

# How socially responsible investing can help bridge the gap between Islamic and conventional financial markets

Michael S. Bennett and Zamir Iqbal  
The World Bank Treasury, Washington, DC, USA

## Abstract

**Purpose** – Islamic finance and socially responsible investing (SRI) have been two of the most rapidly growing areas of finance over the last two decades. During this period, they have each grown at rates that far exceed that of the financial markets as a whole. The purpose of this paper is to find similarities and commonalities of both markets and identifies how both could benefit from each other.

**Design/methodology/approach** – The paper takes a comparative approach in comparing and contrasting two markets. The paper reviews the progress and driving forces in both markets and makes policy recommendations.

**Findings** – Islamic finance has grown at a very impressive rate over the last two decades, but the Islamic fixed income market remains under-developed. SRI has become an increasingly common investment strategy during that same time period, but there is still insufficient supply of SRI fixed income instruments. The convergence of these two facts creates the opportunity for a fixed income product to be developed that could appeal to both SRI and Shariah (Islamic Law) compliant investors, and thereby serve as a bridge between the Islamic and conventional financial markets. The paper believes the product that could play this role is Sukuk for which the proceeds are used to fund economic development.

**Research limitations/implications** – The paper takes a view from a financial expert's point of view which could be different from the scholars of Islamic legal system.

**Practical implications** – The paper provides an innovative view to two different markets and suggests that there are commonalities which need to be exploited for the benefit of both markets.

**Originality/value** – This is probably the first known attempt to related SRI financing to Islamic financing particularly Islamic capital markets.

**Keywords** Islamic finance, Socially responsible investments, Sukuk, Capital markets, Islam, Finance Paper type  
Conceptual paper

## I. Introduction

Islamic finance and socially responsible investing (SRI)[1] have been two of the most rapidly growing areas of finance over the last two decades. During this period, they have each grown at rates that far exceed that of the financial markets as a whole. Moreover, judged by the number of new products that are introduced in a given week or by the number of conferences or seminars that are held, most financial professionals could attest that the growth trend line for both Islamic finance and SRI appears to continue to point upwards.

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Although the principles of Islamic finance go back several centuries, its practice in modern financial markets only became recognized in the 1980s, and only began to represent a meaningful share of global financial activity around the beginning of this century. Over the last two decades, by some estimates, the total volume of Islamic financial assets has grown by 15-20 percent a year and now exceeds US\$1 trillion.

Similarly, SRI is a concept that has precedents that go far back into history, but that only coalesced as a recognized investment strategy in the 1980s, and only developed significant size during the last two decades. In the USA, some commentators have estimated that the total volume of assets held by explicitly SRI investors now exceeds US\$3 trillion, having increased by more than 30 percent just since 2005[2]. SRI has grown at a comparable rate in Europe, with estimates that e5 trillion of assets in Europe are subject to some kind of socially responsible mandate[3].

Islamic finance and SRI share several commonalities including that they are focused principally on individuals using their money in a manner that conforms to their morals and beliefs. Whereas finance traditionally has been driven solely by the effort to maximize risk adjusted returns, Islamic and SRI investors have added an additional objective for financial market activity – compatibility with the investor’s ethics and promotion of social-welfare activities. Although both types of investors seek to achieve a strong return on their investments, they take into account not only the pure economic return, but also the social returns the society receives from their money being used in compliance with their beliefs. In addition, the growth of both Islamic finance and SRI has been largely demand-driven, with financial institution devoting more resources to these two areas in response to the increasing demand from individual investor clients for these products.

Islamic finance and SRI share another similarity as well. To date, they both have been focused, within the capital markets sphere, more on equity than on fixed income investments. The fundamental principles behind Islamic finance, such as an emphasis on equitable sharing of risks and the prohibition of interest based financing, are most easily compatible with investing in equities. Likewise, SRI traditionally has been a strategy applied mainly to equity investing through the application of various types of portfolio screening techniques. As a result, financial intermediaries have found it easier and more straight forward to create Shariah compliant and SRI equity products than fixed income ones.

With equity products having been well-established, practitioners of both Islamic finance and SRI are increasingly turning their attention to developing the fixed income side of the capital markets. This convergence of interest in fixed income creates a clear opportunity. Given their similar histories and similar focus on ethics, it should be possible to create fixed income products that meet the needs and demands of both types of investors. Such products could then become a useful bridge to connect the conventional and Islamic markets.

