names and affiliations of the working group members appear at the back of this report; we extend our sincere thanks for their input and guidance in developing this research.

CFA Institute does not take views on political or religious matters, and we do not endorse any mode of finance over another. With this research, we hope to broaden horizons and provide an entry point for investment professionals to explore Islamic finance and SRI approaches, highlighting the ethical orientation of both. In doing so, we aim to catalyse the building of institutional awareness, knowledge, and professional expertise in our MENA markets and beyond.

William Tohmé, CFA  
*Senior Regional Head, Middle East and North Africa*  
CFA Institute

# INTRODUCTION

This publication aims to explain the similarities and differences between the theory and practice of sustainable, responsible, and impact (SRI)<sup>1</sup> investing and Islamic finance.<sup>2</sup>

The estimated size of the global assets of SRI investing and Islamic finance have exceeded US\$30 trillion<sup>3</sup> and US\$2 trillion,<sup>4</sup> respectively. No less importantly, these segments seem to be trying to address the concerns many have regarding financial services, from causing economic instability to worsening inequality and more. Both are growing and evolving fields and have much unrealized potential.

SRI investing and Islamic finance have a natural tendency to consider their impact on society and the environment. The modern expression in financial services that best captures this tendency is the consideration of environmental, social, and governance (ESG) issues. Separating "ethics" from notions of "sustainability" and "responsibility" and the consideration of ESG issues is difficult. These different labels are attributed to similar ideas. Therefore, we first explain ESG issues and how they are considered within the context of SRI investing and Islamic finance before discussing the two approaches' similarities, differences, and shared challenges.<sup>5</sup>

## ESG ISSUES

The media frequently highlight ESG issues when discussing the impact of finance on society and ecology, particularly when a large company is

embroiled in a scandal. For example, think of the breaches of user privacy by Facebook, accounting irregularities by Steinhoff International, corrupt practices at Grupo Odebrecht, fraudulent employee behaviour at Wells Fargo, siphoning of funds from 1Malaysia Development Berhad, cheating of investors by Abraaj Capital, manipulation of emissions tests by Volkswagen, spilling of oil in the Gulf of Mexico by BP, bribery and corruption at Unaoil, organizational culture issues at Uber Technologies, and of course accounting fraud by Enron. The database of large ESG scandals and the losses suffered by stakeholders keeps growing.

**Exhibit 1** lists examples of ESG issues.

ESG issues, particularly the governance issues, are far from new. What is new is that awareness of these issues as relevant considerations in financial decisions has increased. No single, exhaustive list of ESG issues exists, and the issues are often interconnected. In general, they can often be measured (e.g., rate of employee turnover for a company), but assigning them a monetary value can be difficult (e.g., the cost of employee turnover).

Companies that address ESG issues are expected to perform better over the long term because these companies are likely to avoid costly controversies and conflicts, attract better staff, develop more reliable supply chains, and enjoy better relationships with the communities in which they operate, their customers, and their regulators and policymakers. Through a higher expected return or lower expected risk, the benefits of better ESG performance could be passed on to investors and other stakeholders.

<sup>1</sup>A variety of labels and abbreviations are used, such as sustainable investing, socially responsible investing, responsible investing, green investing, and ethical investing. In this publication, we use SRI investing as a comprehensive, umbrella term covering the various shades. Bear in mind that the shades vary depending on which ESG method is used and how lightly or rigorously it is applied.

<sup>2</sup>The content of this publication is based on a study of academic literature and industry reports from both Islamic finance and SRI investing. Its scope is confined to for-profit business initiatives with a focus on investment management.

<sup>3</sup>Global Sustainable Investment Alliance, "2018 Global Sustainable Investment Review." [www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR\\_Review2018.3.28.pdf](http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf).

<sup>4</sup>Islamic Financial Services Board, *Islamic Financial Services Industry Stability Report 2019* (Kuala Lumpur: Islamic Financial Services Board, 2019). [www.ifsb.org/download.php?id=5231&lang=English&pg=/index.php](http://www.ifsb.org/download.php?id=5231&lang=English&pg=/index.php).

<sup>5</sup>For a more detailed discussion of ESG issues, please refer to the CFA Institute publication "Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals." [www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx](http://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx). More resources are available at [www.cfainstitute.org/en/research/esg-investing](http://www.cfainstitute.org/en/research/esg-investing). For a more detailed discussion of Islamic finance, please refer to the CFA Institute Research Foundation publication *Islamic Finance: Ethics, Concepts, Practice*, by Usman Hayat and Adeel Malik (Charlottesville, VA: CFA Institute Research Foundation, 2014). [www.cfainstitute.org/-/media/documents/book/rlit-review/2014/rflr-v9-n3-1-pdf.ashx](http://www.cfainstitute.org/-/media/documents/book/rlit-review/2014/rflr-v9-n3-1-pdf.ashx).



**EXHIBIT 1. EXAMPLES OF ESG ISSUES**

Environmental Issues	Social Issues	Governance Issues
Water pollution	Data protection	Board composition
Air pollution	Diversity	Accounting standards
Biodiversity	Employee relations	Anticompetitive behaviour
Climate change	Government relations	Bribery and corruption
Deforestation	Community relations	Compliance

## SRI INVESTING AND ESG METHODS

SRI investing uses one or more methods to consider ESG issues across asset classes. It is also expected to take a longer-term investment perspective. Six main methods are used to consider ESG issues.<sup>6</sup>

### Exclusionary Screening

Exclusionary screening refers to avoiding securities of certain companies or countries on the basis of traditional moral values (e.g., excluding products or services involving alcohol, tobacco, or gambling) and on the basis of standards and norms (e.g., those pertaining to human rights and environmental protection). In values-based exclusions, the focus is on the company's business, and entire sectors are excluded. In norms-based screening, the focus is on the company's behaviour regarding internationally accepted norms in such areas as human rights and labour standards. When such values-based avoidance is built into the governing legislation (e.g., a ban on financing controversial weapons), exclusionary screening can also become a legal obligation.

