CMi2i RESEARCH & INSIGHTS

FIXED INCOME ESG INVESTING: OPPORTUNITIES & CHALLENGES FOR SUKUK ISSUERS

AN EXPLORATION OF THE RELATIONSHIP BETWEEN SUKUK AND ESG INVESTING

SUKUK ISSUERS: OPPORTUNITIES & CHALLENGES IN ESG INVESTING

INTRODUCTION

Many investors are unaware that Islamic finance and ESG investing share similar principles - particularly being a good steward to society and the environment.

In fact, ESG and Sharia-compliant investments are complementary investment and capital-raising approaches that should converge over time.

ESG investing is growing fast. Issuance is expected to approach $1 trillion this year and issuers of sukuk bonds should not only look at ESG investing as an additional source of investment but also to raise the issuer's profile within the global financial markets. This is particularly important for those issuers that wish to attract a more geographically diverse investor base (over 60% of Islamic fixed income funds are based in Saudi Arabia and Malaysia) (*Source*).

ISLAMIC FINANCE & ESG INVESTING - THE SIMILARITIES

The main similarities between Islamic finance and ESG investment relate to the exclusion of certain industries. Shariah prohibits investments in tobacco, alcohol, pork, pornography, weapons, gambling, human trafficking and other products and activities that are deemed unlawful (haram). As such, any Shariah-compliant product is screened to avoid these industries. This practice closely resembles the screens applied by ESG investors as they also avoid similar activities and products to ensure that their portfolios align to their principles and goals. Furthermore, environmental issues that play a key part in ESG investments are also consistent with the fundamental principles of Shariah.

Overall, there are three common types of ESG screening generally used by fixed income investors:

1) Negative/exclusionary screening or absolute rules: Exclusion of certain sectors or companies based on specific ESG criteria (e.g. exclude tobacco, cluster munitions, alcohol, pornography, weapons, gambling); or apply relative rules (e.g. exclude companies that produce 10% or more of their revenues from tobacco); or simply prohibit companies that violate international norms.

2) Positive/Best-in-class screening: Selection of the best sectors or companies based on positive ESG performance relative to peers.

3) Norms-based screening: Screening companies against minimum ESG standards (*Source*).

Like with Islamic finance, active ownership is often part of ESG strategies. This is done to mitigate risks, enhance returns and improve ESG performance and disclosure of companies/issuers. Therefore, as Islamic investors pursue sustainable risk-adjusted investment returns, they are likely to unintentionally integrate ESG factors and screens.

ISLAMIC FINANCE AND ESG INVESTING – THE DIFFERENCES

Besides the cultural and religious distinctions that separate Islamic finance and ESG investing, the biggest difference is that security lending and shorting is prohibited within Islamic finance but not in ESG investments. While security lending is not as widespread within the fixed income world as it is among equities, it is still worth highlighting. It is also important to note that a sizable portion of ESG investors do not partake in these activities or require to be able to vote on shareholder resolutions so once again, Islamic finance and ESG investment appear to be closer than conventional investment management (*Source*).

Finally, another major difference is in their overall goals: while Islamic finance aims to invest in accordance with Shariah, ESG criteria within fixed income is ultimately used to analyse and establish issuer creditworthiness. This means that while these two worlds are converging, one cannot replace one with the other and some distinctions will always continue.

ESG INTEGRATION WITHIN ISLAMIC FINANCE – THE STATUS QUO

Despite their natural affinity, ESG integration within Islamic finance is in its early stages and far behind that of conventional finance. Some progress has been made but several challenges remain, including the lack of standardisation and general understanding of ESG, especially when it comes to reporting. When issuers do report, it is often to mitigate the reputational risk associated with poor ESG performance. This is despite large sections of the Islamic market, including energy, banking, and real estate, being well suited to ESG integration.

The main driving forces behind this integration are international investors and local regulators. The increase in demand for ESG by international investors continues to raise awareness around ESG while regulators can and have started to make it economically beneficial for issuers and investors to integrate the two. The current focus of regulators in the Middle East has been on environmental issues (e.g. UAE Energy Strategy 2050 and Saudi Vision 2030) spurred by their need to tackle climate change, but this is starting to change with the Malaysian government, for example, now paying for the cost of third-party checks for issuers of SRI green bonds (*Source*).