In this article, we will look at the growth of the Islamic finance and SRI markets. We will then demonstrate how the SRI community could learn lessons from Islamic finance, and how Shariah compliant investors can benefit from advancements that have been made in the SRI market. Finally, we will analyze the opportunity for socially responsible Sukuk to become the “bridge” product that links the Islamic and conventional financial markets. A lack of Shariah compliant fixed income type instruments is often cited as an obstacle to further growth of Islamic capital markets, and a lack of appropriate fixed income instruments is often cited an obstacle to growth of the SRI market. Therefore, the development of socially responsible Sukuk could benefit both markets simultaneously, expanding the universe of Sukuk issuers and Sukuk buyers while at the same providing the SRI community with a new kind of ethical fixed income instrument.

## II. Growth of Islamic finance and the Sukuk market

Islamic finance has experienced significant growth in last couple of decades. Following on from the significant developments that have occurred in what we view as the core area for this market, the predominantly Muslim countries, we are now witnessing the globalization of Islamic finance. In recent years, we have seen significant interest in Islamic finance in the world’s leading conventional financial centers, including London, New York and Hong Kong, and Western investors are increasingly considering investment in Islamic financial products.

The growth of this market has been driven both by the high demand for Shariah-compliant products as well as the increasing liquidity in Gulf region due to high oil revenues. Figure 1 shows the growth trend in Islamic finance for both the banking and capital markets sectors from 2006 to 2010 (Deutsche Bank, 2011; IIFM, March, 2012; Ernst & Young, 2011). Figure 2 shows how the growth of the Islamic financial sector has bypassed the growth of conventional financial sector in all segments of the market ranging from commercial banking, investment banking, fund management, and insurance in several Muslim-majority countries (Deutsche Bank, 2011).

Efforts to develop and launch a Shariah-compatible bond-like security were made in Jordan as early as 1978, when the government allowed the Jordan Islamic Bank to issue Islamic bonds known as Muqaradah bonds. This was followed by the introduction of the Muqaradah Bond Act of 1981. Similar efforts were made in Pakistan, where a special law called the Mudarabah Companies and Mudarabah Flotation and Control Ordinance of 1980 was introduced. However, neither of these efforts resulted in any significant activity, because of the lack of proper infrastructure and transparency in the market. Another attempt to develop an “Islamic

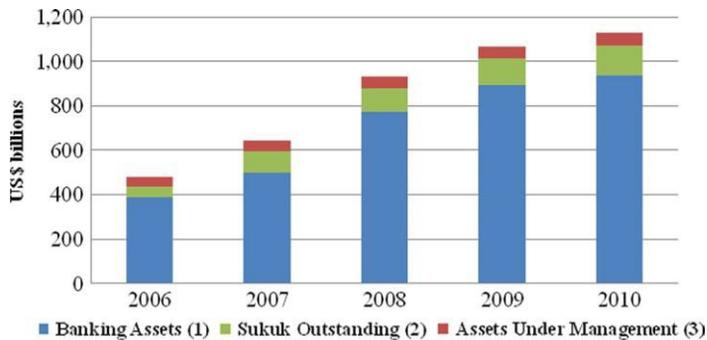


Figure 1. Global Shariah-compliant financial assets

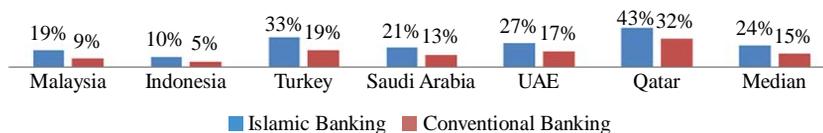


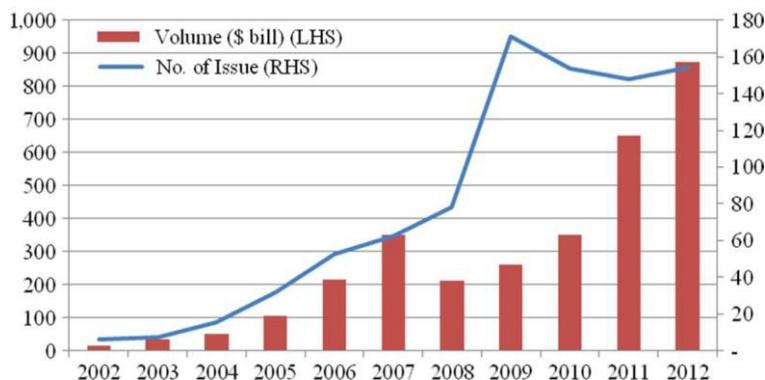
Figure 2. Growth of Islamic banking and conventional banking assets in selected countries (2006-2010)

bond” market was launched in Malaysia in 1983, with the issuance of the Government Investment Issues (GII) – formerly known “Government Investment Certificates (GIC).” However, an active market for such securities never developed.

