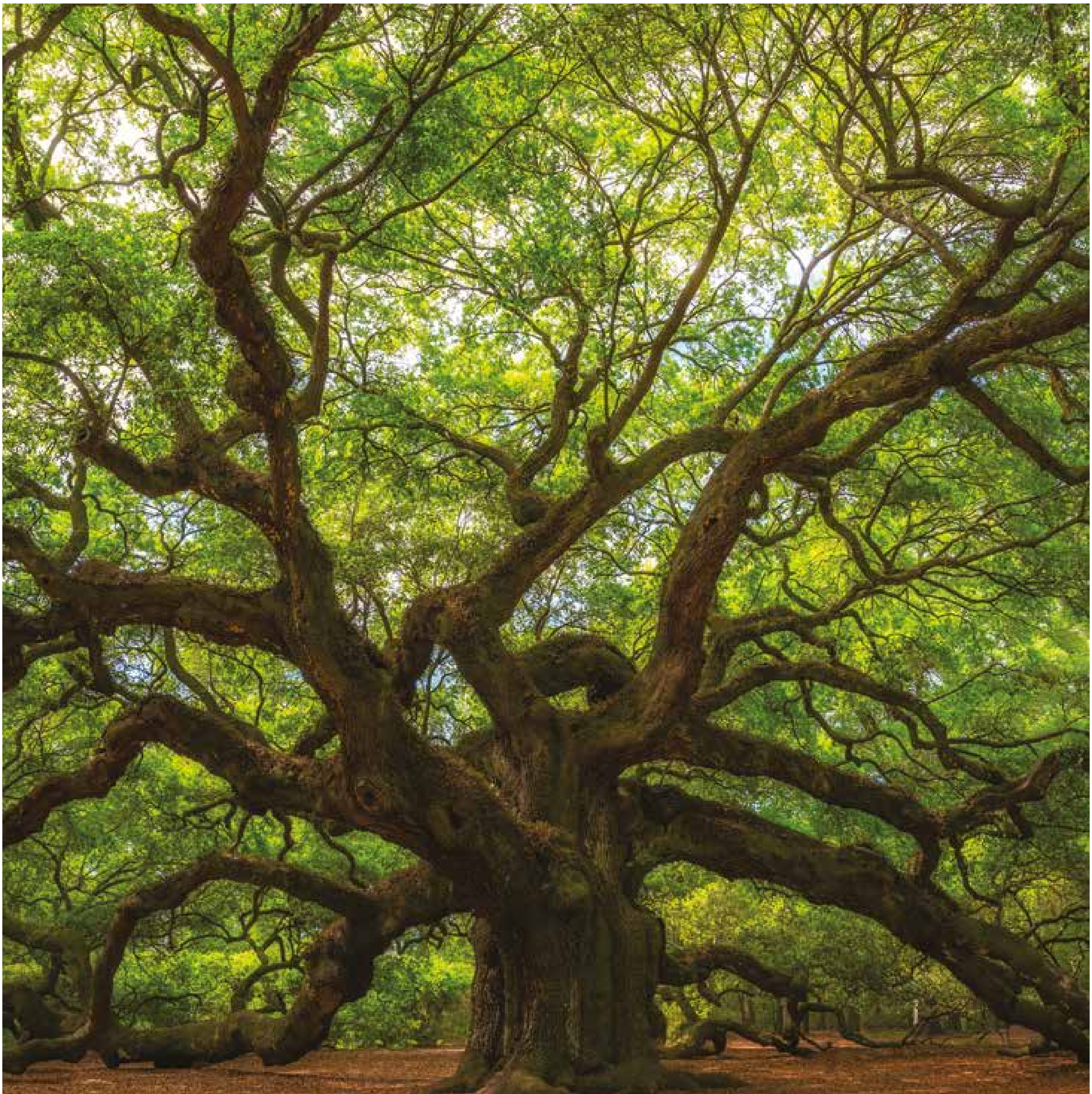
ISLAMIC FINANCE ESG OUTLOOK 2019

Shared Values



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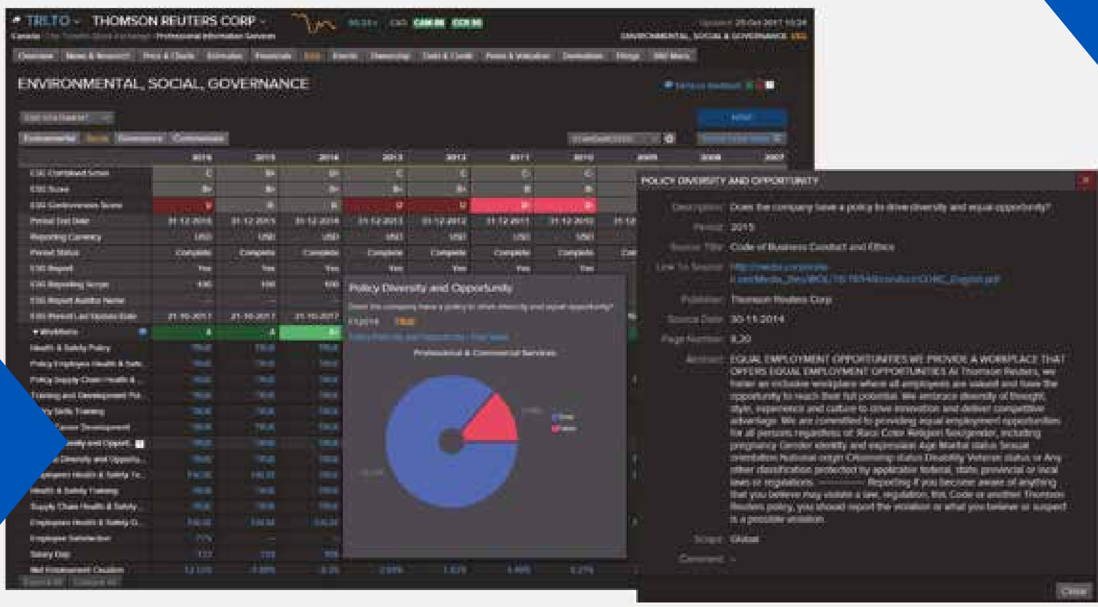


Our proprietary ESG scores were designed to objectively measure a company's relative ESG performance, based on company-reported data on over 400 metrics and across 10 themes (including emissions, environmental, product innovation, human rights and shareholders).

REFINITIV™

DATA IS JUST THE BEGINNING

CONTENTS

Foreword

As your longstanding trusted intelligent information provider, we understand the importance of staying abreast of the world's most pressing issues. With this in mind, we are pleased to introduce our Islamic finance ESG report, developed in collaboration with RFI Foundation, highlighting the roles and initiatives of governments, financials and non-financial institutions towards a better world.

The global adoption of responsible finance continues to grow at a rapid pace. The UN-supported Principles for Responsible Investment has now collected as signatories asset owners and investment managers overseeing $81.7 trillion using environmental, social and governance (ESG) integration strategies.

A major milestone for the banking sector was reached in 2018 when the UN Environment Program – Finance Initiative (UNEP FI) established the Principles for Responsible Banking, with 28 banks from around the world committing to aligning their business strategies with society's goals. These 28 have now been joined by 17 more, highlighting the fast-growing trend of responsible finance around the world.

This report is a contribution towards this trend. It is aimed at encouraging Islamic banks to re-evaluate their connections with the real economy and to address the risks and seize the opportunities that this will create for them.

A variety of industries that Islamic banks finance, including manufacturing, agriculture, utilities, transport, healthcare, and extractive industries face significant ESG risks, and Islamic financial institutions are responsible for sharing risks with those they finance. As a result, the risks faced by the businesses they finance are perhaps more relevant to Islamic banks than they are to conventional banks.

Among the most important ESG risks identified in this report are those created by investee companies. These include emissions into the air and water, workplace safety, liabilities created by contamination risk, and by the waste that is produced throughout the production process and left over after use.

Our research from Refinitiv's EIKON database covering over 6,500 publicly listed companies shows a clear link between Shariah compliance screening and stronger ESG performance, but this is not always enough. Although the Shariah screening process is effective at identifying some of the riskiest companies, the explicit use of an ESG framework will do much to improve the identification, measurement and, ultimately, mitigation of ESG risks.

Mustafa Adil

Head of Islamic finance

Refinitiv

Executive Summary

Recommendations:

- Islamic banks should acknowledge that ESG issues have financial relevance to their financing operations

- Islamic banks should assess the indirect ESG risks that affect their own financial performance, which are frequently not priced into the cost of financing they provide

- Islamic asset managers should conduct further practical assessment about the degree to which their exclusion of Shariah-compliant financing may benefit more from additional ESG screening in markets where the leverage screens are less restrictive as a result of greater availability of Islamic financing

- Central banks and other regulators should assess the degree to which specific types of ESG risks that are relevant to the economic sectors typically financed by Islamic banks are addressed in the prudential and supervisory requirements relating to both project-level financial risk but also systemic risk within less diverse economies.

- Researchers in industry and academia should analyse the degree to which ESG risks of bank financing obligors creates different financial outcomes in markets with a large degree of Islamic bank activities

- Researchers in industry and academia should study empirically to determine the degrees to which ESG and Shariah compliance are complementary across a wider range of asset classes and markets

It is clear from our research that Shariah compliance screening can do much to improve environmental, social and governance (ESG) performance. ESG scores from Refinitiv's EIKON database of over 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.

Still, while screening for Shariah compliance can help identify many ESG issues, there are shortfalls in certain areas and geographies that can leave financial institutions exposed to unnecessary risk, particularly in emerging and frontier markets. It is possible that in emerging markets there is greater complementarity between Shariah and ESG screening methods, which would minimise the difference in scores, although Shariah screening in these markets does seem to positively impact social quality in relation to workplace issues and human rights.