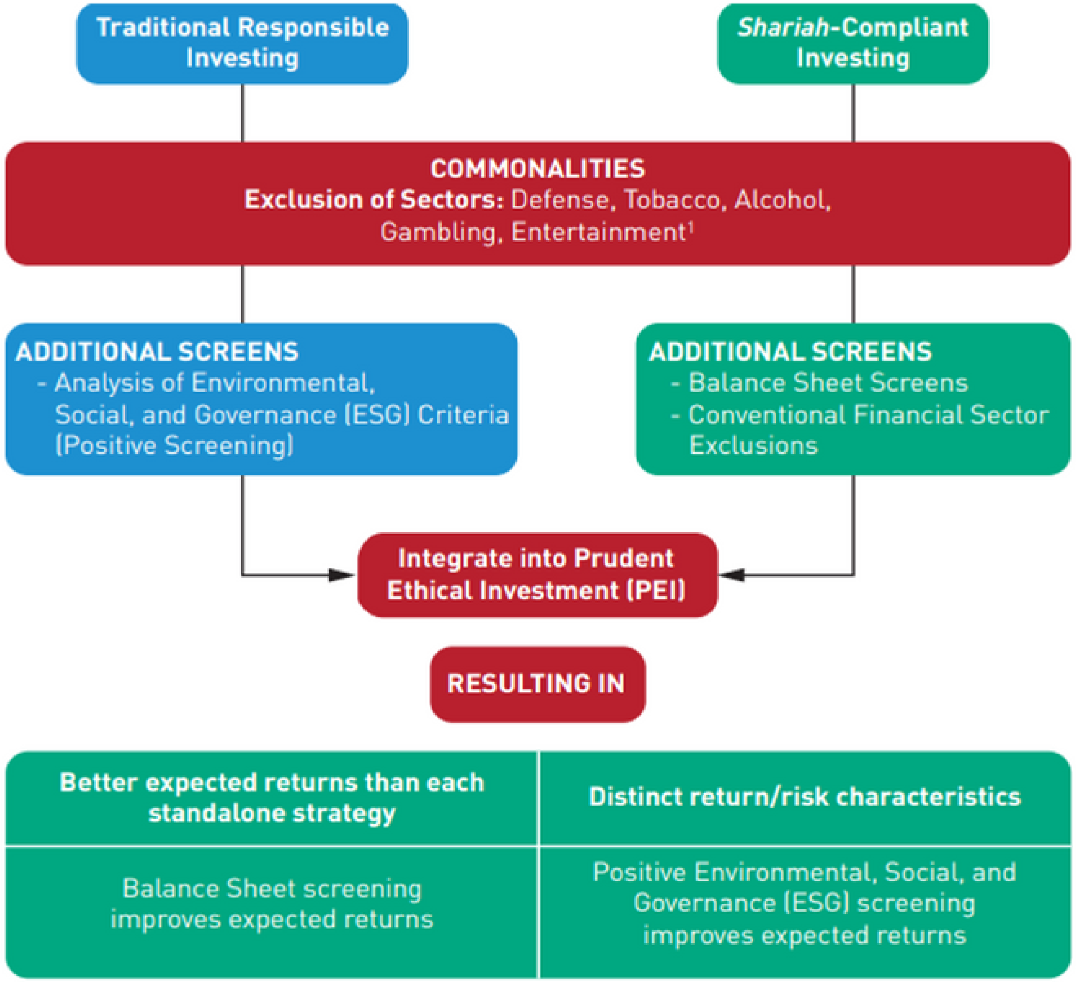

FIG. 1 Integration of ESG investment screenings and Shariah compliant investing

Source

Despite the challenges mentioned earlier, it has become clear to sukuk issuers and investors that being included and covered by research and rating providers opens many doors and raises an issuer's profile. The inclusion of sukuk into standard benchmarks, for example, did exactly that so there is no doubt that issuers covered by ESG research and rating providers will see their profile increase internationally (*Source*).

WHAT SHOULD SUKUK ISSUERS KNOW ABOUT ESG INVESTMENTS

Sukuk issuers hoping to attract ESG investment can follow two routes:

1) Issue ESG certified sukuk bonds that are ESG certified such as green sukuks, or,

2) Engage with ESG investors without having issued ESG-labelled bonds.

The first option is an obvious choice and despite the costs involved appears to become more popular. Since 2015, global ESG bond issuance has grown exponentially and it is expected that ESG debt issuance will reach $1trillion by the end of the year (*Source*).

The second option is a good stepping-stone for issuers that are new to the world of ESG and that cannot or do not have the resources to issue green bonds. It simply requires issuers to engage with ESG investors highlighting the issuer's ESG credentials and how a sukuk can meet investors' ESG requirements. Unknown to many issuers, ESG investors do not simply invest in green or social bonds but are able to invest in any type of bonds that meet their ESG screening criteria. In a previous paper, CMI2i has examined the level of ESG investment in non-ESG labelled bonds and discovered that these funds already represent a significant portion of European corporate bonds; roughly 8% of the EUR35.7 billion sample (*Source*). There is no reason why the same couldn't happen in the sukuk market, especially given the synergies between Islamic finance and ESG investments.

Issuers choosing this second route should, however, be aware that fixed income ESG investments are more concentrated than conventional investors, with a quarter of ESG investors in non-ESG labelled bonds accounting for almost 80% of total investments (*Source*). This means that it is especially important for any corporate wishing to tap into this new source of capital to carefully plan their investor outreach and carry out a detailed and planned targeting exercise.

CONCLUSION

The rise of ESG investments opens substantial opportunities for issuers of sukuk bonds that want to diversify their investment base and find additional sources of capital and not just for green sukuks. As shown in this paper, the similarities between Islamic finance and ESG investment all favour sukuk issuers, but it is up to these issuers to actively target ESG investors with a compelling investment narrative.

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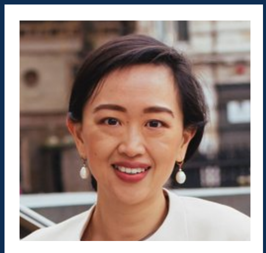

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