Meanwhile, the success of asset securitization in the conventional markets provided a framework that eventually was applied to Islamic assets as well. In a conventional securitization, the cash flows generated by an underlying pool of assets or a set of underlying transactions are transferred to a special purpose vehicle that then issues interest-bearing securities backed by those cash flows (Schwarcz, 2010). Applying those same basic principles to Islamic assets, a tradable, asset-backed security in the form of a Sukuk was developed in Bahrain and Malaysia. By the late 1990s, this structure had attracted the attention of potential issuers (borrowers) and the investors and a general consensus had developed among Islamic finance practitioners that Sukuk was the right vehicle to develop the fixed income side of the Islamic capital markets. A Sukuk is a certificate that represents the right to receive payments from an underlying asset or business venture. Unlike a conventional bond, however, that represents an interest-bearing debt, Sukuk create participation rights in assets or ventures based on various types of contracts recognized under the principles of Islamic law[4].

Figure 3 shows total number of Sukuk and their volume over the last ten years which is testimony to rapid growth and recovery of this market. The Sukuk market has been used by both public (sovereign and quasi-sovereign) and corporate sector. Tables I and II list the total number of Sukuk issued and the size of Sukuk issuance by different sector[5]. Compared to conventional finance, where in most markets sovereign issuance predominates, the Sukuk market has seen less activity by sovereigns. This lack of

Figure 3.  
 Total Sukuk  
 issuance(2002-2012)



Source: IFIS

Table I.  
 Number of Sukuk  
 issuance by issuer  
 type

	2006	2007	2008	2009	2010	2011	2012
Sovereign	101	139	245	250	218	233	306
Quasi-sovereign and supranationals	15	23	24	46	21	25	40
Corporate	178	187	166	654	616	565	512
Total	294	349	435	950	855	823	858

regular sovereign issuance poses a problem for the development of the market, as the lack of high quality government Sukuk hinders the establishment of benchmarks that can be used to price corporate issuers.

The Sukuk market suffered a slowdown in issuance during 2008 and 2009 due to the global financial crisis and the resulting economic slow-down, but the market re-bounded in 2010 and has continued to grow at a strong pace with record issuance in 2012. Despite such high growth, at less than \$200 billion, the volume of total outstanding Sukuk is a drop in a bucket compared to global bond markets of approximately \$30 trillion[6].

Figure 4 shows breakdown of Sukuk issuance by country. It is obvious from this chart that Malaysia dominates the market. One reason for such dominance is the strong domestic demand for Sukuk in Malaysia as well as the long-standing efforts of the government to promote Sukuk issuance and establish the country as a principal center for Islamic finance.

Table III provides a break-down of the Sukuk market by currencies in each sector. Although Sukuk have been issued in several currencies, two currencies, US dollars and Malaysian ringgit, dominate all sectors. Sukuk issuance in US dollar caters to both conventional and Islamic investors as well as to domestic and foreign investors, while issuance in Malaysian ringgit is intended mainly for domestic Malaysian investors.

Conventional financial markets have developed hypothetical portfolios in form of indices to serve as benchmarks for different asset classes, markets and sectors. An index is often used as benchmark to represent risk-return characteristics of well-defined markets. Such index is used by portfolio managers to manage portfolios and to measure their performance against such index. Leading index provides include Dow Jones, S&P,

	2006	2007	2008	2009	2010	2011	2012
Sovereign	13,189	19,631	21,188	28,093	39,221	83,193	94,068
Quasi-sovereign and supranationals	10,717	7,528	5,914	11,183	7,450	6,750	15,881
Corporate	15,436	35,548	11,241	8,127	16,505	27,392	46,984
Total	39,343	62,708	38,342	47,402	63,176	117,335	156,934

Table II.  
Total Sukuk issuance  
by issuer type (\$ mil)

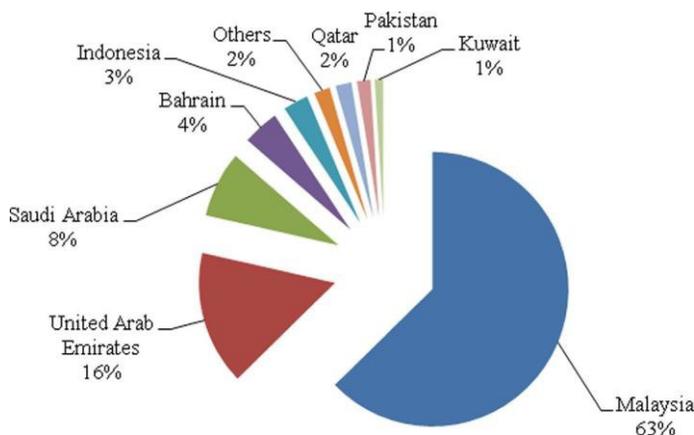


Figure 4.  
Cumulative Sukuk  
issuances (1996-2010)