The research suggests that even if Shariah and ESG screening show some correlation, combining the two could improve overall risk-adjusted returns. This may occur whether the investment is in the form of equity held in listed companies or in the financing provided by an Islamic bank.

Most Islamic banks operate within their home markets so the indirect environmental and social exposure to these markets will be reflected in the companies they deal with. This would suggest that a greater focus on ESG-specific screening on top of Shariah screening would minimise the risks from such exposure. The research shows there may be particular value for Islamic banks that screen for environmentally risky projects, which they can either reject or raise the financing costs for.

We have found that the most common risks across the 11 markets with the largest Islamic finance industries are emissions to air & water, the management of waste and the effects of site contamination, as well as workplace safety & health. These risks are particularly prevalent for Islamic banks that are financing utilities, manufacturing, healthcare, mining/oil & gas, and primary agriculture.

If a bank is not taking active measures to integrate these risks into the financing process, it is taking on additional risk while receiving no compensation for doing so. As more research demonstrates the importance of ESG risks to financial return, financial institutions are becoming increasingly aware of how these risks affect their potential profitability, portfolio risk levels and return on capital.

It is imperative that an Islamic bank that has become aware of ESG risks that will have a financial impact first addresses these concerns with employees at all levels to create buy-in to the changes that will need to be made. Change will take time, but improving ESG risk management will not only benefit the bottom line, but will allow the bank to stand out from its peers and discover new business opportunities.

ESG SCORES

No. of companies		GLOBAL	Environment	Social	Governance
6,554	Full sample	50.5	50.6	50.6	50.2
2,387	Shariah compliant	52.3	52.8	52.8	51.2
4,167	Not Shariah compliant	49.4	49.3	49.4	49.7
ESG Score Gap (Compliant vs non-Compliant)		5.9%	7.3%	7.0%	3.0%

SOURCE: EIKON — DATA AS OF FEB 2019

RFI FOUNDATION RISK ASSESSMENT — SUMMARY

	Total Islamic banking assets ($ bn)	Number of Islamic banks and windows:	Aggregate country risk score (SSRI[1]):	Aggregate country risk rank (SSRI):	Aggregate country risk score (SASRI[2]):	Aggregate country risk rank (SASRI):
Malaysia	$160.6	17	1.38	9	1.82	10
Bahrain	$63.0	21	1.65	6	2.43	6
UAE	$153.9	11	1.74	2	2.18	7
Pakistan	$12.8	7	1.70	5	3.89	1
Saudi Arabia	$344.8	12	1.37	11	2.44	5
Oman	$9.7	8	1.51	7	2.15	8
Kuwait	$83.1	4	2.06	1	3.41	2
Indonesia	$26.7	18	1.43	8	2.07	9
Qatar	$95.8	4	1.38	10	1.55	11
Bangladesh	$29.0	7	1.73	3	3.21	4
Turkey	$43.9	6	1.71	4	3.21	3

SOURCE: RFI FOUNDATION RISK ASSESSMENT

1 Sector-Specific Risk Intensity (SSRI): The sector risk for each sector to which the financial institution has exposure is multiplied by the share of the exposure.

2 Sector-Adjusted Specific Risk Intensity (SASRI): The sector adjusted specific risk intensity for each of the sector / specific risk pairings to which the financial institution has exposure is multiplied by the share of the exposure.

GLOBAL NON-FINANCIAL			Environment	Social	Governance
ESG Scores	Full sample	50.5	50.6	50.7	50.2
	Shariah compliant	52.3	52.8	52.8	51.1
	Not Shariah compliant	47.5	47.0	47.3	48.1
ESG Score Gap (Compliant vs non-Compliant)		10.2%	12.4%	11.6%	6.2%

ENVIRONMENTAL AND SOCIAL RISK EXPOSURES

	Disaster Risk	Ecosystems	Emissions to Air	Emissions to Water	Energy	Site Contamination	Waste	Water Use	Workplace Health & Safety
	10	10	10	10	9	10	11	10	10
	7	6	6	5	6	5	5	6	5
	5	8	7	7	7	9	8	8	9
	1	1	1	1	1	1	2	1	2
	6	5	5	6	5	6	6	5	7
	8	7	8	9	9	7	7	9	6
	3	3	2	3	3	2	1	3	1
	9	9	9	8	8	8	9	7	8
	11	11	11	11	11	11	10	11	11
	2	4	4	2	2	4	4	2	4
	4	2	3	4	4	3	3	4	3

Low Risk 11 10 9 8 7 6 5 4 3 2 1 High Risk

Note: Risk exposures are ranked from low to high against the same risk exposure for all countries. Each country's risks are normalized to be on the same scale before the ranking is computed across countries.

SOURCE: RFI FOUNDATION RISK ASSESSMENT

Can ESG and Shariah Compliance Deliver Greater Performance Impact Together?

There is a critical question relating to ESG and Islamic finance that will affect its widespread uptake. If there is a demonstrable performance benefit to adopting either ESG or Shariah compliance screening, would there be a greater benefit from using both rather than one? A first analysis of ESG and Shariah using screening data from Refinitiv's EIKON database covering over 6,500 publicly listed companies demonstrates the possible alignment between the two.

There have been very few attempts to explicitly link Islamic finance, ESG and performance, whether for equities or fixed income securities. Showing such a link would provide evidence that Shariah compliance screening and ESG screening complement each other in evaluating risk and return. This in turn could serve as a proxy for the benefit that Islamic banks could receive by using both ESG screens and Shariah-compliant financing structures.

The research to support this hypothesis outlines how the data available in EIKON and other data platforms with Shariah compliance screening capabilities could be used to build a stronger case for Shariah-compliant responsible finance.

The ESG Qualities of Shariah-compliant Companies

An analysis of the 6,554 companies in Refinitiv's EIKON global database shows an average 5.9% higher ESG score for Shariah-compliant companies than for those that are not compliant.

The ESG sub-indicator scores for Shariah-compliant companies ranged from +3.0% for governance to +7.3% and +7.0%, respectively, for environment and social pillars. It is often presumed that Shariah compliance methodologies are tilted naturally towards the governance angle because the screening process involves an extra layer of governance oversight. However, when analysing potentially investable equities, the universe is tilted more the towards environmental and social dimensions.

Digging in further to the data on ESG scores of Shariah-compliant and non-compliant companies shows that across multiple metrics, Shariah-compliant companies tend to receive higher scores than non-compliant companies. In particular, the ESG performance of Shariah-compliant companies tends to be highest in workforce scores, corporate social responsibility (CSR) strategy, and human rights scores.

A large proportion of the global investable universe is covered by the analysis. It shows there is a built-in tilt towards better ESG scoring companies after the universe is screened for Shariah compliance. An Islamic bank, therefore, could benefit both from its focus on financing Shariah-compliant businesses, which results in a financing portfolio that has more exposure to companies that have better ESG scores. Islamic banks can enhance the beneficial bias introduced by Shariah compliance screening by addressing any systematic shortfalls in environmental, social or governance practices among Shariah-compliant companies that are out of line with peer averages.

The preceding data covers a wide universe and we investigated whether there is a difference between financial and non-financial companies, drilling further within the global universe.

An analysis of the 6,554 companies in Refinitiv's EIKON global database shows an average 5.9% higher ESG score for Shariah-compliant companies.

TABLE 1A: SHARIAH SCREENING AND ESG SCORES — GLOBAL UNIVERSE

	ESG Score
Full sample	50.5
Shariah compliant	52.3
Not Shariah compliant	49.4
ESG Score Gap (Compliant vs non-Compliant)	**6%**

SOURCE: EIKON — DATA AS OF FEB 2019

TABLE 1B: SHARIAH SCREENING AND ESG SCORES — GLOBAL UNIVERSE

	Environment	Social	Governance
Full sample	50.6	50.6	50.2
Shariah compliant	52.8	52.8	51.2
Not Shariah compliant	49.3	49.4	49.7
ESG Score Gap (Compliant vs non-Compliant)	**7%**	**7%**	**3%**

SOURCE: EIKON — DATA AS OF FEB 2019

TABLE 1C: SHARIAH SCREENING AND ESG SCORES — GLOBAL UNIVERSE

		Environment		Social				Governance		
	ESG Controversies Score	Emissions Score	Environmental Innovation Score	Workforce Score	Human Rights Score	Community Score	Product Responsibility Score	Management Score	Shareholders Score	CSR Strategy Score
Full sample	49.3	50.7	50.3	50.9	50.9	50.1	50.4	50.4	49.8	50.2
Shariah compliant	49.2	53.0	52.4	54.2	53.2	50.4	52.1	50.7	51.2	53.4
Not Shariah compliant	49.4	49.4	49.1	49.0	49.5	49.9	49.5	50.3	49.1	48.4
ESG Score Gap (Compliant vs non-Compliant)	**0%**	**7%**	**7%**	**11%**	**7%**	**1%**	**5%**	**1%**	**4%**	**10%**

SOURCE: EIKON — DATA AS OF FEB 2019

Companies in the real economy get a bigger ESG lift from Shariah compliance screening

Analysis of the 5,487 companies that are non-financial shows that those companies which are Shariah-compliant have on average 10.2% higher ESG scores than the non-compliant — a larger margin than for the global universe as a whole. This provides at least an initial gauge that the Shariah screening process tilts the investable universe towards higher scoring companies.

As we have found consistently across the results, there is a larger difference in the 'E' and 'S' scores against the 'G' scores for companies that are Shariah-compliant compared with those that are non-compliant.

Upon deeper analysis, the environmental score is being boosted by the presence of companies that are developing innovative technology to address environmental issues. There is far less difference between Shariah-compliant and non-compliant companies on emissions scores. This may be a reflection of the natural overweighting of more dynamic companies in the Shariah-compliant investment universe because they tend to rely less upon debt.

The improvement in the social scores may be driven by the sector exclusion screens, which avoid companies dependent upon products that harm humanity. The financial ratio screens may also help avoid companies whose reliance upon debt may drive their focus too much towards the short term at the expense of long-term environmental and social sustainability.