### Best-in-Class Selection

Best-in-class selection refers to preferring companies with better or improving ESG performance relative to sector peers. It could be implemented on either the level of or the change in ESG performance—that is, investing more in companies with better ESG performance levels or momentum relative to sector peers. Best-in-class methodology is sometimes referred to as positive selection, positive screening, or positive alignment.

### Active Ownership

Active ownership refers to the practice of entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change. Active ownership is in sharp contrast to the idea that investors should vote with their feet—that is, simply sell off investments with questionable practices. A wide range of practices qualify as active ownership, such as voting in shareholder general meetings, writing a letter to the company, or issuing a statement to the news media.

### Thematic Investing

Thematic investing refers to investing that is based on trends, such as social, industrial, and demographic trends. A number of investment themes are based on ESG issues, including clean tech, green real estate, sustainable forestry, agriculture, education, and health.

### Impact Investing

Impact investing refers to investing with the disclosed intention to generate and measure social and environmental benefits alongside a financial return. According to the Global Impact Investing Network, the practice of impact investing has four core characteristics: (1) Investors intend to have a social and/or environmental impact, (2) investors use evidence and available data to drive investment design, (3) investors manage investments towards the intended impact through measures such as establishing feedback loops and communication of performance, and (4) investors with credible impact investing practices use shared industry terms, conventions, and indicators.<sup>7</sup>

<sup>6</sup>The definitions in this section come from "Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals." [www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx](http://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx).

<sup>7</sup>Global Impact Investing Network, "Core Characteristics of Impact Investing." [https://thegiin.org/assets/Core%20Characteristics\\_webfile.pdf](https://thegiin.org/assets/Core%20Characteristics_webfile.pdf).

## ESG Integration

ESG integration refers to systematic and explicit inclusion of ESG risks and opportunities in investment analysis. Unlike best-in-class selection, ESG integration does not necessarily require peer group benchmarking or overweighting (underweighting) the leaders (laggards). Similarly, ESG integration does not require any *ex ante* criteria for inclusion or exclusion. The integration of ESG risks and opportunities into investment analysis is relevant for most investors.

## ISLAMIC FINANCE

Islamic finance is finance that abides by the Islamic prohibitions regarding the purpose and structure of finance. Specifically, it must avoid financing prohibited businesses, and it must also abide by the Islamic prohibitions of *riba* and excessive *gharar*, which are generally understood to include lending money at interest and the sale of risk, respectively.<sup>8</sup> Consider a simple example: Islamic finance is not to be used to finance a brewery because the underlying activity—the consumption of alcohol—is prohibited by Islam. Similarly, the money cannot be used for lending money at interest (as is the case in a conventional bond) or the sale of risk (as in conventional derivatives). An idea strongly associated with Islamic finance is that financiers and those being financed need to assume risk associated with business outcomes or ownership of an asset. Where risk is to be managed through insurance, it should be done through a mutual risk-sharing arrangement. Since the 2008 global financial crisis, blamed on the excesses of the financial sector, Islamic finance has been saying the kinds of things many want to hear from the financial sector, such as making finance a servant, not the master, of the real economy where goods and services are produced.

## ISLAMIC FINANCE AND ESG METHODS

The ESG method most widely used in Islamic finance is exclusionary screening. To abide by Islamic prohibitions, all institutions in Islamic finance across all segments—banking, capital markets, insurance, and

microfinance—have to apply exclusionary screening regarding the primary business of the client entity. That is, Islamic finance must not provide financing to activities that Islam prohibits, such as business built on *riba*, excessive *gharar*, alcohol, pornography, or gambling. Therefore, conventional banking, insurance, breweries, casinos, and providers of adult entertainment are excluded.

In Islamic equity investing, further exclusionary screening is applied based on the proportion of impermissible income and the leverage of the companies. Generally, a threshold of 5% is used for income and 33% for debt. That is, the companies with impermissible income of more than 5% of total income or with a debt level more than 33% of book value or market capitalization are excluded.

The exclusionary screening in Islamic finance may vary depending on how the ratios are defined and calculated. In general, however, the screening is largely consistent across providers and jurisdictions.

Tobacco provides an interesting case in Islamic exclusionary screening. Unlike the consumption of alcohol and some other prohibited activities, tobacco consumption is not directly associated with a prohibition in the primary sources of Islam. It is included in the list of mandatory exclusions in modern Islamic finance, however, perhaps because of evidence establishing that smoking is harmful to health. The precedent of tobacco shows that Islamic exclusionary screening may continue to evolve with respect to ESG issues.

After the mandatory requirements have been met, the voluntary options begin. The entity then decides how and to what extent it applies other ESG methods, such as best-in-class selection or ESG integration.

## A HISTORICAL CONNECTION

The ideas associated with Islamic finance are not exclusive to Islam. They are found in other religions as well as in secular discourse on finance. A clear point of convergence in this regard is the prohibition of *riba*, which is shared by the other Abrahamic religions of Christianity and Judaism. As one study notes (p. 2), "Both Judaism and Christianity have, for example, banned the receipt and payment of interest for

<sup>8</sup>There is a great deal of debate in Islamic finance literature over what is meant by *riba* and *gharar*. To learn more about these concepts, please refer to the literature review published by CFA Institute Research Foundation entitled *Islamic Finance: Ethics, Concepts, Practice*, by Usman Hayat and Adeel Malik (Charlottesville, VA: CFA Institute Research Foundation, 2014). [www.cfainstitute.org/-/media/documents/book/rlit-lit-review/2014/rflr-v9-n3-1-pdf.ashx](http://www.cfainstitute.org/-/media/documents/book/rlit-lit-review/2014/rflr-v9-n3-1-pdf.ashx).



a significant period of time," although interpretations have varied.<sup>9</sup>

The origins of modern SRI investing can be traced to Christianity. Islam reveres Jesus as a prophet of God and sees him as a part of the same religious tradition from the first man and prophet, Adam, to the last, Muhammad. Therefore, the fact that an inherent historical connection exists between SRI investing and Islamic finance should come as no surprise.