Currency	2006	2007	2008	2009	2010	2011	2012
<b>Sovereign</b>							
USD	480	1,623	350	3,050	6,304	19,700	10,450
MYR	12,038	16,996	19,340	21,674	28,447	48,392	76,102
BHD	318	553	366	770	673	1,521	1,612
BND IDR	354	294	257	417	472	781	1,103
PKR	–	–	508	1,071	1,853	1,378	2,379
Others	–	166	159	364	1,029	1,840	1,259
Total	–	–	208	746	444	9,581	1,164
	13,189	19,631	21,188	28,093	39,221	83,193	94,068
<b>Corporate</b>							
USD	2,941	9,095	490	500	4,055	9,865	8,745
MYR	11,667	23,113	5,424	6,798	11,150	12,775	30,154
SAR	800	2,100	1,874	393	374	2,014	2,999
SGD	–	–	–	102	74	38	65
IDR	–	35	70	155	22	23	145
PKR	29	862	206	178	9	45	22
Others	–	343	3,177	–	821	2,632	4,853
Total	15,436	35,548	11,241	8,127	16,505	27,392	46,984
<b>Quasi-sovereign and supranationals</b>							
USD	7,770	2,700	1,300	3,450	500	850	4,358
MYR	2,792	1,209	2,587	5,532	3,214	4,694	5,728
SAR	–	1,333	–	1,867	1,900	–	4,000
SGD	–	–	–	21	1,094	–	–
IDR	22	111	96	91	87	–	116
PKR	134	133	78	82	–	–	–
Others	–	2,042	1,852	141	654	1,206	1,680
Total	10,717	7,528	5,914	11,183	7,450	6,750	15,881

FSTE, and several renowned investment banks. With the development of Sukuk market, several indices have been introduced in the market since 2005. Dow Jones partnered with Citigroup to introduce early version of indices while HSBC partnered with NASDAQ, Dubai to offer a family of Sukuk indices.

Introduction of Sukuk index is very positive development and should encourage professional fund managers to offer portfolio management services. However, due to several reasons, the growth in this area is below expectation due to several reasons. First, the supply of Sukuk is limited which impacts the flexibility of constructing diversified indices. Second, there are very few sovereign Sukuk which carry high rating, i.e. AAA. Sovereign Sukuk are essential for the markets as these issuances serve as benchmark for pricing risks and thus prices of risky securities. Third, due to low liquidity, index replication turns out an expensive exercise. Finally, an index is supposed to be a transparent representation of the market but due to low supply and low liquidity, the performance of Sukuk indices may not reflect the performance of the market.

### III. The growth of SRI

Like Islamic finance, SRI has its roots in religious doctrine, and specifically the objective, pursued by practitioners of many religions, to use their money in a way that is compatible with their religious beliefs. In the Western world, Christian theology includes a focus on the individual's moral responsibility to use money consistent with

one's faith[7]. Similarly, passages of the Jewish Talmud support using investment to promote ethical activities and achieve social good (Biema, 2008). These religious prescriptions have impacted individual investment decisions for centuries. Early examples of this type of proto-SRI activity include the refusal of certain religious groups to support "sinful" industries, such as slave-trading, or to trade in products seen as "sinful," such as guns or alcohol.

In the 1960s and 1970s, SRI began to grow beyond such an explicitly religious context to encompass a wide range of objectives. These objectives were often expressed in the form of investment boycotts, for example with respect to companies involved in the war in Vietnam or in trade with apartheid-era South Africa. Such efforts were generally focused on a single issue and were motivated by a desire to achieve a specific political goal. It has only been over the past few decades that SRI has grown beyond that type of single issue focus and come to be recognized as a comprehensive investment strategy in its own right.

SRI investors now include a large number of asset managers, pension funds, university endowments, foundations, religious institutions and individual investors. The types of issues that are of concern to SRI investors include human rights, labor relations, environmental practices and corporate governance. Some SRI investors are focused on one of these issues in particular, while others take into account a variety of such issues. In making investment decisions, these investors overlay a qualitative analysis of a company's policies or practices in the specific area or areas of concern to the investor onto their quantitative analysis of the company's financial condition and prospects. Some investors apply such a SRI strategy to their entire portfolio, while others use a SRI strategy only with respect to certain segments of their portfolio or portion of their assets under management.

Traditionally, the most common type of strategy employed by SRI investors has been referred to as "negative screening," which simply involves not purchasing securities issued by companies that fail to meet the investor's standards in certain areas[8]. The types of companies that are excluded by negative screens typically include those involved in the manufacture of tobacco or alcohol, as well as casino operators, defense contractors and companies with poor environmental records. Over the last decade, however, more SRI investors have begun to employ positive screening techniques, actively searching out for investment companies that the investor considers to be having a beneficial social or environmental impact. This more proactive SRI philosophy is often referred to as "impact investing[9]."