TABLE 2A: SHARIAH SCREENING AND ESG SCORES — GLOBAL NON-FINANCIAL

	ESG Score
Full sample	50.5
Shariah compliant	52.3
Not Shariah compliant	47.5
ESG Score Gap (Compliant vs non-Compliant)	**10%**

SOURCE: EIKON — DATA AS OF FEB 2019

TABLE 2B: SHARIAH SCREENING AND ESG SCORES — GLOBAL NON-FINANCIAL

	Environment	Social	Governance
Full sample	50.6	50.7	50.2
Shariah compliant	52.8	52.8	51.1
Not Shariah compliant	47.0	47.3	48.1
ESG Score Gap (Compliant vs non-Compliant)	**12%**	**12%**	**6%**

SOURCE: EIKON — DATA AS OF FEB 2019

TABLE 2C: SHARIAH SCREENING AND ESG SCORES — GLOBAL NON-FINANCIAL

		Environment		Social				Governance		
	ESG Controversies Score	Emissions Score	Environmental Innovation Score	Workforce Score	Human Rights Score	Community Score	Product Responsibility Score	Management Score	Shareholders Score	CSR Strategy Score
Full sample	49.3	49.3	50.6	50.4	51.0	51.0	50.3	50.5	50.2	49.8
Shariah compliant	49.2	49.2	53.0	52.4	54.2	53.2	50.4	52.1	50.6	51.1
Not Shariah compliant	50.3	50.3	46.8	47.3	46.6	47.5	48.5	47.6	48.3	47.9
ESG Score Gap (Compliant vs non-Compliant)	**-2%**	**-2%**	**13%**	**11%**	**16%**	**12%**	**4%**	**10%**	**5%**	**7%**

SOURCE: EIKON — DATA AS OF FEB 2019

CASE STUDY

Responsible Finance Champions

CIMB Islamic Bank & CIMB Group

In 2017, Bank Negara, Malaysia's central bank ("BNM"), began an engagement with Islamic banks on whether Islamic finance could deepen their contribution to meet the higher Shariah objectives on which the industry is founded.[1] The result was BNM's guide to responsible finance: The *Implementation Guide for Value-based Intermediation ("VBI")*, released the following year. During the consultation period ahead of its publication, CIMB Islamic Bank began considering how its corporate values could translate into action as an Islamic financial institution.

Rafe Haneef, CEO of CIMB Islamic Bank, explained the connection that motivated the bank's actions: "Islamic banking was founded on the core principles of promoting social justice through financial intermediation. From the very beginning, Islamic banking has been focusing on reducing harm and maximizing benefit for the society, such as by avoiding financing sectors which cause broad negative impact to society."

Luanne Sieh, Group Head of Sustainability at CIMB Group, noted that at the end of 2017 Mr. Haneef elevated the discussion into a wider discussion across the whole of CIMB Group when he spoke about sustainable finance at a gathering of the bank's top 300 leaders. Ms. Sieh explained how this moment became so transformational for the bank: "There was a lot of interest in sustainability within the bank and the discussion came at the right time, where it led to presentations to the board members overseeing Forward23, the new five-year transformation strategy that CIMB Group was debating and developing at that time."

Engaging Stakeholders

Behind the scenes, there was significant effort at multiple levels and across different business departments to conduct a rigorous process of internal review involving many stakeholders to achieve buy-in from a business perspective. Mr. Haneef said: "If a company adopts sustainability only to meet the expectations of regulators or other stakeholders, it is less likely to improve its return on capital, which requires making a complete shift internally and externally towards these sustainable goals."

For CIMB Group, the process took two years, and it started with management, the board of directors, and shareholders. Mr. Haneef credits younger employees for the success of this and sees a benefit in engaging this demographic, which banks often struggle to attract and retain. He said, "Our millennial employees have been a key element of support towards achieving our sustainability objectives."

Shareholders were also an important stakeholder group supporting CIMB Group's move towards sustainability. Mr. Haneef said it was helpful that they were asking management the right questions about return on capital, market valuation, and our policies on environmental and social issues in order to identify sustainability as a strategic pillar. The shareholders' input, which added further rigor to the board of directors' inquiries, was constructive for the overall process and led to the board seeing sustainable finance as a strategic differentiator that could shape the future of CIMB Group.

1 These objectives include the preservation of faith, life, family, intellect and wealth; as well as the overall goals of maximizing benefit and minimizing harm to individuals and society.

When sustainability was adopted as one of the five key pillars of Forward23, CIMB's new strategic plan for the period 2019 - 2023, the mind-set shift at the top level that had begun two years earlier was largely completed. Shareholders, board members and key members of senior management were convinced that sustainability was the right thing to do for the people and the planet as well as for CIMB Group.

Mr. Haneef said: "We showed that by making sustainability a strategic part of our process, the quality of the portfolio will also improve because we'll be financing more good citizens who are also good obligors. There is evidence of a link between firms who will meet the commitment not only to the environment but also to the banks for the financing they have taken, which makes it a win-win situation for the bank, for customers, and to the people and planet as a whole."

Pursuing VBI Adoption and Sustainability in an Integrated Manner

In adopting the value-based intermediation ("VBI") principles encouraged by Bank Negara Malaysia, CIMB Islamic Bank engaged with various non-profit organisations to learn more. It was instrumental in enabling CIMB Group to become a member of United Nations Environment Programme Finance Initiative ("UNEP FI") as well as a Founding Member to the UNEP FI Principles for Responsible Banking while it developed a sustainability strategy covering the whole Group. Mr. Haneef explained the connection:

"VBI gave us a broad guideline, and we felt that being a member of UNEP FI, the RFI Foundation and other global organizations, provided us with a way to get more specific details and identify how to embark on this initiative. Being a member of these organisations will help us to better structure our own journey in line with VBI. After all, we are putting together a blueprint to help us to achieve our targets."

Throughout the process that was occurring across CIMB Group, there was a related effort underway within CIMB Islamic Bank to engage its Shariah board on sustainability and in line with an Organisation of Islamic Cooperation (OIC) Fiqh Academy resolution which called for signing onto international agreements that focus on environmental protection including UNEP FI, United Nations Principles for Responsible Investment ("UN PRI"), and the Equator Principles, a resolution which the Shariah board supported.

The Shariah board also strongly recommended the adoption of sustainability practices and also highlighted that in order to address the challenge of embedding sustainability throughout the Group, the bank would need a dedicated sustainability department to fulfil this requirement.

When CIMB Group adopted sustainability and sustainable finance policies that incorporated the Shariah scholars' feedback, the Shariah advisory head, Mr. Ashraf Gomma Ali, returned to receive the Shariah board's approval. The board signed off on the sustainability policy at that point and was pleased to see that CIMB Group had demonstrated it was devoting sufficient resources and headcount across different geographies to ensure the sustainability concept could be implemented effectively.

Sustainability @ CIMB Group

CIMB Group has set out a comprehensive process for assessing materiality and consulting with many key stakeholder groups including customers and clients, suppliers, employees, CSR beneficiaries, and the local community. The first cut of this materiality assessment was based on the stated priorities of each group. The finalised top 14 material topics will remain CIMB's key areas of focus over the next 3-5 years. The list of 6 Highly Material Issues and 8 Important Topics are listed on page 17. For each of the material topics, CIMB has clearly articulated the strategic link to its business, the risks and opportunities, and our long-term strategy.

CIMB recognizes its influence towards sustainable and ethical business practices. It adopts an inclusive approach to all its business relations and strives to positively influence their own sustainability performance and commitment. However, it also recognizes that what its partners do and how they conduct their own business can have a direct impact on CIMB's own projects, its business continuity, as well as its reputation. It is therefore critical to monitor the environment and social impact and take necessary measures towards positive impact.

CASE STUDY

LIST OF 6 HIGHLY MATERIAL ISSUES

1	Customer experience
2	Sustainable finance
3	Technology
4	Governance
5	Nurturing growth
6	Talent attraction, growth & retention

LIST OF 8 IMPORTANT TOPICS

1	Sustainable Supply Chain
2	Sustainability education & participation
3	Corporate culture
4	Financial literacy, inclusion and well-being
5	Health, safety & well-being
6	Diversity & inclusion
7	Corporate citizenship & volunteerism
8	Climate change (direct footprint)

- Business Relation Assessment

  The assessment begins with a basic due diligence to assess the sustainability risk of business relations so that it does not knowingly engage in business activities or with business relations that do not meet the Group Sustainability Policy requirements. CIMB will exercise a precautionary approach, taking due care and diligence to evaluate, adopt and advocate measures that will minimise and in the long-run prevent, environmental harm as well as promote social equity.

- Sustainable Financing Assessment

  Separately, the focus on the client portfolio was driven by a recognition that the greatest indirect impact that CIMB Group creates comes from what its clients do with the financing it provides. This analysis resulted in a list of key sensitive environmental and social risk sectors, and CIMB identified the material topics relevant to each of these sectors.

  Therefore, when new or increased business financing is being sought, the nature of financing will be examined. If it does not fall into a high risk sector, basic sustainability due diligence will apply. If it does not pass this, it will then be subjected to enhanced sustainability due diligence. However, if the nature of financing falls into a pre-identified high risk sector, enhanced sustainability due diligence will automatically apply.

Not all of the sustainability initiatives are necessarily focused on identifying risks. For example, to encourage positive behaviour and sustainable lifestyle choices, clients applying for mortgage financing of green-certified homes are able to receive lower-cost financing at CIMB. If more buyers become incentivised to buy green homes, this may influence developers' choices to favour projects that are green certified to increase their saleability.

The sustainability journey at CIMB Group was spearheaded by the CEO of CIMB Islamic Bank with oversight from the Group CEO, together with Group Strategy and Design. These actions undertaken by an Islamic banking subsidiary within a regional banking group provides a proof-of-concept reference of how a bank can feasibly adopt and incorporate sustainability meaningfully into its business strategy. As other banks consider their approach to sustainability, they can benefit from some lessons that CIMB Group identified in its own journey.