More specifically, the history of SRI Investing is traced to the money management practices of the Methodists in the 18th century. The Methodists were followed by the Quakers, who sought to avoid investments in slavery and war. Their ideas were implemented by a mutual fund, the Pioneer Fund, which dates back to 1928.

SRI investing was developed before Islamic finance, and it established some key practices and structures, such as exclusionary screening and mutuality. These practices and structures have become part and parcel of modern Islamic finance. This is not a coincidence. Islamic finance has actively studied and employed the methods developed by SRI investing.

In the 1980s, several mutual funds were launched to consider the concerns of socially responsible investors. The Domini Social Index, made up of 400 primarily large-cap US companies, was launched in 1990. Within the same decade, in 1999, the Dow Jones Islamic Market Index was launched.

Mutual insurance companies, a classic form of SRI investing, existed in many countries before the initiation of modern *takaful* or Islamic insurance that uses mutuality. Royal London Group, established in 1861, is one such mutual insurance company. More than a century later, in 1979, the first Islamic insurance company was founded in Sudan. In fact, one of the pioneering experiments in modern Islamic finance, in Mit Ghamr, Egypt, in the 1960s was inspired by Germany's savings banks.

This historical connection between Islamic finance and SRI investing persists, and the time lag between innovation in SRI investing and its adoption in Islamic finance seems to be decreasing. The World Bank launched the first green bond in 2008. Within 10 years, in 2017, the first green *sukuk*, also known as an Islamic investment certificate or Islamic bond, was issued.<sup>10</sup>

The first social impact bond was launched in 2010, and the first SRI *sukuk* followed in 2015.

With the growth in impact investing, the Global Impact Investing Network was established in 2009. Seven years later, in 2016, the Global Islamic Finance and Impact Investing Platform was created by the Islamic Development Bank and the UNDP Istanbul International Centre for Private Sector in Development.

## Islamic or SRI or Both?

For financial services to qualify as both Islamic and SRI is entirely possible. Indeed, we shall discuss several examples later. Most SRI offerings in developed countries, however, are unlikely to meet Islamic criteria because they are not concerned with Islamic prohibitions. Lending money at interest and the trading of risk are not areas the SRI universe generally seeks to avoid. For instance, a conventional bank may rate highly as a sustainable bank, but it would not qualify as Islamic because of the prohibition of *riba*.

On the other side, although Islamic finance offerings are unlikely to qualify as SRI, this is not necessarily a given. A report on Islamic finance and impact investing published by the United Nations Development Programme points out (p. 30) that

even if an investment is made using structures ... that meet Sharia principles, that doesn't mean it's socially responsible or an impact investment. It simply means that the investment meets the criteria for Sharia compliance. Furthermore, not all Sharia compliant investing overlaps with responsible investing. For example, there is significant Islamic investing in extractive resources, just as there is significant conventional investment in this sector.<sup>11</sup>

Financial institutions familiar with taking ESG considerations into account may find offering Islamic financial services relatively easier. As two professionals working at one such investment firm in London explain (p. 66):

Our teams also took the view that there was a natural and pronounced alignment between responsible and Shariah values. Clearly, both approaches have a strong ethics foundation. Commonalities include a concern for human

<sup>9</sup>Natalie Schoon and Julinda Nuri, "Comparative Financial Systems in Judaism, Christianity and Islam: The Case of Interest" (1 June 2012). <https://dx.doi.org/10.2139/ssrn.2126503>.

<sup>10</sup>The word *sukuk* is plural in Arabic. Its singular is *sak*. However, in Islamic finance literature in English, it is mainly used as a singular. We have followed the English convention.

<sup>11</sup>United Nations Development Programme, *Islamic Finance and Impact Investing* (Istanbul: United Nations Development Programme, 2014).

rights and the environment, a focus on long-term sustainability and success, and an avoidance of aggressive leverage. By creating our responsible screen, we had already done much of the heavy lifting for populating a Shariah-compliant fund.<sup>12</sup>

Another case in point is the launch of the Dow Jones Sustainability Indices in 1999 and of the first global Islamic sustainability index by the same provider in 2006.

A research report on Islamic finance and ESG considerations states (p. 7) that ESG scores from more than 5,000 non-financial companies

suggest a direct correlation between Shariah compliance and higher ESG scores. Shariah-compliant companies—to which Islamic financial institutions will direct capital—have ESG scores that are on average 6% higher than for those excluded by the Shariah screening process. For non-financial companies, the difference rises to 10%. ESG scores for Shariah-compliant companies ranged from 3.0% higher for governance to 7.3% and 7.0%, respectively, for environmental and social issues.<sup>13</sup>

## ECONOMIC VALUE VERSUS MORAL VALUES

Investors consider ESG issues for various reasons. Some may see them solely as economic risks and opportunities, a source of economic value. Others may see ESG issues not just as risks and opportunities but also as a matter of moral values. A fundamental point in the "value versus values" debate is that what investors mean by economic value is usually quite similar but what they see as moral values may differ widely.

Those motivated by moral values may not wish to become complicit in actions they find objectionable, or they may actively attempt to make a positive impact on society or the environment. For instance, regardless of the economics of investing in the tobacco industry, an individual investor or a health-related charity may

find investing in tobacco unacceptable because smoking is harmful to one's health. But other investors may not share these concerns. They may invest in the tobacco industry if they believe it is an economically attractive investment, and they may look at ESG issues simply to complement their traditional financial analysis.

Investors who take into consideration ESG issues, whether motivated solely by economic value or moral values, or by a mix of both, may help bring positive change for society and the environment. For instance, regardless of their motivation, investors concerned about potential losses from health and safety risks at a company may engage with the company to change its practices for the better, which could result in better health and safety for its employees and vendors.

## FINANCIAL PERFORMANCE: COMPROMISE OR NOT?

Financial performance is one area that has received substantial, if not the most, attention in the research on ESG issues. The critical issue here is whether or not, compared with conventional finance, SRI investing or Islamic finance makes a compromise on financial performance. Those who expect this compromise point out that excluding assets based on moral values reduces the investable universe, which could lead to assuming more risk or earning lower returns. They also argue that anything other than a pure economic perspective, such as a desire to make a positive difference to society and the environment, is likely to affect performance.

