ISLAMIC FINANCE AND THE MISSION TO NET ZERO

BACKGROUND

The 26th United Nations Climate Change Conference of the Parties (COP26) summit held in Glasgow in November 2021, for the first time, targeted fossil fuels as the key driver of global warming. Over 130 countries committed to a net zero impact on climate within the next 50 years, with India committing to net zero emissions by 2070. This commitment moves the world closer to the key objectives of the summit: **secure global net zero by mid-century and keep the average global temperature to 1.5 degrees Celsius within reach; adapt to protect communities and natural habitats; mobilise finance** to secure global net zero; and work together to deliver the implementation of the Paris climate agreement commitments (United Nations, 2021). However, to achieve the set objectives, some of the following issues prevail post summit: a systematic approach to reimburse damages from climate change; prioritising countries with high sea levels; and addressing the increasing frequency of extreme disasters. What is generally the role of the financial sector and particularly Islamic finance in facilitating the efforts towards the net zero emissions target? This article focuses on the expectations, responsibilities, achievements and challenges for Islamic finance with reference to green sukuk.

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FINANCIAL SECTOR RESPONSES TOWARDS CLIMATE CHANGE

The World Bank's research indicates that climate change may push over 130 million people worldwide into poverty by 2030 and cause over 200 million people to migrate by 2050 (Walsh, Rozenberg & Hallagatte, 2020). COVID-19 alone has pushed about 150 million people into extreme poverty in 2021. These trends combined will affect people who are already marginalised and further increase the inequality gap. The financial sector is expected to play a significant role in supporting a more sustainable future transition through financial and market inclusion and infrastructure development that is sustainable and in compliance with the environmental, social and governance (ESG) parameters.

In response to the efforts to mitigate the global climate crisis through the commitments made at the Paris Agreement, the European Union (EU), Association of Southeast Asian Nations (ASEAN) Taxonomy Board and several countries including Malaysia have issued taxonomies for sustainable activities, as depicted in Figure 1.

These initiatives, among others, have embraced the inclusion of Islamic financial institutions and Shariah-compliant businesses to align their business models with a low-carbon future. Non-compliance to these initiatives may result in legal, economic and social impacts that will affect the competitiveness and survival of these institutions.

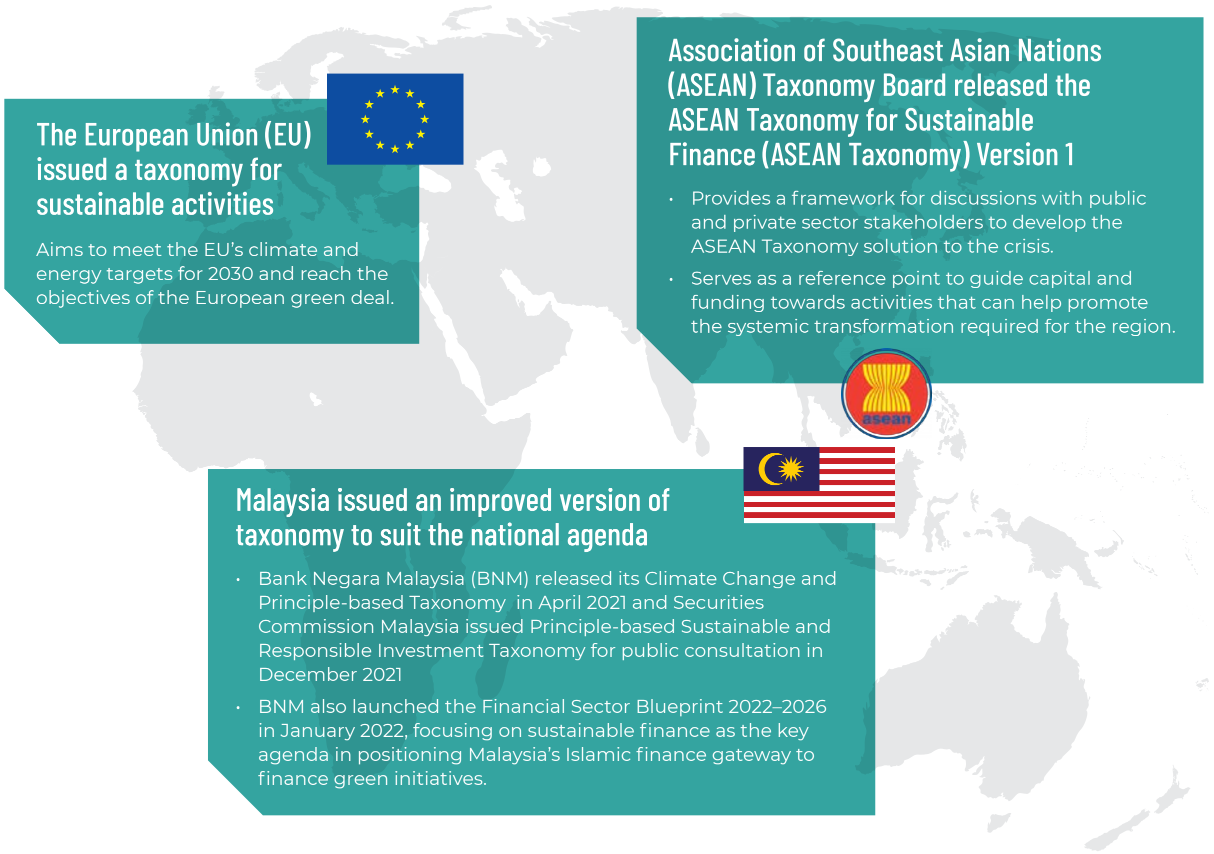

Figure 1: Some Taxonomies Issued for Sustainable Activities Worldwide

Sources: European Commission (2021); ASEAN (2021); BNM (2022); Securities Commission Malaysia (2021)