Hussam Sultan, Regional Head of Commercial and Transaction Banking (Islamic) at CIMB Islamic Bank, said: "Our journey can be replicated but it needs other champion banks from across the ASEAN region in addition to CIMB."

Ms. Sieh said: "We had a senior leader who was vocal and passionate enough to garner interest at the senior level. We had a push from the regulator, Bank Negara Malaysia, on the Islamic banks through Value-Based Intermediation. We had people involved with a deep knowledge of the internal working of the organisation. From there, it came down to effort and execution to operationalise sustainability through good policies, a dedicated department, and the budgets needed to support good delivery. What we have created at CIMB Group is a repeatable formula."

Mr. Haneef concluded, "The initial realisation and strategy development has been completed but for us, the journey has just begun and we are committed to working with all stakeholders to ensure the success of this initiative, even beyond CIMB Group's current five-year growth strategy." ■

What are the Biggest Environmental and Social Risks for Islamic Banks?

The RFI Foundation Risk Assessment is a simple tool based upon publicly available data on bank financing provided by the Islamic banking market. The data measure the degree of environmental and social risk facing individual Islamic banks, and through a process of aggregation also estimate the relative levels of environmental and social risk across the Islamic banking systems of the largest 11 countries by Islamic banking assets. Our tool represents around 90% of the global Islamic banking assets excluding Iran, around $1 trillion in total assets.

Through our RFI Risk Assessment, we have identified four types of risk that are pervasive across the portfolios of individual banks across the major markets in which Islamic finance operates. When the financial industry is linked into the economies in which it operates, as Islamic finance aspires to be, many of the underlying risks that Islamic banks face will be largely predetermined by the economy. However, Islamic banks rarely make up a majority of total banking sector assets.

As a result, Islamic banks have more flexibility to determine the precise make-up of the businesses which they finance, which gives some latitude to prioritize some sectors while avoiding others. This flexibility, however, becomes limited the larger a financial institution becomes, and as a result it becomes more important to address the risks that are then built into the financing portfolio through the financing they provide.

Each risk comes in a different manner through the different businesses that are financed, but in general we classify these risks as being of medium or high impact for six business sectors: utilities; manufacturing; mining/oil & gas production; primary agriculture; construction; and the social sector including education, healthcare and other related service sectors.[2]

The reason why we look at the risks the way we do — viewing the risks facing the businesses receiving financing as if those risks were present for the Islamic banks — is because they have been shown to be financially material for the underlying

2 We break down all financing activity into 12 sectors: Primary agriculture, Mining and quarrying, Manufacturing, Electricity, gas and water supply, Construction, Transport, storage and communications, Finance, takaful, real estate and business activities, Education and health, Wholesale and retail trade, and restaurants and hotels, Government and government agencies, Household, and Others.

businesses. Any financially material risk facing a business will indirectly affect its creditworthiness, which in turn will affect all those who invest in or provide financing to these businesses. Banks providing financing can either choose to avoid or limit their exposure to higher-risk businesses, or change the terms of the financing they do provide in order to be appropriately compensated for the risks to which they are exposed.

In companies where these workplace health & safety risks are the most likely to be present, there is a significant embedded potential for financial loss. For the banks that are financing sectors including construction, manufacturing, healthcare facilities, mining and oil & gas extraction, utilities, and agriculture, there may be unmeasured financial risk embedded in the financing portfolio.

A concentration of financing provided to the sectors with the highest levels of workplace health & safety risk will expose the bank to higher expected losses unless it is measuring and mitigating its exposure to these risks. If the obligors to whom the bank has provided financing are more likely to be exposed to these risks relative to their sector peers, then the bank financing their activities will, all else being equal, be taking on additional risk without receiving due compensation for the higher expected losses.

The analysis we present in this report ranks the nine different risk types we identify from low to high in each country. In order to prioritise the impact of the different risks for Islamic banks in each of the 11 countries, we looked at which issues were among the top three risks in the most countries. Four of the risks — Workplace Health & Safety, Emissions to Water, Waste, and Site Contamination — stood out as being common across the greatest number of countries with diverse economies. We present a brief overview of some of the types of risk that may fall under these categories.

Workplace health & safety: In addition to their human impact on affected employees, workplace injuries and deaths create potential sources of financial liability and reputational harm that can lead to more dramatic financial repercussions. These risks affect companies regardless of whether they can insure themselves directly against them. A business will face a steep liability faces a steep liability if it is found to have violated worker protection laws or created unsafe working conditions.

The presence of insurance against these risks — such as the risk arising from the use of heavy machinery, transport vehicles, or equipment failures in the context of mining, oil & gas production, manufacturing or construction — may provide some insulation. However, in economies where enforcement of labour rights and the required conditions associated with insurance cover are lax, the presence of insurance may create risks of moral hazard, which could cause the unrealised risks to be greater than immediately apparent.

Sectors with the highest risk exposure: Utilities, manufacturing, healthcare, mining/oil & gas, primary agriculture.

Emissions to Water: Many industrial businesses including those in manufacturing, mining, utilities and agriculture use water, and can either create wastes that contaminate water or place heavy demand on water resources. Although the risk we specifically identified is linked with contamination, the financial risks relating to water are also linked with access to water.

If a business contaminates the water supply it may lose its social license to operate, and it puts its own access to water at risk both through the reputational repercussions but also by reducing the available supply of uncontaminated water when and where it is needed. The contamination issue also presents an opportunity for businesses whose products contribute to reducing emissions, or whose processes are designed to minimise their emissions, through mitigation of the underlying financial risk drivers.

Sectors with the highest risk exposure: Utilities, manufacturing, mining/oil & gas.

Waste: The emissions to water discussed above represent one specific case of the financial risks arising from the waste created directly by a business, or indirectly through the products it sells. For example, in many manufacturing processes, the waste products may include hazardous waste that must be properly disposed of or recycled to avoid creating ancillary financial harm through emissions to water and site contamination.

In mining, for example, hazardous wastes may be stored away for long after the revenue has been generated. Because of improper storage or natural disaster risks, these companies will need to make a long-term investment to manage the contingent liabilities created by their production process. If they fail to properly mitigate the risks, or events occur beyond what is contemplated in their mitigation plan, this could quickly move a hypothetical risk onto their financial statements and affect their ability to service the financing payable to banks and others.

Sectors with the highest risk exposure: Healthcare, construction, utilities, manufacturing, mining/oil & gas, and primary agriculture.

Site Contamination: One ancillary risk that may be created as a result of the damage caused by emissions to water and waste management is the permanent or long-term damage done to property and buildings. A company's land and the facilities built upon it. These often provide security for creditors, and anything that attaches a contingent liability to them will inhibit the ability of creditors to rely upon them for security.

Another situation where site contamination could become an issue of financial concern would be when land is acquired for development that was previously used for other purposes. If financing is extended to acquire land, it will likely be evaluated for contamination before the sale closes. However, if a company receives unsecured financing and owns or acquires land that requires remediation due to undisclosed site contamination, this creates a financial liability that could be persistent and material. It may not be identified if the financing provided does not directly include all of a company's property or buildings.

Sectors with the highest risk exposure: Utilities, manufacturing, mining/oil & gas, construction.

Government and Islamic Financial Institution (IFI) Initiatives in Responsible Finance

2014

JULY 2014

SEDCO Capital becomes the first Islamic asset manager to become a signatory to the UN-supported Principles for Responsible Investment, followed by Arabesque Asset Management

AUGUST 2014

The Securities Commission Malaysia introduces the Sustainable and Responsible Investment Sukuk Framework to cover sukuk issuance addressing the environmental and social impact of business

SEPTEMBER 2014

Bangladesh Bank announces the BDT 2 billion ($23.8 million) Refinance Scheme for Renewable Energy & Environment Friendly Financeable Sectors, including for Shariah-compliant banks and financial institutions

2015

JUNE 2015

Sovereign wealth fund Khazanah Nasional issues Malaysia's first social impact sukuk, with a first tranche raising MYR 100 million ($24.6 million), to finance programs undertaken by Yayasan AMIR, a non-profit organisation to support its school programs

OCTOBER 2015

Bursa Malaysia amends its listing requirements to require sustainability reporting on a phased basis

NOVEMBER 2015

Qatar Stock Exchange joins the Sustainable Stock Exchange Initiative

2016

JUNE 2016

Dubai Financial Market joins the Sustainable Stock Exchange Initiative

NOVEMBER 2016

Boursa Kuwait joins the Sustainable Stock Exchange Initiative

2017

JANUARY 2017

The Securities Commission Malaysia introduces a 5-year Islamic Fund and Wealth Management Blueprint, which places a heavy emphasis on links between Islamic finance and ESG

JANUARY 2017

Chittagong Stock Exchange joins the Sustainable Stock Exchange Initiative

AUGUST 2017

Following engagement with Malaysian Islamic banks about whether Islamic finance could be advanced beyond meeting the Shariah objectives on which the industry is founded, Bank Negara Malaysia issues the Value-Based Intermediation (VBI) strategy paper

AUGUST 2017

Khazanah Nasional issues the second tranche under its SRI Sukuk program, raising RM 100 million ($23.9 million), with RM 5 million raised from retail investors including via crowdfunding platforms

OCTOBER 2017

The Dubai Electricity & Water Authority, National Bonds and the Investment Corporation of Dubai announce the Dubai Green Fund, with AED 2.4 billion ($650 million) to finance renewable energy, retrofitting existing fossil fuel-based energy systems, energy efficiency and demand response programs

2018

MARCH 2018

Indonesia issues the first sovereign green sukuk, with an oversubscribed offering raising $1.25 billion

AUGUST 2018

CIMB Group becomes the first ASEAN regional bank to become a founding member of the Principles for Responsible Banking launched by UNEP FI

"It is increasingly clear that economic prosperity in the long run cannot exist without social equity and environmental responsibility. With much at stake, the call to action for sustainable finance is one that the financial sector, perhaps more particularly Islamic finance, cannot afford to ignore."