In 2014, a report by the University of Oxford and Arabesque Partners analysed approximately 200 studies to assess how sustainable corporate practices can affect investment returns. It concluded (p. 48) that "88% of the studies show that solid ESG practices result in better operational performance" of firms and that "80% of the studies show that stock price performance is positively influenced by good sustainability practices."<sup>14</sup>

<sup>12</sup>Alice Evans and Jamie Jenkins, "From Responsible to Shariah Investing: Insights, Process and Performance," in *The Emerging Convergence of SRI, ESG and Islamic Finance*, 66–73 (Thomson Reuters, 2015).

<sup>13</sup>Refinitiv and RFI Foundation, "Islamic Finance ESG Outlook 2019: Shared Values." [www.refinitiv.com/content/dam/marketing/en\\_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf](http://www.refinitiv.com/content/dam/marketing/en_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf).

<sup>14</sup>Gordon L. Clark, Andreas Feiner, and Michael Viehs, "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance," University of Oxford and Arabesque Partners (March 2015). [https://arabesque.com/research/From\\_the\\_stockholder\\_to\\_the\\_stakeholder\\_web.pdf](https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf).

In 2015, a study published by Deutsche Bank's Asset & Wealth Management division on how ESG considerations affect corporate financial performance examined 2,250 academic studies from 1970 to 2014, concluding that ESG made a positive contribution to corporate financial performance in 62.6% of meta-studies and produced negative results in 10%, with the remainder being neutral.<sup>15</sup>

A 2015 study by Elroy Dimson, Oğuzhan Karakaş, and Xi Li documented engagements at 613 US public firms between 1999 and 2009. It shows that after successful engagement, firms' investment returns were higher on average than would have been expected without the engagement.<sup>16</sup>

In Islamic finance, financial performance has also received considerable attention. The number of studies is far less than is found in SRI investing, but the reports tend to point to a similar pattern of results.

In a study published by the International Monetary Fund in 2010, using data for eight countries for the period 2007–2009, Maher Hasan and Jemma Dridi suggest a differential impact of the global financial crisis on Islamic banks relative to their conventional counterparts. Although factors related to the business model of Islamic banks helped limit the adverse impact on profitability in 2008, weaknesses in risk management practices led to a larger decline in profitability in 2009.<sup>17</sup>

In a study published by the World Bank in 2010, using a large dataset from 1995 to 2007, Thorsten Beck, Asli Demirgüç-Kunt, and Ouarda Merrouche find that when comparing conventional and Islamic banks and controlling for other bank and country characteristics, there are few significant differences in business orientation, efficiency, asset quality, or stability.<sup>18</sup>

A study published in 2018 for which M. Kabir Hassan, Sirajo Aliyu, Andrea Paltrinieri, and Ashraf Khan reviewed 81 articles regarding mutual funds, sukuk, and equity investments says the findings are mixed, showing superior, par, and inferior financial performance.<sup>19</sup>

The key point is that, on the whole, the empirical evidence does not support the notion that ESG

considerations or Islamic finance restrictions adversely affect performance, even when exclusionary screening is applied.

## STANDARDS AND STANDARD SETTERS

A number of principles, standards, and conventions—and associated advocacy organizations—serve as a common reference point for investors considering ESG issues, including the Principles for Responsible Investment, the United Nations Global Compact, the Equator Principles, the OECD Guidelines for Multinational Enterprises, the International Labour Organization Declaration on Fundamental Principles and Rights at Work, SA8000 (auditable social certification standards for decent workplaces), and ISO 26000 (guidance on how businesses and organizations can operate in a socially responsible way). Some investors use these frameworks in applying ESG methods, such as exclusionary screening and active ownership. Others are likely to refer to them in ESG integration.

Organizations in different parts of the world are also working to promote ESG considerations in investing. These include the Global Sustainable Investment Alliance (including the Forum for Sustainable and Responsible Investment [US SIF] and the European Sustainable Investment Forum [Eurosif]), the Global Reporting Initiative, the Sustainability Accounting Standards Board, the World Resources Institute, the International Integrated Reporting Council, CDP (formerly the Carbon Disclosure Project), Accounting for Sustainability, the Global Impact Investing Network, and the International Corporate Governance Network.

These bodies' publications influence practices in both SRI investing and Islamic finance. The development of Islamic finance has also benefited from standard-setting bodies, most prominently, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 1990, and the Kuala Lumpur-based Islamic Financial

<sup>15</sup>"ESG & Corporate Financial Performance: Mapping the Global Landscape," Deutsche Asset & Wealth Management (December 2015). [https://qxasset.com/cfoinnovation/field/field\\_p\\_files/white\\_paper/Deutsche-AWM-ESG\\_and\\_corporate\\_financial\\_performance\\_mapping\\_global\\_landscape.pdf](https://qxasset.com/cfoinnovation/field/field_p_files/white_paper/Deutsche-AWM-ESG_and_corporate_financial_performance_mapping_global_landscape.pdf).

<sup>16</sup>Elroy Dimson, Oğuzhan Karakaş, and Xi Li, "Active Ownership," *Review of Financial Studies* 28, no. 12 (December 2015): 3225–68.

<sup>17</sup>Maher Hasan and Jemma Dridi, "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study," International Monetary Fund Working Paper No. 10/201 (September 2010). [www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf](http://www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf).

<sup>18</sup>Thorsten Beck, Asli Demirgüç-Kunt, and Ouarda Merrouche, "Islamic vs. Conventional Banking: Business Model, Efficiency and Stability," World Bank Policy Research Paper 5446 (October 2010). <http://documents.worldbank.org/curated/en/482731468333056240/pdf/WPS5446.pdf>.

<sup>19</sup>M. Kabir Hassan, Sirajo Aliyu, Andrea Paltrinieri, and Ashraf Khan, "A Review of Islamic Investment Literature," *Economic Papers* (September 2018): 1–36.