Impact investing mitigates one of the criticisms that has been leveled against the traditional negative screening based form of SRI investing – that it is susceptible to companies making only minor, public relations oriented changes to their business practices in order to avoid being excluded by a SRI screens. This practice, which is often referred to as "greenwashing" (Laufer, 2003), involves, for example, a corporation publishing positive environmental or social reports on its activities without any external verification or way for a SRI investor to benchmark such activities against actions taken by other similar companies. An impact investor is looking to fund efforts to achieve specific and measurable economic or social changes, and therefore, absent outright fraud, a company cannot meet the requirements imposed by impact investors merely through effective public relations. The funding provided by impact investors must actually be put to work in the manner specified in the fund raising documents.

In the capital markets, SRI strategies mainly have been applied to equity investing. In the USA alone hundreds of equity mutual funds now exist that invest, partially or entirely, subject to a SRI mandate. In contrast, use of SRI strategies for fixed income investing has been more limited, with one of the principal obstacles being a lack of supply. The majority of corporate and sovereign bonds are general, unsecured obligations of the issuer, meaning the use of the proceeds of the bonds is not restricted to a particular purpose. Most SRI investors that are considering investing in bonds want to know precisely how their money will be used. Bonds that are general obligations of issuer, therefore, have limited appeal to SRI investors unless all of the activities of the issuer meet the investor's social, governance and environmental standards.

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In recent years, however, the development of SRI fixed income products has begun to accelerate. The World Bank, for example, has issued since 2008 a type of bond it calls a World Bank green bond. Rather than funding all of the activities of the World Bank, the proceeds of World Bank green bonds only go to support certain projects that meet pre-determined criteria for low carbon development[10]. World Bank green bonds are ideal fixed income investments, therefore, for SRI investors who are focused on climate change and the protection of the environment. Likewise, a number of funds that seek to make positive societal impacts through their investments have been created in recent years, investing in areas as diverse as low-income housing in South America and clean energy in Asia and Africa[11].

Although there is still an insufficient supply of SRI fixed income instruments, products like World Bank green bonds are feeding the growth of the fixed income side of SRI. Europe, in particular, has seen the focus of its SRI market moving from equity to fixed income, with bonds now representing just over half of all assets managed by European asset managers that use SRI strategies.

The adoption of SRI investment strategies over the past two decades has increased, and continues to increase, at a pace that far outstrips the growth of investment assets as whole. In the USA, for example, it has been estimated that assets managed under a SRI mandate increased by more than 380 percent between 1995 and 2010, while professionally managed assets as a whole increased by 260 percent[12]. Given the current focus of the international press on issues of concern to SRI investors, such as climate change, the labor and environmental practices of multinational companies and, in the wake of the financial crisis, corporate governance, we expect that interest in SRI will continue to grow, and consequently that the total volume of SRI assets will continue to increase into the foreseeable future at a rapid rate.

#### **IV. The relevance of Islamic finance to SRI**

It is widely recognized that the central economic tenant of Islam is to develop a prosperous, just and egalitarian economic and social structure in which all members of society irrespective of their beliefs and religious affiliations could maximize their intellectual capacity, preserve and promote their wealth, and actively contribute to the economic and social development of society. Economic development and growth, along with social justice, are the foundational elements of an Islamic economic system. All members of an Islamic society must be given the same opportunities to advance themselves; in other words, a level playing field, including equitable access to natural resources.

The concept of development in Islam had three dimensions: individual self-development, the physical development of the earth, and the development of the human collectivity, which includes both. In Islam all three dimensions of development assign heavy responsibility on individuals and society, with both held responsible for any lack of development. Balanced development is defined as balanced progress in all three dimensions (Abbas and Askari, 2010). This is supposed to be achieved by following the objectives of the tenets of Islamic Law commonly known as *maqasid-e-Shariah* which includes the goals to preserve the public good (*maslahah*). The objective of the *Shariah* is to promote the well-being of all mankind, which lies in safeguarding their faith (*din*), their human self (*nafs*), their intellect (*`aql*), their posterity (*nasl*) and their wealth (*mal*). Whatever ensures the safeguard of these five serves public interest and is desirable (Dusuki and Abdullah, 2007).

The purpose of the above background is to emphasize that the economic and financial system driven by social-welfare and socially-responsible mandate will lead to financial dealing and transactions with built-in preservation of social values. This feature of Islamic financial instrument should be attractive to the investors in the conventional SRI market. A comparison of top ten constituents of S&P 500 Shariah Equity Index and Domini 400 Social SM Index shows significant overlap (six out of ten) of the constituents (Stanley and Jaffery, 2009) and illustrates the point that there are more commonalities than the differences.