Bank Negara Governor Nor Shamsiah Mohd Yunus, October 2018

MAY 2018

After receiving input from the Islamic banks represented in the Community of Practitioners, and a public consultation, Bank Negara Malaysia issues a final concept paper and commences the process of developing VBI Implementation Guidance

JUNE 2018

Dhaka Stock Exchange joins the Sustainable Stock Exchange Initiative

OCTOBER 2018

Bank Negara Malaysia adopts a VBI implementation guide for Islamic financial institutions

The ASEAN Capital Markets Forum launches the ASEAN Social Bond and Sustainability Bond Standards, which include explicit reference for social sukuk as well as social bonds

Bahrain FinTech Bay launches the Global Islamic & Sustainable FinTech Centre to encourage growth in Islamic FinTech through alignment with sustainability

DECEMBER 2018

Bursa Malaysia's sustainability reporting requirements become effective for all issuers

The Saudi Stock Exchange — Tadawul — joins the Sustainable Stock Exchange Initiative

JANUARY 2019

Abu Dhabi Global Market leads the formation of the Abu Dhabi Sustainable Finance Declaration and Abu Dhabi Securities Exchange joins the Sustainable Stock Exchange Initiative

FEBRUARY 2019

State Bank of Pakistan issues an Islamic Financing Facility for Renewable Energy Financing targeting Islamic banks with equal access to a refinance scheme available to conventional banks

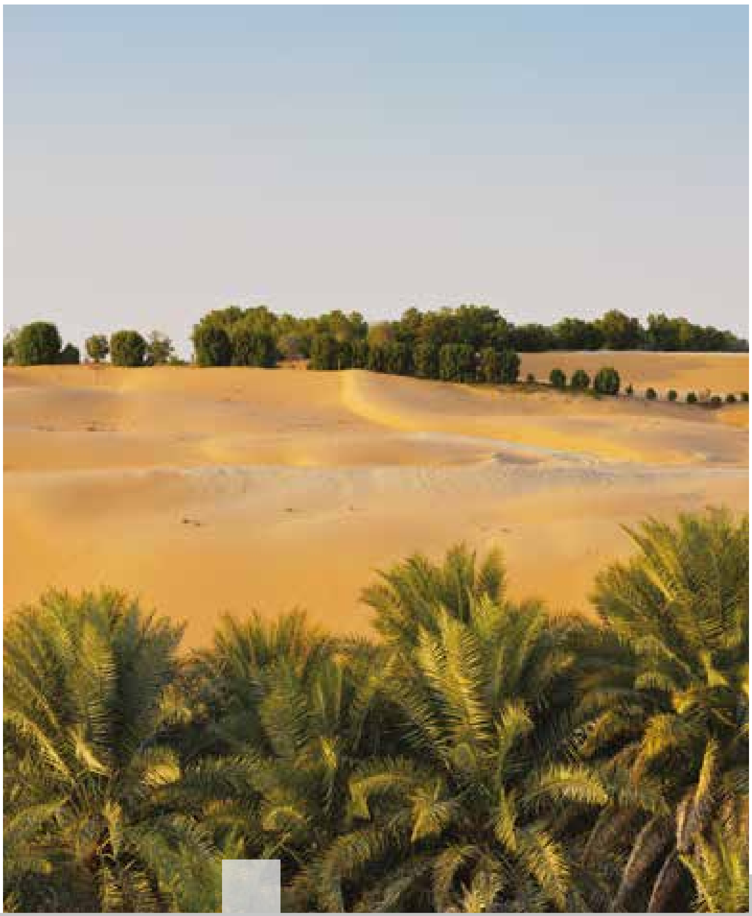
Indonesia returns to the market, raising $750 million from a green sukuk alongside a $1.25 billion sovereign green bond issuance

Bahrain Bourse joins the Sustainable Stock Exchange Initiative

MARCH 2019

The ASEAN Capital Markets Forum launches a Roadmap for Sustainable Capital Marketsv

2019



Prudent Ethical Investment: Expanding Frontiers for Shariah-Compliant Asset Management

SEDCO Capital

Creating the Prudent Ethical Investment strategy

SEDCO Capital, a Saudi Arabia-based asset manager, regards responsible finance as a result of the synergies between Islamic finance and responsible investment, both of which are ethical in nature. They each align an ambition to improve the living conditions and well-being of society, to establish social equality and to prevent injustice in trading relations. SEDCO Capital became the first Shariah-compliant signatory to the UN-supported Principles for Responsible Investment (PRI) based on the similarities between the ethical principles of Islamic finance and responsible investment.

Prudent Ethical Investment is the term that SEDCO Capital uses to describe its approach to responsible finance, which combines the exclusions of the 'sin sectors' of the ethical investment approach with financial ratio screening, which filters out undue risks and seeks sustainable investments with strong governance. It also includes an integrated assessment of environmental, social and governance (ESG) considerations.

SEDCO Capital's Prudent Ethical Investment (PEI) strategy combines ESG, which is mainstream, and Shariah-compliant investment strategies, which are less well known among global asset owners. To help improve knowledge of its approach to responsible finance, SEDCO Capital has conducted research to show the value-add from Islamic investment screens.

Overcoming the 'sin stock' performance barrier

The ESG elements are widely known, so SEDCO Capital focused on the two unique aspects of PEI: 'sin screen' exclusion; and financial ratio screening to avoid exposure to companies with large interest income or expense or that are over leveraged. A common understanding, supported empirically, is that negative screens for 'sin stocks' lead to a deterioration in expected performance for a portfolio as a whole compared with unscreened investments.[3] The 'sin stocks' screen is common ground for many responsible investors as well as Shariah-compliant investors.

SEDCO Capital's research covers ten years of data across a global universe of equities. It found that the balance sheet constraints used by Islamic investors can improve the risk-adjusted returns of an unscreened and an exclusions-focused strategy. The biggest difference between the exclusions-focused strategy and the Shariah-compliant strategy was the leverage ratios. This provides evidence that PEI can deliver distinct return/risk characteristics from the exclusions-focused strategy but also improvement on a conventional investment approach.

Christian Gueckel, SEDCO Capital's Chief Risk Officer and author of the research, said: "The lower financial leverage and better cash conversion result in a bias to quality and growth, which adds the prudence element to the PEI approach". The research shows that PEI delivered benefits as a result of the factor exposures to quality and growth characteristics.

3 See, for example, Harrison Hong and Marcin Kacperczyk, "The price of sin: The effects of social norms on markets," *Journal of Financial Economics* 93, no. 1 (2009): 15–36; Frank J. Fabozzi, K.C. Ma, and Becky J. Oliphant, "Sin Stock Returns," *The Journal of Portfolio Management* 35, no. 1 (2008): 82–94; and David Blitz and Frank J. Fabozzi, "Sin Stocks Revisited: Resolving the Sin Stock Anomaly," *The Journal of Portfolio Management* 44, no. 1 (2017): 105–111.

Tapping into a global network

The combination of SEDCO Capital's internal research and resources it received from external sources including the PRI has provided significant integration of ESG into SEDCO Capital's products and significantly affects its investment process. For example, SEDCO Capital combines internal and external data sources on its investment targets and it addresses an environmental consideration by reviewing different product and service revenue sources.

If a particularly environmentally detrimental practice represented a material portion of the revenue for a target company, SEDCO Capital would analyze the company separately, assuming that the problematic revenue sources were phased out over time. The valuation of the company would be viewed as if those revenue sources were phased out even if there was a historical track record of growth in sales and profitability from these revenue sources.

Since becoming a PRI signatory, SEDCO Capital has gained connections within the global responsible investment industry, which has become an enormous market. Based on one measure of PRI signatory assets under management, responsible investment accounts for $81.7 trillion, with just over $30 trillion invested into fixed income and just under that amount in equities.

Educating asset owners in the Middle East

This broad network brings significant resources, guidance, network and collaboration opportunities that have enhanced SEDCO Capital's ability to use strategies such as active ownership and engagement, and specific practices with regards to ESG integration. According to the PRI's 2018 annual report, however, SEDCO Capital is somewhat unique in the Middle East, where it is one of only nine signatories, compared with nearly 70 in Africa and 130 across Asia.

SEDCO Capital is also moving further ahead of most other Islamic financial institutions, which makes the research it has conducted so important. The research explains how Islamic investment is an investment strategy on its own, not based solely on personal ethical conviction, but also complementary to other strategies within responsible investment.

The research lays out a case for why the unique focus on leverage in PEI can drive improvements to conventional investment strategies and helps build the foundation of evidence for performance. These were instrumental in responsible investment and ESG building a mainstream following among asset owners, whose interest drove the capacity development among asset managers.

Improving active ownership in the GCC

SEDCO Capital is taking the next steps to improving the responsible finance landscape, including addressing the lack of ESG data being disclosed by many companies within the Gulf Cooperation Council (GCC) countries. SEDCO Capital's Gueckel said: "We aim to have a constructive dialogue with listed companies to create awareness of risks resulting from a company's ESG practices so these risks can be abated."

Active ownership in these markets is more difficult than in developed markets, for reasons including technical challenges as well as challenges in generating impact. In many GCC markets, the infrastructure to handle proxy voting research and recommendations is less developed. Company general meetings may be less transparent and there are challenges such as the presence of dominant shareholders.

Gueckel pointed to improvements in Saudi Arabia's market infrastructure relating to proxy voting as a "key milestone". The Saudi stock exchange upgraded its technology system, Tadawulaty, to enable shareholders to more easily execute their proxy voting, which helps asset managers like SEDCO Capital to meet their goals for executing a high percentage of the available proxy votes within their portfolios.