Services Board (IFSB), inaugurated in 2002. AAOIFI has a standard on corporate social responsibility known as "Corporate Social Responsibility, Conduct and Disclosure for Islamic Financial Institutions" that lays out mandatory and voluntary conduct and serves as a common reference point in Islamic finance.<sup>20</sup>

## DIFFERENCES

Having discussed the similarities and historical connection between SRI investing and Islamic finance, let us examine the salient differences.

### Size, Composition, and Geographic Concentration

Islamic finance is smaller than SRI investing, most of its assets are in commercial banking, and it is concentrated in 12 jurisdictions. According to the Islamic finance standard setter IFSB, Islamic finance assets are estimated to have surpassed the US\$2 trillion mark.<sup>21</sup> Most Islamic finance assets are in commercial banking (76%) and capital markets (23%), with less than 2% in *takaful*. Collectively, 12 jurisdictions account for 92% of the global Islamic banking assets, with the largest being Iran (34.4%), Saudi Arabia (20.4%), the United Arab Emirates (9.3%), Malaysia (9.1%), Kuwait (6.0%), and Qatar (6.0%).

According to the Global Sustainable Investment Review (p. 3) covering Europe, the United States, Canada, Japan, Australia, and New Zealand, "Globally, sustainable investing assets stood at \$30.7 trillion at the start of 2018."<sup>22</sup> The three largest regions were Europe, the United States, and Japan. Most of these assets are traced to asset managers and asset owners.

Clearly, a separation exists between SRI investing and Islamic finance in terms of core markets. A 2015 report by the Thomson Reuters Responsible Finance Institute on Islamic finance and responsible investing points out (p. 6):

Responsible finance has been dominated by Western markets where it has grown

dramatically but which should not overshadow the future growth potential in emerging markets. With a population of 1.65 billion Muslims, most of who[m] live in emerging markets across the Organisation of Islamic Cooperation (OIC) countries, there is a significant opportunity from offering products which conform to their values.<sup>23</sup>

A notable exception to the concentration of Islamic finance and SRI investing in different markets is the United Kingdom, where Islamic finance has had some presence since the 1980s. UK policymakers have had much success in accommodating Islamic finance to strengthen London's position as a global financial centre. The 2018 Islamic Finance Country Index ranks the United Kingdom 17th out of 48 countries, putting it first in Europe and first among non-Muslim-majority nations.<sup>24</sup>

### SRI Investing Becoming Increasingly Secular

Although the origins of SRI investing are in Abrahamic faiths, it has become increasingly secular. This change has been brought about by different factors, including the secularization of Western Europe, which is the heartland of modern SRI investing. The secularization of SRI investing has also come about with changing social values, which in some cases may be quite different from the values espoused by classic socially responsible investing. The emphasis in the discourse on modern SRI investing has shifted from exclusionary screening based on moral values. The issues that seem to receive more attention have moved from slavery, war, and apartheid to others such as gender diversity and climate change. On the other hand, Islamic finance remains deeply religious, focusing on exclusionary screening of "sin" industries and a prominent role for the subject matter experts in Islamic commercial jurisprudence, commonly known as the Shariah scholars. The narratives of Islamic finance and SRI investing are couched in relatively different vocabularies with different underlying priorities, signifying the cultural differences.

<sup>20</sup>AAOIFI Governance Standard 7.

<sup>21</sup>Islamic Financial Services Board, *Islamic Financial Services Industry Stability Report 2018* (Kuala Lumpur: Islamic Financial Services Board, 2018). [www.ifsb.org/download.php?id=4811&lang=English&pg=/index.php](http://www.ifsb.org/download.php?id=4811&lang=English&pg=/index.php).

<sup>22</sup>"2018 Global Sustainable Investment Review," Global Sustainable Investment Alliance. [www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR\\_Review2018.3.28.pdf](http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf).

<sup>23</sup>Thomson Reuters Responsible Finance Institute, *The Emerging Convergence of SRI, ESG and Islamic Finance* (Thomson Reuters, 2015).

<sup>24</sup>"Islamic Finance Country Index – IFCI 2017," in *Global Islamic Finance Report 2017*, edited by Humayon Dar and Sofiza Azmi, 47–67 (London: Edbiz Consulting, 2017). [www.gifr.net/publications/gifr2017/ifci.pdf](http://www.gifr.net/publications/gifr2017/ifci.pdf).

Compared with SRI investing, Islamic financial services exhibit greater consistency across countries. For example, Islamic equity funds around the world use quite similar exclusionary screening regarding business purpose and capital structure. In the SRI space, the values vary widely, and exclusionary screening based on capital structure is not a norm. That a financial institution might let its customers set its values is also possible; for example, The Co-operative Bank in the United Kingdom polls its customers and sets its ethics policy based on the values and ethics they prefer.<sup>25</sup>

## A Deeper Economic Thought Underlying Islamic Finance

Islamic finance was born out of Islamic economic thought, also referred to as Islamic economics—a relatively large body of literature in its own right.<sup>26</sup> It tends to criticize the free market versions of capitalism. Using an Islamic worldview, it seeks to identify ways and means to arrive at a more just economic order, one with less inequality and more stability than the present one. Those contributing to Islamic economic thought include economists trained at leading Western universities. Some of these contributors also have many years of experience working in multilateral banks. Their names often feature prominently in some of the voluminous publications on Islamic finance produced by these multilateral banks. These individuals and their works continue to influence the discourse on Islamic finance globally. A similar body of literature does not underpin SRI investing, which focuses more on financial decisions rather than the wider economy. Economists and critics of capitalism in the West who are working on alternative economic systems tend not to have strong links and direct association with SRI investing the way their counterparts developing Islamic economic thought are linked to and associated with Islamic finance.

## SHARED CHALLENGES

Islamic finance and SRI investing share some key challenges.