Islamic financial industry is perceived as a market where economic agents avoid dealing with interest but the ethical and socially responsible element of the system is often ignored and or not well-understood. The feature of prohibition of interest could itself attract some non-Muslim investors who are opposed to excessive use of debt and leverage. Social aspects of the Islamic financial instruments could be attractive to SRI markets due to the following reasons:

- Islam's approach to social responsibility has two aspects. One aspect is to prohibit activities deemed damaging to the society and the social order while the other aspect is through commanding humans to undertake activities promoting economic justice and ensuring protection of the rights of less fortunate segments of the society. Following these principles, Islamic finance will shy away from financing of any businesses involved with activities such as gambling, pornography, production of alcohol, and other unethical businesses. On the other hand, Islamic finance would encourage financing of businesses engaged in environment friendly practices and socially responsible behavior.
- Islam's emphasis on developing more inclusive financial system and enhancing the access to finance would promote more effective micro-finance. Islam's instruments of distribution and re-distribution would provide cost-effective financing to poor so that they get a fair opportunity to participate in the economic activities and thus contributing to economic development (Mohieldin et al., 2011).
- Islamic finance puts great emphasis on preserving the rights of all stakeholders of a business. Based on the Islam's principles of property rights and contracts, a stakeholder who has any implicit or explicit contractual agreement with the business could influence the decision-making. As a stakeholder-centric as opposed to shareholder-centric governance structure, a business would be conscious of every stakeholder's rights and obligations whether the stakeholder is an employee, customer, local community, or environment.

#### **V. How SRI investment can inform Islamic finance**

Shariah compliant investors can be viewed as a unique sub-set of the SRI community. Like all SRI investors, Shariah compliant investors demand that their investments not only be attractive in economic terms but that they meet certain non-financial criteria as well. In the case of Shariah compliant investors, those non-financial criteria involve compliance with Islamic law and principles.

Viewed in this light, it is natural that developments in SRI investing should also inform the development of Islamic finance. Although Islamic law imposes unique structural requirements on the types of investments that Shariah compliant investors can make, on the broad question of how money can best be put to use in support of an investor's values, advancements in SRI investing should have relevance for Islamic finance.

One of the most important recent developments in SRI investing has been the move to actively search out and support certain types of activities with their investment money, as opposed to relying on negative screens. In other words, instead of simply avoiding investing in industries that do not meet their standards, more SRI investors are looking for ways to actively promote social change through investing in activities and industries they support.

Islamic finance also traditionally has relied heavily on negative screening. Shariah compliant equity funds, for example, have grown significantly through screening and filtering of stocks of businesses deemed unethical and devoid of social-welfare, such as gambling and alcohol. Likewise, on the fixed income side of the market, negative screening has been the pre-dominant strategy (which, in the case of fixed income, means primarily screening products for payments that represent interest). While negative screening ensures Shariah compliant investors that their money will not support activities or structures prohibited by their religion, these investors have not been given many opportunities to affirmatively support activities they believe in through their investments.

There are a great number of areas that seem likely to appeal to large segments of the Islamic finance community, such as funding economic development in poorer Islamic-majority countries. The conventional capital markets have been used to channel investment to development projects in poor countries for decades. The World Bank pioneered this use of the conventional capital markets when it issued its first bond in 1947. The World Bank, and other supra-national institutions, issue bonds and use the proceeds of those issues to fund projects in developing countries[13]. However, to date, very few Shariah-complaint products have been developed that give investors the opportunity to invest in such activities. We believe the lack of supply of such products is largely a result of a lack of clearly expressed demand from investors.

As long as the Islamic finance market remains driven principally by the concept of negative screening, such demand will remain latent. What is required for such products to develop is for Shariah compliant investors to make the same transition as conventional SRI investors and begin to demand products that allow them to affirmatively express their beliefs. In other words, what is needed is for Islamic investors to become proactive “impact investors.” Given the development of Islamic finance since the 1970s has been largely investor driven, we believe that the product supply side of the Islamic finance market certainly would respond to this kind of investor demand.

A move to more positive investment strategies would also mitigate a concern that is sometimes expressed about Islamic finance that it can seem overly formalistic and rule-bound. Particularly with respect to the fixed income side of the market, some commentators have expressed the view that, in practice, Islamic finance has been overly focused on the replication of conventional products in forms that merely meet the formal requirements of Islamic law. In other words, the objective of the supply side of the market is simply to mimic conventional fixed income products through structures that do not involve interest payments rather than to create products that affirmatively respect the ethical and socially conscious nature of the underlying Islamic scripture[14].

Such a criticism of Islamic finance mirrors in many respects the criticism of traditional, negative screening based form of SRI that it is susceptible to “greenwashing.” In other words, the concern securities issuers can evade negative screens simply by taking certain formulaic, public relations-based actions, such as publishing environmental reports. Impact investing strategies are largely immune to such criticisms since they demand specific disclosure of how the money invested will be used.