Beyond equities: How can responsible finance benefit sukuk and other asset classes?

The ESG integration that SEDCO Capital conducts on companies in the GCC provides qualitative and quantitative inputs for its estimate of each company's enterprise value. This may be quantitative, for example, if addressing the likely loss of revenue generated by an investment target through environmentally damaging activities.

An ESG approach may also drive enterprise value through competitive advantage from other channels such as opportunities for new revenue streams, cost savings, risk reduction including from governance, and as a result of lower share price volatility. Beyond the ESG analysis done on a corporate level for equity investments, SEDCO Capital evaluates sovereign-level systemic risks, as well as the social and governance quality of countries in which it invests. This approach also drives its sukuk investment strategy, which is one of just a few ESG-screened sukuk investment strategies globally.

Although ESG has traditionally been primarily focused on equity markets, SEDCO Capital is one of a small number of asset managers using ESG for private equity and real estate investment. Gueckel contrasted the difficulty of affecting ESG practices in listed companies with the increased opportunities for private equity and real estate investors:

"In private asset classes such as real estate or private equity [...] we may have greater influence and control as the owner of properties and can consider ESG aspects in the business plan for value-add actions. Furthermore, we are active in certain markets in which sustainability practices are at an earlier stage, giving SEDCO Capital an opportunity to demonstrate leadership in sustainability practices."

When SEDCO Capital signed the Principles for Responsible Investment in 2014, it became a leader for the Islamic finance sector in showing the compatibility of responsible investment strategies including ESG with Islamic investing. Since then, by applying the whole package of Prudent Ethical Investing to a variety of asset classes, supporting the establishment of the RFI Foundation, and working internally to enhance its ability to be an active owner in the GCC and globally, SEDCO Capital has been a consistent champion for responsible finance. ■

Shariah Compliance and Investment Performance

Empirical research conducted by RFI Foundation-member SEDCO Capital (see case study above) provides some evidence for how financial ratio screens alone affect the performance of Shariah-compliant equities. SEDCO Capital compared unscreened indices for the US, Europe and Asia against Shariah-compliant and socially responsible investment (purely exclusions-based SRI) indices.

SEDCO Capital found that Shariah-compliant equity outperformed both unscreened and socially responsible benchmarks, while SRI indices slightly underperformed the unscreened indices. SEDCO Capital found evidence for the hypothesis that SRI screens can cause a performance drag when the exclude companies for non-financial reasons. However, the addition of financial ratio screening in the Shariah-compliant investment process was able to generate enough outperformance to more than offset any drag created by the business sector non-compliance exclusions.

SEDCO Capital found that the driving reason behind the Shariah relative outperformance was the portfolio's bias towards growth and quality factors and as a result of the exclusion of the financial sector.[4] This puts Islamic investing into some alignment with responsible investment, where research from BlackRock Investment Institute released in 2019 found that ESG influenced performance through the quality and low-volatility factors.[5]

SEDCO Capital found evidence for the hypothesis that SRI screens can cause a performance drag when the exclude companies for non-financial reasons. However, the addition of financial ratio screening in the Shariah-compliant investment process was able to generate enough outperformance to more than offset any drag created by the business sector non-compliance exclusions.

4 Christian Gueckel. 2017. "How can responsible investors benefit from Islamic criteria?" *SEDCO Capital Working Paper,* 22 February 2017. Available from: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2918849

5 Brian Deese, Philipp Hildebrand, Rich Kushel, Barbara Novick and Mark Wiseman. 2019. "Sustainability: The future of investing," BlackRock Investment Institute Global Insights, February 2019. Available from: https://www.blackrock.com/institutions/en-axj/literature/whitepaper/bii-sustainability-future-investing-jan-2019.pdf

Triangulating the Link Between ESG, Shariah Compliance and Performance

These two research studies do not tell us conclusively if similar factor exposure (i.e., quality) driving performance benefit in Shariah-compliant and ESG portfolios are linked. It may be that Shariah compliance screening creates portfolios with similar characteristics to portfolios developed using ESG screening methodologies, so that combining the two cannot add significant new information. Or the new information added through ESG integration could provide a signal boost to the quality factor.

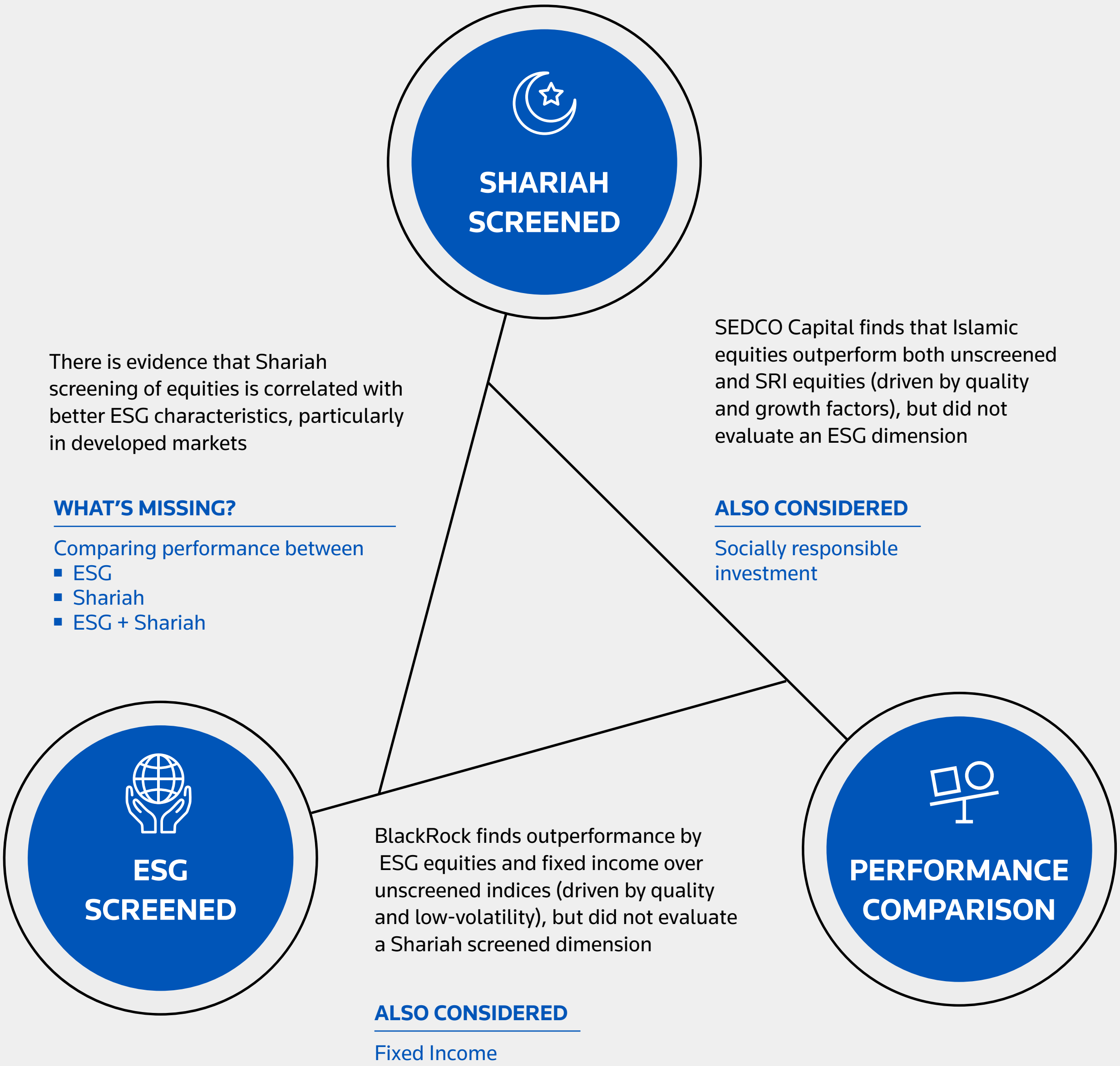
If Shariah compliance screens can enhance the information gained through ESG screening and improve risk-adjusted performance compared to an unscreened benchmark, this could offer added benefit to responsible investors not motivated by the Shariah compliance itself. Further research is needed to elucidate this conclusion and to validate whether Shariah-compliant, ESG-screened investments outperform portfolios that use either Shariah compliance or ESG integration alone.

One conclusion that would be particularly valuable for Islamic financial institutions and other responsible investors if ESG and Shariah screening were complementary would be the application in fixed income securities markets and Shariah-compliant debt. The aforementioned research by BlackRock Investment Institute found a similar performance benefit for fixed income.

BlackRock concludes by stating that "ESG-friendly bond portfolios should generate total returns similar to traditional portfolios over a full market cycle — even if they sacrifice a little yield". This signals a possibility for those providing debt and debt-like financing including Islamic banks to mitigate their environmental and social risk exposures through using ESG integration. For sectors in which they have a greater ability to influence the practices of those to whom they provide financing, they may be able to further increase their ability to mitigate risk and improve returns.

Our analysis reflects the proposition that since Islamic financial institutions are primarily focused on financing real economy (non-financial) activities, the primary indirect environmental and social risks they will face derive from the types of economic activity an Islamic bank finances. A higher environmental and social risk profile is not a 'bad' quality for a bank. If it is able to reduce the magnitude of its exposures by financing many (uncorrelated) projects, it can diversify individual risks. It may also be able to generate higher than average absolute profits if it factors environmental and social risks into what it charges and it applies strategies to reduce its risk exposure by influencing clients to adopt mitigation techniques.