### Authenticity versus Scale

Just as the charge of putting legal form over economic substance is pervasive in Islamic finance,<sup>27</sup> the charge of "green washing" is rampant in SRI investing.<sup>28</sup> Claims of being green in SRI investing or based on risk-sharing principles in Islamic finance often are not supported by details about the offerings. The problem has reached such an extent that in April 2019, Hong Kong's Securities and Futures Commission announced new disclosure requirements for ESG funds, demanding they explain how they take ESG considerations into account.<sup>29</sup>

The industry reports from both Islamic finance and SRI investing seem overly focused on the size of and growth in assets that are labelled Islamic or SRI by the offering institution. Whether the growth is in fact achieving the intended objectives seems to receive much less attention. Understandably, despite all the challenges in collecting global data, counting assets under management is far easier than measuring outcomes. A trade-off must be made, however, between authenticity and scale. A report published by CFA Institute notes the concern (p. 2) "that ESG mutual funds and ETFs [exchange traded funds] offered to investors may be driven by marketing decisions and may not be true ESG investment products."<sup>30</sup> In 2016, after 10 years of existence, the Principles for Responsible Investment (PRI) commissioned an evaluation by a third party, which noted (p. 4):

Ultimately, the success of the PRI will not be measured by its ability to engage the investor world in dialogue about change, but by its ability to influence their investment practices. And the impact this has on the lives of current

<sup>25</sup>See The Co-operative Bank's ethical policy at [www.co-operativebank.co.uk/assets/pdf/bank/aboutus/ethicalpolicy/ethical-policy.pdf](http://www.co-operativebank.co.uk/assets/pdf/bank/aboutus/ethicalpolicy/ethical-policy.pdf).

<sup>26</sup>See, for example, Asad Zaman, "Islamic Economics: A Survey of the Literature," University of Birmingham Religions and Development Research Programme, Working Paper No. 22 (1 June 2008). <https://ssrn.com/abstract=1282786> or <http://dx.doi.org/10.2139/ssrn.1282786>.

<sup>27</sup>Usman Hayat, "Islamic Finance Is Growing Fast but Faces the Form-Versus-Substance Debate," *Enterprising Investor* blog (11 June 2013). <https://blogs.cfainstitute.org/investor/2013/06/11/islamic-finance-is-growing-fast-but-faces-the-form-versus-substance-debate-video>.

<sup>28</sup>See, for example, Cecile Lefort and Jonathan Barrett, "Ethical Investment Tide Lifts 'Greenwash' Concerns," Reuters (1 April 2017). [www.reuters.com/article/us-investment-ethics-idUSKBN174016](http://www.reuters.com/article/us-investment-ethics-idUSKBN174016).

<sup>29</sup>Securities and Futures Commission, "SFC Publishes Guidance on Enhanced Disclosures for Green or ESG Funds" (11 April 2019). [www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=19PR28](http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=19PR28).

<sup>30</sup>Matt Orsagh, James Allen, Justin Sloggett, Sofia Bartholdy, Anna Georgieva, Nabylah Abo Dehman, and Yulia Sofronova, *ESG Integration in Europe, the Middle East, and Africa: Markets, Practices, and Data* (Charlottesville, VA: CFA Institute, 2019).



and future generations, and indeed on the planet itself.<sup>31</sup>

In a similar vein, a detailed report on Islamic finance in 2016 published by the World Bank and the Islamic Development Bank Group noted (p. 3),

To live up to the ideals of Islamic finance, Islamic banks face many challenges, ranging from the gap between the prevalence of debt-based instruments and the aspirations of financing predominantly through equity and risk sharing, to the need for increased social capital, and to the challenges of creating an enabling regulatory framework.<sup>32</sup>

## An Unhelpful Academic Narrative

The traditional economic narrative that has found a permanent home in many a finance textbook is unhelpful to both SRI investing and Islamic finance. In these textbooks, finance is meant to be values-free, and environmental and social issues or ethical values are mostly conspicuous by their absence. A search for key terms such as "ESG issues" in some of the popular corporate finance textbooks may return no results.

Neoclassical economics assumes an investor is rational in a particular way, such as mean-variance rational in the capital asset pricing model. This scenario is surely not observed in reality but remains pervasive in textbooks. As per the Modigliani-Miller theory, a company's capital structure is irrelevant when reality may suggest otherwise. Moreover, the efficient market hypothesis suggests financial assets are fairly priced and that markets have already discounted the available information on ESG risks and opportunities.

Such textbooks continue to popularize the idea that business's social responsibility is to maximize its profits, as the economist Milton Friedman contended in the early 1970s.<sup>33</sup> Over the years, the idea of shareholder wealth maximization has been extended to the alignment of incentives. That is, top management of companies should be offered financial incentives (e.g., stock ownership and call options)

to align their interests with maximizing stock price. Some criticize such ideas and the methods used to put them into practice for exacerbating short-termism and inequality.<sup>34</sup> The consideration of ESG issues and alternative economic paradigms, such as the ideas underlying Islamic finance, are more likely to become mainstream when they are given due coverage in the academic narrative.

## Debt Favoured over Equity

The 2008 global financial crisis hurt millions of households, costing them their jobs, homes, and savings. Excessive debt is held as a root cause of the crisis. But debt also turned out to be the principal cure. That a cure could be the same as the disease is rather puzzling. Perhaps unsurprisingly, global debt levels have been rising since the global financial crisis. Researchers at the International Monetary Fund note that nominal global debt reached an all-time high of US\$184 trillion in 2017, the equivalent of 225% of GDP, and the private sector's debt has tripled since 1950, "mak[ing] it the driving force behind global debt."<sup>35</sup> The corporate tax systems continue to favour debt over equity by allowing tax deductibility of interest but not the return to equity. Regulations, such as capital adequacy requirements, also make offering equity financing more difficult and costly for the providers of capital. The dominance of debt over equity poses a huge challenge to Islamic finance in practicing its cherished principle of risk sharing. It also poses a challenge to SRI investing because higher levels of debt pose a risk of economic instability with potential adverse impacts on society and the environment.