ISLAMIC FINANCE AND SUSTAINABLE FINANCE

Islamic finance and sustainable finance share similar values in providing financial support to protect the environment and fund sustainable development projects. The protection of the environment is consistent with the protection of wealth under the objectives of the Shariah. In addition, several Qur'anic verses and *hadith* emphasise the need to care for the environment and the forms of life that Almighty Allah has created on earth, including the proper usage of natural resources. Allah mentions:

'Corruption has appeared in both land and sea, because of what people's own hands have brought. So that they may taste something of what they have done...' (Qur'an, 30: 41)

Prophet Muhammad (SAW) said:

'The world is beautiful and verdant green, and Allah appoints you to be His regents in it, and will see how you acquit yourselves...' (Muslim, *hadith* no. 2742).

In another *hadith*, the destruction of plants and trees without legitimate cause is prohibited. Prophet Muhammad (SAW) said:

'He who cuts a lote-tree [without justification], Allah will send him to Hellfire' (Abu-Dawud, *hadith* no. 5239).

Several Sustainable Development Goals (SDGs) are in consonance with the Shariah requirements developed over 1400 years ago. For example, the protection of wealth under the objectives of Shariah may be measured through several SDGs: Goal 6–Clean water and sanitation; SDG Goal 7–Affordable and clean energy; SDG Goal 11–Sustainable cities and communities; SDG Goal 12–Responsible consumption and production; SDG Goal 13–Climate action; SDG Goal 14–Life below water; and SDG Goal 15–Life on land.

Thus, the objectives of Shariah and the relevant SDGs are to maintain, sustain and conserve resources of sea, land and space coupled with the promotion of economic growth, industrialisation, the safety of cities, cooperation among all, and sustainable consumption patterns.

Additionally, impact reporting in green and sustainable finance that assists in monitoring and governance aligns with the principles of transparency, fairness, equality and ethics in Islamic finance. The prohibition of uncertainty (*gharar*) in Islamic finance obligates all parties to be transparent in financial reporting and disclosure. This is in line with the Green Bond Principles (GBP) introduced by the International Capital Market Association (ICMA), which requires detailed explanations of the utilisation of proceeds before and after the green bond issuance.

The integration of 'green' and sustainability in Islamic finance is a 'natural' fit. But how far has Islamic finance effectively integrated sustainability principles in its role towards net zero emissions? The issuance of green sukuk is an effort of the Islamic finance industry to support renewable and clean energy projects. The IFSB (2020) anticipates green sukuk issuance to accelerate in the coming years as part of efforts to tackle climate change and achieve SDG targets.

Malaysia and Indonesia have been leading in green sukuk issuances.

While Malaysia issued the first corporate green sukuk in 2017, Indonesia released the first sovereign green sukuk in 2018 (Securities Commission Malaysia, 2019).

Figure 2: Challenges in Green Sukuk
Source: Authors' own

Since then, green sukuk have also been issued by other jurisdictions such as the UAE and Saudi Arabia. Total green sukuk issuances in 2019 exceeded USD3 billion (2.4 per cent of all sukuk for the year) and increased to USD10 billion in 2020. This growth trajectory can be maintained if the fundamental challenges depicted in Figure 2 are overcome. These challenges would restrict the proliferation of green sukuk and thus affecting the Islamic finance industry's contribution to net zero.

WAY FORWARD

Several concerns and recommendations arise in the Islamic finance industry's new effort to move towards net zero:

1. Islamic finance is often criticised for appealing to religious sentiment to make a profit. Whether green sukuk is another avenue for attracting more funds from Islamic investors or an effort to effect positive change is still to be determined. Embracing international benchmarks, standardising data and its analysis, and integrating more socially driven assessments will help reduce exploitation.

2. Will underlying assets be categorised as green for the sake of scoring points with regulators or enticing investors without really making an impact on greenhouse gases? External reviewers who provide independent verification about the quality of the framework and governance capabilities of green sukuk can minimise the risk of greenwashing. The issuance of the taxonomy, such as SC's principles-based SRI Taxonomy (Securities Commission Malaysia, 2021), may also provide clarity and guidance to capital market actors when identifying sustainable investment assets or activities.

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3. The global practice of emphasizing on Shariah compliance before sukuk issuance only raises the question of green and Shariah compliance from issuance to maturity. Will the green sukuk market move the industry to more consistent monitoring and review until maturity to ensure holistic compliance is achieved? Will Shariah scholars integrate sustainability as part of the compliance criteria when approving sustainability projects? This is still an unknown.

4. Most of the major CO2 emitters in the Islamic finance world have not made a significant effort for carbon set-offs using green sukuk or similar instruments. Are these countries really committed to effect change using the ideals of Islamic finance? Transition sukuk (similar to transition bonds) may be the interim solution to moving these countries from brown to green projects.

Islamic finance can be scaled up significantly to support the world to achieve net zero and has the potential to accelerate the transition to a greener, more inclusive and resilient growth path. To achieve this, regulators, issuers and investors must strategise to enable more Islamic finance jurisdictions to issue green sukuk by providing skills support, joint issuances and generally a more unified Islamic finance net zero emissions strategy.

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