FIGURE 1: TRIANGULATING THE LINK BETWEEN ESG, SHARIAH COMPLIANCE AND PERFORMANCE



RFI Foundation Risk Assessment Findings

The RFI Foundation describes the process for creating its Risk Assessmeent tool, and the results. We relied upon two sources of data to underpin our analysis. First, we gathered information from the notes in financial statements publicly released by each of the banks in our sample showing their exposure to particular economic sectors for the year ended Dec. 31, 2017.[6] We have harmonised the definitions to narrow the sector list to 12.[7] For each of these sectors, we use a risk level contained in our second data source, the IFC-developed ESAT Environmental and Social Assessment Tool (version 1.0 dated 2005).[8]

We created two measures of environmental and social risks that Islamic financial institutions face:

- Sector-Specific Risk Intensity (SSRI): Weighted average of the aggregate sector risk ratings for a bank
- Sector-Adjusted Specific Risk Intensity (SASRI): Weighted average of the risk level of each risk for each sector financed, weighted by the bank's exposure to each sector.

Each of these measures is normalised by dividing by 1 minus the share of the portfolio that is in the "finance, real estate, takaful and business activities" category, which cannot be classified because they contain a large degree of unmeasurable indirect risk. This has the effect of up-rating the overall risk levels for banks with a lot of exposure to financial institutions and real estate sectors. This methodology incorporates these exposures into the risk level in a non-linear way. The indirect risks from finance & real estate exposure has a small impact on overall risk where exposure is small but increases in magnitude as the share of the portfolio directed towards finance and real estate activity rises to higher and higher levels.

Our analysis covers almost all of the Islamic banks globally excluding Iran, across banks totalling up $1.03 trillion of Islamic banking assets. Some dual-system banks (conventional banks with Islamic windows) do not break out their balance sheets between conventional and Islamic banking assets. For these banks, we have relied upon bank-level data from Refinitiv. The average score for each country is the weighted average (by bank asset size) of each individual bank's Islamic banking assets covered by the analysis.

> *[The methodology] has the effect of up-rating the overall risk levels for banks with a lot of exposure to financial institutions and real estate sectors. [due to its embedded unmeasurable & indirect risk]*

6 In some cases where a bank has a year-end not corresponding to the calendar year, we selected the closest year-end to Dec. 31, 2017.

7 These sectors are: Primary agriculture; Mining and quarrying; Manufacturing; Electricity, gas and water supply; Construction; Transport, storage and communications; Finance, takaful, real estate and business activities; Education and health; Wholesale and retail trade, and restaurants and hotels; Government and government agencies; Household; and Others.

8 For two sectors (primary agriculture and manufacturing), we have had to create a composite risk level based on sub-components that combine several different risk levels.

Country-level RFI Risk Assessment Summaries

Malaysia:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Workplace Health & Safety	Primary agriculture
Emissions to Water	Construction
Site Contamination	Manufacturing

Malaysia occupied the number one spot in the Islamic Finance Development Indicator 2018. The country has a strong regulatory landscape and a promising experience of nurturing the growth of Islamic finance. It has also taken a proactive and regulatory-led approach to responsible finance. The central bank, Bank Negara Malaysia, promoted the Value-Based Intermediation strategy for Islamic banks to generate positive and sustainable impact on the economy, community and environment, consistent with the long-term interests of shareholders.

Malaysian banks have relatively high exposure to 'workplace health & safety' risks across their financing portfolios, with emissions to water and site contamination risks also present. They hold less exposure to disaster risk, water use, and ecosystem impacts. The risk exposure of Malaysian Islamic banks is lower than it is for many other markets with significant Islamic finance presence, particularly in risks arising from waste, disaster risk, water use, and workplace health & safety.

Saudi Arabia:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Waste	Manufacturing
Workplace Health & Safety	Construction
Emissions to Water	Wholesale and retail trade

Saudi Arabia is a mature Islamic finance market place in terms of total assets, with the second highest volume of Islamic finance assets globally, and sits in third rank in terms of quantitative development. It ranks fourth, behind Malaysia, the UAE and Bahrain, in the Global Islamic Economy Indicator. Saudi Arabia ranks third in terms of quantitative development in the Islamic Finance Development Indicator.

Saudi Arabia's governance and regulatory landscape for the Islamic finance industry is still weak, however, despite the large number of accredited Shariah scholars and auditors. This may present a challenge to adopting broader considerations in responsible finance. The country's Islamic banks are exposed to risks related to waste, workplace health & safety, and emissions to water. Saudi Islamic banks face relatively low levels of aggregate risks embedded in their financing, but are more highly exposed than peer markets to risks arising from emissions to air, ecosystem management, and disaster risk mitigation.

Bangladesh:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Emissions to Water	Manufacturing
Site Contamination	Primary agriculture
Energy Use	Wholesale and retail trade

Bangladesh has only recently broken into the top ten Islamic finance markets in terms of total assets. It is also ranked among the top 15 for Islamic finance development, according to the Global Islamic Economy Indicator for 2018. Bank Bangladesh has introduced some programs in the past to support green finance, but its Islamic finance regulatory landscape is still weak, which may inhibit its development of responsible finance.

Through their exposure to higher risk sectors including manufacturing and primary agriculture, Islamic banks in Bangladesh face exposures including emissions to water, site contamination, and energy usage. Lower-risk sectors including wholesale and retail trade represent a greater share of Islamic banks' financing portfolio, however, which reduces the risks to ecosystems and, as a result, to disasters and water use. However, compared with other markets in this assessment, Bangladeshi Islamic banks face greater risks from emissions to water, water use, and disasters.

Indonesia:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Workplace Health & Safety	Manufacturing
Emissions to Water	Construction
Waste	Primary agriculture

Indonesia, the world's largest Muslim-majority country, recently rose into the top ten Islamic finance markets in the Global Islamic Economy Indicator. It has a strong landscape for governance and regulatory framework, with a large number of Shariah scholars and auditors, and stringent supervision from Bank Indonesia. Its government is the only sovereign to have issued a green sukuk, of which to date it has issued two.

The Islamic finance ecosystem in Indonesia has higher exposure than its peer markets to risks related to waste, emissions to water, and workplace health & safety. Indonesian Islamic banks face a lower level of environmental and social risks as a result of a large exposure to wholesale and retail trade sector. There are some gaps in the disclosure of some economic sector exposures, where an 'other' category is used too liberally to classify particular sector exposures. Indonesia's environmental and social risks are among the lowest among the countries surveyed in the RFI Risk Assessment.

RFI FOUNDATION RISK ASSESSMENT FINDINGS

Qatar:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Waste	Healthcare
Workplace Health & Safety	Manufacturing
Emissions to Water	Wholesale and retail trade

Qatar has secured its position among the top five Islamic finance markets in terms of assets. In the Global Islamic Economy Indicator, it is the seventh-ranked Islamic finance marketplace. The country has also been successful in setting up a strong regulatory framework for its Islamic finance industry, and is highly ranked in terms of regulation and corporate social responsibility, according to the Islamic Finance Development Indicator 2018.

Islamic banks in Qatar face higher risks from waste, workplace health & safety, and emissions to water as a result of their higher exposure to healthcare and manufacturing. Relative to other Islamic finance markets, a larger share of Qatar's financing is provided to the government, making its overall risk level among the lowest of the countries we assessed.

Pakistan:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Emissions to Water	Manufacturing
Energy Use	Primary agriculture
Workplace Health & Safety	Utilities

Pakistan's Islamic banks are rapidly gaining steam and Pakistan ranks seventh and eighth, respectively, in the Islamic Finance Development and Global Islamic Economy indicators. The country has set up a strong governance and regulatory framework, which is promoting initiatives focused on Shariah governance, social inclusion and environmental impact.

Pakistan's Islamic banks are exposed to more environmental and social risks as a result of their financing than most other countries we assessed. These risks include waste, emissions to water, and workplace health & safety. Pakistan's profile for environmental and social risks is led by the risks associated with emissions to air and water, site contamination, and energy consumption. These risks emerge from a large footprint within manufacturing, primary agriculture, and utilities, all of which are important to the broader economy but carry higher potential risks that need to be mitigated.

Oman:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Workplace Health & Safety	Construction
Waste	Healthcare
Site Contamination	Manufacturing

The Islamic finance industry in Oman has developed rapidly since its introduction in 2013. With only five years' experience it is notable that Oman is already ranked fifth in the Global Islamic Economy Indicator and seventh in the Islamic Finance Development Indicator. Oman's Islamic Finance Regulatory Framework provides a strong regulatory and governance backdrop for its Islamic finance industry, putting it in third place in the IFDI rankings despite being home to only a limited number of Shariah scholars and auditors.

Through its financing exposures, the Islamic finance landscape in Oman has relatively high risk from workplace health & safety, waste, and site contamination. Those businesses financed by Oman's Islamic banks carry lower energy, ecosystem and disaster risks. In comparison to peer markets, Oman has lower risk exposure but faces moderate exposures in workplace health & safety and ecosystem risks.

Turkey:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Workplace Health & Safety	Manufacturing
Waste	Construction
Site Contamination	Wholesale and retail trade

Turkey has seen a number of new participation banks in recent years and is ranked among the top 15 in the Global Islamic Economy Indicator. It ranks outside the top 10 in quantitative development in the Islamic Finance Development Indicator, reflecting a weak governance framework due to there being little specific regulatory guidance from the central bank. The country does, however, have relatively high transparency in terms of financial disclosure.

Turkish participation banks are exposed to higher risks in workplace health & safety, waste management, and site contamination through having a high share of financing directed towards the manufacturing and construction sectors. participation banks in Turkey have a lower relative exposure to disaster, ecosystems, and water use risks. In comparison with other markets surveyed in this assessment, Turkey has a modest level of environmental and social risks, driven by the sector concentrations of participation banks' financing customers.

Bahrain:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Waste	Manufacturing
Workplace Health & Safety	Construction
Emissions to Water	Healthcare

Bahrain is a significant hub for the Islamic finance industry in the GCC and globally, ranking seventh in terms of Islamic finance assets in the State of the Global Islamic Economy Report 2018. It is also third in the Global Islamic Economy Indicator and second in the Islamic Finance Development Indicator. Bahrain has a strong governance and regulatory framework, with a high level of Shariah governance, strong corporate social responsibility activities and disclosures by Islamic banks, and strong overall financial disclosures.