## THE ETHICAL BRIDGE: AVOID HARM, DO GOOD

There is an ethical bridge between Islamic finance and SRI investing. It is built upon a shared concern about society and the environment as well as a historical connection.

<sup>31</sup>Steward Redqueen, "From Principles to Performance: An Independent Evaluation of the PRI's Achievements and Challenges at Ten Years" (April 2016). [https://10.unpri.org/wp-content/uploads/2016/04/PRI-final-report\\_-single-pages.pdf](https://10.unpri.org/wp-content/uploads/2016/04/PRI-final-report_-single-pages.pdf).

<sup>32</sup>World Bank Group, *Global Report on Islamic Finance: Islamic Finance—A Catalyst for Shared Prosperity?* (Washington, DC: World Bank and Islamic Development Bank Group, 2016).

<sup>33</sup>Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *New York Times Magazine* (13 September 1970). <http://umich.edu/~thecore/doc/Friedman.pdf>.

<sup>34</sup>See, for example, Usman Hayat, "Shareholder Value Maximization: The World's Dumbest Idea?" *European Investment Conference* blog (23 October 2014). <https://eic.cfainstitute.org/2014/10/23/shareholder-value-maximization-the-dumbest-idea-in-the-world>.

<sup>35</sup>Samba Mbaye and Marialuz Moreno Badia, "New Data on Global Debt," *IMF Blog* (2 January 2019). <https://blogs.imf.org/2019/01/02/new-data-on-global-debt>.



Historically, similarities between Islamic investing and SRI investing are most visible with respect to traditional faith-based, socially responsible investing in the United States that used similar exclusionary screening on similar industries. But we also find modern examples of financial services providers who have been able to create offerings that both meet Islamic prohibitions and take into account ESG considerations. Let us look into some of these.

A notable example is Amana Mutual Funds in the United States, which also happen to be among the largest equity funds in Islamic finance.

According to the funds' literature, these funds seek companies that demonstrate both Islamic and sustainable characteristics. The funds' literature defines sustainable issuers as those that are more established, consistently profitable, financially strong, and following robust ESG policies.<sup>36</sup>

SEDCO Capital, one of the largest asset managers in Saudi Arabia, combines traditional Islamic screening with modern ESG considerations. It describes this as its Prudent Ethical Approach and believes that it leads to financial outperformance.<sup>37</sup>

Some examples of sukuk meet advanced ESG criteria. In 2017, a green sukuk was issued in Malaysia, raising US\$59 million to finance a solar power plant. The sukuk was issued under Malaysia's SRI sukuk framework and endorsed by the Shariah Advisory Council of the Securities Commission. The issue benefited from an independent review and a "dark green" rating by the Centre for International Climate and Environmental Research in Oslo, Norway. This pioneering green sukuk in Malaysia was followed by two more green sukuk in the same year.<sup>38</sup>

The government of Indonesia issued its first Islamic green sovereign sukuk in early 2018, raising more than US\$1 billion. Green projects under this green sukuk refer to those that promote transition to a low-emission economy and climate-resilient growth, including

climate mitigation, adaptation, and biodiversity conservation.<sup>39</sup>

The International Federation of Red Cross and Red Crescent Societies is reportedly working with the Islamic Development Bank to issue sukuk as part of its fundraising for a water, sanitation, and hygiene programme to fight cholera and other such diseases.<sup>40</sup>

Some financial services providers in Organisation of Islamic Cooperation (OIC) countries have signed on to ESG frameworks. A 2017 PRI paper notes the following (p. 3):

The main drivers of signatory growth in OIC countries are the strong alignment of social objectives in responsible investment and Islamic finance, and the additional financial value of integrating environmental, social and governance (ESG) factors into investment processes—which can be combined with Sharia screening.<sup>41</sup>

The paper goes on to list nearly 20 OIC institutions that had become signatories to the PRI.

Some Islamic banks are following practices that are aligned with modern notions of sustainable banking. For example, a study comparing Islami Bank Bangladesh Limited and Triodos Bank, which is headquartered in the Netherlands, notes that Islami Bank is ahead of other Islamic banks in Bangladesh in terms of financial inclusion, microfinance, small and medium-sized enterprise (SME) financing, and green banking while still being financially stable and profitable. Nevertheless, it lags behind Triodos, a prominent name in sustainable banking, in some respects.<sup>42</sup>

In Malaysia, CIMB Group, which includes CIMB Islamic, is a founding member of the United Nations Environment Programme Finance Initiative Principles for Responsible Banking. It has been listed on the Thomson Reuters Diversity & Inclusion Index as one of its top 100 most diverse and inclusive organisations

<sup>36</sup>See [www.saturna.com/](http://www.saturna.com/).

<sup>37</sup>See [www.sedccapital.com/](http://www.sedccapital.com/).

<sup>38</sup>Malaysian ICM, *Bi-Annual Bulletin on the Malaysian Islamic Capital Market by the Securities Commission Malaysia*, vol. 12, no. 2 (July–December 2017). [www.sc.com.my/api/documentms/download.ashx?id=1316fd32-1993-44cb-9669-5d5687adda35](http://www.sc.com.my/api/documentms/download.ashx?id=1316fd32-1993-44cb-9669-5d5687adda35).

<sup>39</sup>Securities Commission Malaysia and World Bank, *Islamic Green Finance Development, Ecosystem and Prospects* (March 2019). <http://documents.worldbank.org/curated/en/591721554824346344/pdf/islamic-green-finance-development-ecosystem-and-prospects.pdf>.

<sup>40</sup>International Federation of Red Cross and Red Crescent Societies, "One WASH Sukuk Concept Note" (May 2019). <http://media.ifrc.org/innovation/wp-content/uploads/sites/9/2019/07/One-Wash-Concept-note-May2019.pdf>.

<sup>41</sup>Principles for Responsible Investment, "Islamic Finance and Responsible Investment," Islamic Finance Position Paper (13 July 2017). [www.unpri.org/download?ac=1887](http://www.unpri.org/download?ac=1887).