Were significant numbers of Shariah compliant investors to demand opportunities to invest in a way that proactively promotes community development and positive social change in furtherance of their religious beliefs, Islamic finance would become more immune to such criticisms. If, in other words, Shariah compliant investors became impact investors, the focus of Shariah compliance would shift to encompass both the structure of a product and the ethical nature of the use of the proceeds of the product. As a result, not only would Shariah compliant investments not violate Islamic religious principles, they would affirm those principles through the impacts the investments were having on society.

## **VI. SRI Sukuk as a bridge between conventional and Islamic finance**

To date, there has been only limited overlap between the conventional and Islamic financial markets. Although many Muslim investors buy both conventional and Shariah-compliant products, very few non-Muslims purchase Shariah compliant instruments. In fact, the divide between the two markets in some ways has been growing wider in recent years. The Qatar Central Bank, for example, issued a directive in 2011 preventing conventional banks from continuing to operate Islamic branches and windows to avoid the possible commingling of Islamic and conventional assets and liabilities.

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We do not believe, however, there is anything intrinsic to Islamic financial products that make them inappropriate for non-Muslim investors. Although the structures and terminology will be unfamiliar at first, Shariah compliant instruments can be attractive to non-Muslims if they offer reasonable risk-adjusted returns and are properly marketed. Their appeal should be particularly strong for Western institutional investors who generally have little financial exposure to the Islamic world and could reap immediate portfolio diversification benefits by investing in Shariah-compliant products.

Greater acceptance of Shariah compliant financial products among non-Muslims will take time, but we believe the continued growth of the SRI philosophy among conventional investors can help accelerate this process. The underlying tenets of Islam emphasize social justice and welfare in all economic transactions, and SRI investors share many of the same concerns. Both Muslim and non-Muslim SRI investors are looking for their investments to make a positive impact on their societies.

Therefore, Shariah-compliant products that are focused on producing specific, socially positive impacts could be a vehicle to begin to bridge the gap between conventional and Islamic finance by attracting non-Muslim SRI investors into the Islamic finance market.

The Shariah-compliant product that we believe would most likely appeal to non-Muslim SRI investors is a Sukuk where the proceeds are used to fund a specific sustainable development project. Sukuk are well-suited to serve as a bridge product between Islamic and conventional finance for a number of reasons. First, the structuring of Sukuk is a rigorous process overseen by several stakeholders, including prominent Shariah scholars who review each proposed Sukuk to ensure that the tenets of Islam are not violated in any way. This ensures that Sukuk do not finance any activity considered harmful to the society. As a result, the Sukuk structuring process can be seen as having a kind of built-in SRI due diligence process that should be appealing to SRI investors.

Second, because the payments on a Sukuk that are generated from the underlying asset or venture can be structured in a way that is similar to the interest and principal payments on a conventional bond, traditional fixed income investors will find Sukuk familiar from a cash flow perspective. Although the structure of Sukuk will be new to conventional investors, they should be able to value and account for Sukuk using much the same methodology and systems that they use for their existing fixed income portfolio[15].

Third, Sukuk are appropriate for SRI investors because they provide investors with a high degree of certainty that their money will be used for a specific purpose. In order to comply with the underlying Shariah principles, the funds raised through the issue of a Sukuk must be applied to investment in identifiable assets or ventures. Therefore, if a Sukuk is structured to provide funds to a specified development project that is appealing to SRI investors, such as a renewable energy project or a low-cost housing program, there is little chance the investors' money will be diverted and used for another purpose.

Fourth, many more SRI investment products exist on the equity side of the capital markets than on the fixed income side (Greil-Castro, 2010). In fact, among major asset classes, by some estimates, fixed income trails both public equities and private equity in terms of the number of products that are available for SRI investors. This lack of investment opportunities has meant that SRI fixed income investors often have been forced to choose between having a well-diversified portfolio and having a portfolio that meets all of their SRI criteria. Since Sukuk is most similar to a conventional fixed income security, the development of SRI-oriented Sukuk could help fill in this fixed income gap in the SRI market.

Despite these reasons why socially responsible Sukuk should appeal to conventional SRI investors, there are also significant challenges for investors looking to enter the Islamic finance market for the first time. For example, to be attractive to the broadest possible range of conventional SRI investors, Sukuk should pay a fixed rate of return. In order to create Sukuk that pay a fixed return that is not characterized as interest and otherwise meets all Islamic Law requirements, significant structuring of the underlying cash flows is required. As a result, Sukuk tend to be highly structured instruments, and highly structured instruments pose a set of unique problems for investors. They are often difficult for investors to understand and properly value, they involve more transaction costs to create and they tend to be less liquid than simple securities[16].