Bahrain's Islamic banks face relatively high risks from waste management, workplace health & safety and emissions to water due to higher exposure to the manufacturing, construction and healthcare sectors. They face lower risks from ecosystems management, disaster risk mitigation, and water use. Bahrain's overall risk exposure compared with other Islamic banking markets is moderate.

Kuwait:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Workplace Health & Safety	Manufacturing
Waste	Construction
Site Contamination	Wholesale and retail trade

Kuwait has a large Islamic banking market and is sixth largest in the world in terms of assets, with a slightly lower position (ninth) in the Global Islamic Economy Indicator. The Islamic finance governance and regulatory ecosystem in Kuwait is moderate, according to the Islamic Finance Development Report 2018, and is improving as a result of new regulations being issued by the Central Bank of Kuwait.

Kuwaiti Islamic banks face relatively high risks from their exposures in manufacturing and construction to workplace health & safety, waste management, and site contamination. The modest overall exposure in Kuwait is partially because of limited reporting transparency about sector exposure, with a large proportion uncategorized and about one-third running through other financial institutions and real estate, where it is more difficult to assess the underlying exposures. Kuwait's Islamic banks face significant potential for embedded environmental and social risks relative to the other markets in this assessment.

United Arab Emirates:

TOP 3 RISK EXPOSURES:	TOP 3 RISK SECTORS:
Emissions to Air	Manufacturing
Emissions to Water	Construction
Site Contamination	Wholesale and retail trade

The United Arab Emirates (UAE) is one of the most developed and mature Islamic finance markets. It is ranked fourth in terms of Islamic finance assets. The UAE holds second position behind Malaysia in the Global Islamic Economy Indicator and is ranked third in the Islamic Finance Development Indicator. The Islamic finance governance and regulatory ecosystem in the UAE is considered 'moderate', according to the *Islamic Finance Development Report 2018*.

Islamic banks in the UAE face higher relative risks from waste, disaster risk and workplace health & safety as a result of higher exposures to construction, manufacturing, and transportation, storage & communications sectors. Its risk levels in ecosystems management, water use, and site contamination are lower as a result of the share of financing directed towards the lower-risk wholesale and retail trade sectors. UAE Islamic banks face environmental and social risks through their financing portfolios, being ranked in the middle of the countries reviewed in this survey.

Conclusion and Recommendations

We have analysed the ESG risks which are most common across a sample of nearly every Islamic bank — whether standalone or window — in the world. The principal source of ESG risk facing Islamic banks is embedded in their balance sheets though the financing they provide. Islamic banks aim to be intermediaries supporting the real economy, and as a result they are exposed to the risks derived from non-financial businesses.

If a bank is not proactively integrating these risks into the financing process, including in the cost of financing it provides, then it is taking on additional risk while receiving no compensation for doing so. As more research demonstrates the importance of ESG risks to financial return, it is becoming clear to financial institutions around the world that ESG risks will affect their potential profitability, portfolio risk levels and returns on capital. Regulators are examining the prudential and macroprudential impacts of specific environmental risks including climate change.

The evidence we have collected points to particular risk concentrations for Islamic banks in the markets we analysed. Although these are common to many banks, other issues may be more of a risk for individual banks and it is critical for every bank to analyse its risk exposure and not to adopt ESG just because its peers have.

If a bank wants to quickly assess whether it may have undetected ESG risks, it should look at the financing book and see if it is financing utilities, manufacturing, healthcare, mining/oil & gas, or primary agriculture. These sectors have concentrated ESG risks, and the businesses operating within them may face challenges (or find opportunities in addressing the risks they face). These might be connected to their emissions into air and water, their ability to promote workplace health & safety, their exposure to site contamination at their facilities, or the waste these create. Exposure to real estate and to other financial institutions brings the same risks, albeit less directly. However, in a post-financial crisis world, hidden counterparty risks will surely be a key concern of regulators, increasingly so when there are large and uncertain impacts from climate change.

Once an Islamic bank recognises that it might have unaddressed ESG risks that are financially material, the first move is often internal, where employees concerned about environmental and social risks come together to discuss these issues. Banks are complex institutions, and it takes time to build buy-in at the executive management and board level and throughout the departments that have a role to play in making an internal shift: business & corporate banking; investment banking; strategy; retail banking; risk management; Shariah audit and advisory; sustainability & corporate social responsibility; technology; and human resources.

It may take time to build the support necessary within a bank to drive change, and one of the most important achievements along the way will be a recognition that shareholders, directors, management and employees can all find ways to benefit from a transition towards responsible finance. The financial reward from improving risk management is one benefit, but a strategic shift towards responsible finance will also unlock new opportunities for the bank to differentiate itself from peers and find new business opportunities.

Appendix

DEFINITIONS

Scores	Definitions
ESG Score	Refinitiv ESG Score is an overall company score based on the self-reported information in the environmental, social and corporate governance pillars.
Environment Pillar Score	The environmental pillar measures a company's impact on living and non-living natural systems, including the air, land and water, as well as complete ecosystems. It reflects how well a company uses best management practices to avoid environmental risks and capitalize on environmental opportunities in order to generate long term shareholder value.
Social Pillar Score	The social pillar measures a company's capacity to generate trust and loyalty with its workforce, customers and society, through its use of best management practices. It is a reflection of the company's reputation and the health of its license to operate, which are key factors in determining its ability to generate long term shareholder value.
Governance Pillar Score	The corporate governance pillar measures a company's systems and processes, which ensure that its board members and executives act in the best interests of its long term shareholders. It reflects a company's capacity, through its use of best management practices, to direct and control its rights and responsibilities through the creation of incentives, as well as checks and balances in order to generate long term shareholder value.
CSR Strategy Score	CSR strategy category score reflects a company's practices to communicate that it integrates the economic (financial), social and environmental dimensions into its day-to-day decision-making processes.
ESG Controversies Score	ESG controversies category score measures a company's exposure to environmental, social and governance controversies and negative events reflected in global media
Emissions Score	Emission category score measures a company's commitment and effectiveness towards reducing environmental emission in the production and operational processes.
Environmental Innovation Score	Environmental innovation category score reflects a company's capacity to reduce the environmental costs and burdens for its customers, and thereby creating new market opportunities through new environmental technologies and processes or eco-designed products.
Workforce Score	Workforce category score measures a company's effectiveness towards job satisfaction, healthy and safe workplace, maintaining diversity and equal opportunities, and development opportunities for its workforce.
Human Rights Score	Human rights category score measures a company's effectiveness towards respecting the fundamental human rights conventions.
Community Score	Community category score measures the company's commitment towards being a good citizen, protecting public health and respecting business ethics.
Product responsibility Score	Product responsibility category score reflects a company's capacity to produce quality goods and services integrating the customer's health and safety, integrity and data privacy.
Management Score	Management category score measures a company's commitment and effectiveness towards following best practice corporate governance principles.
Shareholders Score	Shareholders category score measures a company's effectiveness towards equal treatment of shareholders and the use of anti-takeover devices.

COUNTRY SUMMARY DATA-TOP

	Total Islamic banking assets ($ bn)	Number of Islamic banks and windows included in the Risk	Aggregate country risk score (SSRI):	Aggregate country risk rank (SSRI):	Aggregate country risk score (SASRI):	Aggregate country risk rank (SASRI):	IFDI Score (Aggregate):	IFDI Governance Sub-Indicator Score	Top 3 risk exposures:	Top 3 risk sectors:
Malaysia	160.6	17	1.40	10	1.84	11	132	88	1. Workplace Health & Safety 2. Emissions to Water 3. Site Contamination	1. Primary agriculture 2. Construction 3. Manufacturing
Bahrain	63.0	21	1.78	4	2.57	6	74	92	1. Waste 2. Workplace Health & Safety 3. Emissions to Water	1. Manufacturing 2. Construction 3. Healthcare
United Arab Emirates	153.9	11	1.87	3	2.46	7	71	61	1. Emissions to Air 2. Emissions to Water 3. Site Contamination	1. Manufacturing 2. Construction 3. Wholesale and retail trade
Pakistan	12.8	7	1.70	7	3.93	1	59	66	1. Emissions to Water 2. Energy Use Workplace 3. Health & Safety	1. Manufacturing 2. Primary agriculture 3. Utilities
Saudi Arabia	344.8	12	1.37	12	2.44	8	56	38	1. Waste 2. Workplace Health & Safety 3. Emissions to Water	1. Manufacturing 2. Construction 3. Wholesale and retail trade
Oman	9.7	8	1.48	8	2.16	9	52	77	1. Workplace Health & Safety 2. Waste 3. Site Contamination	1. Construction 2. Healthcare 3. Manufacturing
Kuwait	83.1	4	2.06	2	3.41	2	51	66	1. Workplace Health & Safety 2. Waste 3. Site Contamination	1. Manufacturing 2. Construction 3. Wholesale and retail trade
Indonesia	26.7	18	1.43	9	2.07	10	50	58	1. Workplace Health & Safety 2. Waste 3. Emissions to Water	1. Manufacturing 2. Construction 3. Primary agriculture
Qatar	95.8	4	1.38	11	1.55	12	46	50	1. Waste 2. Workplace Health & Safety 3. Emissions to Water	1. Healthcare 2. Manufacturing 3. Wholesale and retail trade
Bangladesh	29.0	7	1.73	5	3.21	5	28	51	1. Emissions to Water 2. Site Contamination 3. Energy Use	1. Manufacturing 2. Primary agriculture 3. Wholesale and retail trade
Turkey	43.9	6	1.71	6	3.21	4	21	24	1. Workplace Health & Safety 2. Waste 3. Site Contamination	1. Manufacturing 2. Construction 3. Wholesale and retail trade

SOURCE: RFI FOUNDATION RISK ASSESSMENT AND REFINITIV

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