<sup>42</sup>Tariqullah Khan and Amirah Bint Raffick Nabee Mohamed, "Ethical Banking and Islamic Banking: A Comparison of Triodos Bank and Islami Bank Bangladesh Limited," *Islamic Economic Studies* 25, no. 5 (April 2017): 111–54.

globally, and it claims to have integrated Bank Negara Malaysia's Value-Based Intermediation principles into its key businesses and sustainability strategies.<sup>43</sup>

Jordan Islamic Bank has a Social Responsibility and Sustainability Committee of the bank's board of directors. It also has a second such committee at the level of executive management. It has published a social responsibility report every year since 2012 that covers a range of initiatives in areas such as renewable energy, SME financing, and financial inclusion.<sup>44</sup>

Bank Nizwa, a fast-growing Islamic bank in Oman, has distinguished itself by embedding social and economic empowerment in its financing and by enabling its staff to participate in charitable activities such as food distribution, blood donations, and beach cleanups.<sup>45</sup>

Ethis, an Islamic crowdfunding platform geared toward positive social impact, matches investors directly with property development in Indonesia. It claims that its thousands of ethical members from more than 60 countries provide funding for social housing development projects in Indonesia. Ethis reports that during its two years of operations, investors have been earning an average of 10% to 16% on their investment and that every home that is built "helps a family break out of poverty."<sup>46</sup>

These examples illustrate that providers of financial services can create offerings that will qualify as both Islamic and SRI investing.

## Outlook on Convergence

In the coming years, several factors favour greater consideration of ESG issues in Islamic finance, such as increasing awareness about these issues in general, greater provision of ESG data by mainstream data providers, more use of ESG data by rating agencies, the economic rise of Muslim millennials, growing legal and regulatory requirements and guidelines regarding ESG issues, support for ESG considerations from multilateral banks, and of course, customer expectations.

Doing more on ESG issues is helpful to Islamic finance in addressing the criticism levelled against it for putting legal technicalities of Islamic commercial jurisprudence over economic and moral substance. Islamic finance has been learning and will continue to learn from developments in SRI investing and will adapt accordingly. The reverse—that is, SRI investing adopting Islamic finance conservatism—is less likely to happen because the financial conservatism built into Islamic finance prohibitions does not feature prominently among the priorities of SRI investing customers and providers in its core markets. That said, the better Islamic finance becomes at managing ESG issues, the more likely it is to be accepted as a part of SRI investing.

## CONCLUDING THOUGHTS

SRI investing and Islamic finance seek to meet the financial needs of customers, perform well financially, and offer better outcomes for society and the environment than conventional finance. The two, however, have core markets in different parts of the world, and there are some conceptual differences between them. Therefore, only limited examples are currently available of financial services that meet criteria underlying both. SRI investing predates modern Islamic finance and was developed in the most advanced economies in the world; that it is setting the standards regarding ESG considerations is therefore understandable. Islamic finance was born of Islamic economics, which seeks a more just and stable economic system, including financial system. As a result, providers of Islamic finance are inherently expected to both abide by Islamic prohibitions and voluntarily take ESG considerations into account. A systematic and substantive consideration of ESG issues in Islamic finance is likely to enhance its value proposition and strengthen its bridge with SRI investing.

<sup>43</sup>CIMB Group Holdings Berhad, *Sustainability Report 2018* (Kuala Lumpur: CIMB Group Holdings Berhad, 2018). [www.cimb.com/content/dam/cimbgroup/pdf-files/annual-reports/CIMB18\\_SustainabilityReport.pdf](http://www.cimb.com/content/dam/cimbgroup/pdf-files/annual-reports/CIMB18_SustainabilityReport.pdf).

<sup>44</sup>Jordan Islamic Bank's annual social responsibility reports are available at [www.jordanislamicbank.com/en/content/social-responsibility](http://www.jordanislamicbank.com/en/content/social-responsibility).

<sup>45</sup>For more information on Bank Nizwa, see [www.banknizwa.om](http://www.banknizwa.om).

<sup>46</sup>Ethis website, accessed 17 October 2019, <https://ethis.co/id>.

## AUTHOR

### Usman Hayat, CFA

Usman Hayat, CFA, is the first CEO of Audit Oversight Board in Pakistan, an independent regulator of audit firms. Previously, he was executive director at the Securities and Exchange Commission of Pakistan, where he headed the Islamic finance department and the systemic risk department. Before that, based in London, Mr. Hayat was a content director (Islamic Finance and Environmental, Social, and Governance Issues in Investing) for CFA Institute. He is the lead author of *Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals* and *Islamic Finance: Ethics, Concepts, Practice*. Mr. Hayat is the content director of the CFA Institute online course "ESG Investing" and one of the two authors contracted to write *Islamic Finance: A Very Short Introduction* for Oxford University Press.

## CONTRIBUTOR

Afzaal Ahmad, Research Assistant

## CFA INSTITUTE STAFF CONTRIBUTORS

Rhodri Preece, CFA, Senior Head, Industry Research

Steve Wallace, CAIA, CDDA, Director of Outreach, Middle East and North Africa

William Tohmé, CFA, Senior Regional Head, Middle East and North Africa

Gary Baker, CFA, Managing Director, Europe, Middle East, and Africa

## ISLAMIC FINANCE WORKING GROUP

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Qutaiba Hawamdeh, CFA, CIPM—CFA Society Jordan and Chair of the Islamic Finance Working Group

Basma Aljar, CFA—CFA Society Bahrain

Bogdan Bilaus, CFA, CIPM—CFA Institute Presidents Council Representative, Middle East and Africa

Geoffrey Ng, CFA—Member of the Board of Governors, CFA Institute

Mahmoud Nawar, CFA—CFA Society Bahrain

Mohamed AlHameli, CFA—CFA Society Emirates

Mohamed Fahim, CFA—CFA Society Doha

Mohammad Shoaib, CFA—CFA Society Pakistan

Tarek Hazim, CFA—CFA Society Kuwait

Vivek Suman, CFA—CFA Society Oman

Zaineb Sefiani—Carrera Learning



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