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Investing in Sukuk will also require a conventional SRI investor to master an unfamiliar set of terms and contract types. Returns on a Sukuk are based on the underlying contract, and the types of contracts that are employed include ijarah (leasing), musharakah (partnership), mudharabah (profit and loss sharing) and istisna (construction)[17]. Although the economic concepts behind these contracts will be familiar to conventional investors, the vocabulary and specific terms will be entirely new. Moreover, for an institutional investor looking to enter the Sukuk market for the first time, many different people within the investor's organization will need time to be educated about the meaning of these terms, from the portfolio managers, to the back office staff that need to book Sukuk in the firm's systems to the accounting staff that must understand how to account for Sukuk.

Many conventional investors will not be willing to take on all of these challenges of investing in Sukuk simply in order to diversify their already very large investment universe. However, conventional impact investors face a shortage of acceptable fixed income opportunities and therefore have an incentive to make the effort needed to broaden their pool of eligible instruments to include Sukuk. Moreover, impact investors are generally not shy of operational challenges, since most needed to adjust their investment processes significantly in order to become impact investors in the first place (i.e. in order to track the impact of their investments). They therefore should be accustomed to making the kind of extra effort that would be needed to move into the Sukuk space for the first time.

To date, there have only been a small number of Sukuk issued in which the proceeds were designated to be used in a way that would appeal to SRI investors. In both Malaysia and Indonesia, for example, there have been Sukuk issues in the education and healthcare sectors[18]. However, these issues were only intended for the domestic market. The proceeds of other sovereign Sukuks have generally not been earmarked for specific socially beneficial projects, but rather have been used for unspecified, general purposes. In terms of regular, large-scale, international issuance of socially responsible Sukuk, there is only one issuer of note, the Islamic Development Bank (IDB). IDB is a regional development financial institution that has used Sukuk to finance development projects in several developing countries, especially in Africa. However, once conventional SRI investors realize the potential of socially responsible Sukuk as a new fixed income alternative for their portfolios, we believe the number issues of this type should increase dramatically.

## **VII. Conclusion**

Islamic finance has grown at a very impressive rate over the last two decades, but the Islamic fixed income market remains under-developed. SRI has become an increasingly common investment strategy during that same time period, but there is still insufficient supply of SRI fixed income instruments. The convergence of these two facts creates the opportunity for a fixed income product to be developed that could appeal to both SRI and Shariah compliant investors, and thereby serve as a bridge between the Islamic and conventional financial markets. We believe the product that could play this role is Sukuk for which the proceeds are used to fund economic development.

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## Notes

1. SRI is sometimes referred to as sustainable investing, ethical investing or socially conscious investing.
2. The Social Investment Forum, 2010 Report on Socially Responsible Investing Trends in the USA.
3. Eurosif, European SRI Study: 2010.
4. For further information on Sukuk and the development of the global Sukuk market generally, Global Growth, Opportunities and Challenges in the Sukuk Market, edited by Sohail Jaffer (Euromoney Books, 2011).
5. Source: Islamic Financial Information Service.
6. The Sukuk volume is based on data compiled by the Islamic Financial Information Service and the size of global debt outstanding is from the Bank of International Settlements.
7. John Wesley, the founder of Methodism, delivered a sermon on the moral use of money that is often cited as one of the clearest, faith-based expressions of the SRI philosophy.
8. On negative screening and its financial effectiveness (Quigley and Taylor, 2010).
9. On the growth of impact investing (The Economist, 2011; Avery, 2012).
10. On World Bank green bonds (Reichelt, 2010).
11. The Global Impact Investing Network publishes information about impact investing initiatives at: [www.impactbase.org](http://www.impactbase.org)
12. The Social Investment Forum, 2010 Report on Socially Responsible Investing Trends in the USA.
13. The term "supra-national" is used in the capital markets to refer to institutions owned by sovereign shareholders that provide funding for development purposes. The largest supra-nationals include the World Bank, the European Investment Bank, the Asian Development Bank, and the Inter-American Development Bank (Standard & Poor's, 2010; Euroweek, 2012).
14. On this argument, Mahmoud El-Gamal, "Limits and dangers of Shariah arbitrage".
15. On the valuation of Sukuk (Godlewski et al., 2011).
16. On these problems in relation to Sukuk (Bennett, 2011).
17. On the types of Sukuk structures that are used in the market (Jobst et al., 2008).
18. In June 2011, Malaysia issued two tranches of sovereign Sukuk based on a wikalah contract to securitize hospital operations in the country. The issues were well-received by the market and were several times over-subscribed. Tranche 1 had a principal of \$1.2 billion and a maturity of ten years, one of the longest maturities in the market to date. Tranche 2 had a principal of \$800 million and a maturity of five years.

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