SPECIAL REPORT

From left: Rifaat, Cox, Goud, Daud, Lieberman, Marten and Gueckel

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Islamic finance and responsible finance

This roundtable looks at the linkages between responsible finance and Islamic finance and the opportunities for greater convergence. Organised recently by International Investor, an MSC Status global provider of industry development and business information services, with *The Edge* as a media partner, it was chaired by Daud Vicary Abdullah, president and CEO of the International Centre for Education in Islamic Finance (INCEIF).

The panellists were Prof Rifaat Ahmed Abdel Karim, CEO of International Islamic Liquidity Management Corp (IILM); Kurt Lieberman, CEO of Magni Global Asset Management (Magni); Stella Cox, managing director of DDCAP Group; Christian Gueckel, head of research of SEDCO Capital; Dr Azmi Omar, director general of Islamic Research and Training Institute (IRTI), Islamic Development Bank Group; Sarah Marten, co–vice chair, board of trustee, at Responsible Finance and Investment Foundation (RFI Foundation); and Blake Goud, CEO of RFI Foundation.

Daud Vicary Abdullah: The main objective of this strategic review roundtable is twofold. First, to analyse responsible finance and how it links with the Islamic finance segment, as well as the opportunities for greater convergence between the two areas. Second, we will look at the governance efforts required to achieve these steps.

I see both top-down and bottom-up approaches in terms of the linkages between responsible finance and Islamic finance.

From the top down, it is crucial that the main actors in the Islamic finance sector confront the twin challenges relating to advancing in an effective manner, given the state of the global economy and, particularly, due to the negative light in which Islam is portrayed by the world's media.

From the bottom up, the research route mentioned is important because sharing greater amounts of information across the sector is fundamental. This sharing of knowledge will help to create the demonstration effect that is needed to drum home the benefits of responsible forms of finance, including Islamic finance.

With that in mind, what approach should be adopted in terms of research and why is it so important?

Prof Rifaat Ahmed Abdel Karim: With regard to linking Islamic and responsible forms of investing, at the IILM, we adhere to the claim that Islamic finance is responsible finance and vice versa.

Of course, such a claim has to be substantiated by research and a good place to start relates to one of the basic rules of shariah — you cannot sell what you do not own. By demonstrating how this rule works in practice, Islamic finance will be able to show that it is responsible finance. In turn, this will give the former a whole new dimension to grow, while providing the latter with a significantly broader base.

Any research will need to focus on investment activity and, within that, whether or not it is shariah-compliant.

Furthermore, it is essential that the Islamic finance sector is able to dispel any misgivings about shariah-compliant investing, and empirical evidence and research will certainly help to raise awareness.

For reasons of credibility, it is vital that independent experts conduct all the research. Once this substantiated research is in place, the Islamic finance and responsible finance segments will be far more likely to succeed in attracting sustainable sources of investment. Moreover, it will enable the Islamic finance sector to dispel some of the myths about shariah and Islam in general.

Kurt Lieberman: That last point is incredibly important. I am not Muslim, I live in America and the reality is that most of my friends understand Islam through what they see in the media.

Clearly, given the nature of religious texts, the focus on prohibition is unsurprising, but fresh approaches are needed to highlight the more positive elements of Islamic finance. For example, the takaful joint guarantee and a values-led perspective are extremely powerful concepts.

As Prof Rifaat stated, the advantages of commissioning independent research are clear. Notwithstanding, I would suggest that non-Muslim organisations are also incorporated into the research side of things. It is no disrespect to Islamic entities to say that non-Muslims will engage to a greater extent if a respected non-Muslim organisation extols the research-backed benefits of a particular Islamic financial activity.

Stella Cox: It is important to note here that, historically, the asset management component of the Islamic finance industry has been under-represented and the sector has not always benefited from the research excellence that it now enjoys due to the presence of firms such as SEDCO Capital and Arabesque [Asset Management]. Indeed, much of the past research and development in this area has come from conventional firms, mostly large banks and institutional fund managers, seeking to originate product to capitalise on the momentum of the Islamic finance sector.

The Islamic finance sector has grown from a banking platform within the emerging markets of the Middle East and, in the past, Islamic banks have not necessarily developed or aligned their investment perspective with their global, conventional counterparts. They have not moved in a significant manner towards ESG (environmental, social and corporate governance) principles, as they adhere to certain financial considerations and disciplines distinct from those of conventional institutions and investors. There is now a growing momentum among those who want to include other perspectives, such as ESG, towards the development of Islamic finance and to explore how these elements might begin to be brought together, since they are viewed as being complementary.

My career has been focused on Islamic finance, rather than socially responsible investing (SRI). However, having held discussions with traditional SRI firms, I know of a certain disinterest in, or even dislike for, faith-based investment strategies. Such sentiments are for reasons not necessarily related to the negative image of Islam mentioned by Daud and Kurt and more associated with a matter of historical portfolio performance. Thus, industry stakeholders from each sector have a lot of work to do in this area.

Christian Gueckel: In terms of research, the work done by Arabesque is especially interesting because of its strong conclusions highlighting a positive impact on performance. Another important angle for this kind of research would be to consider the elements of shariah, related to restrictions on sectors and financial ratios, especially leverage, and to investigate how these affect performance.

Many investors now see no trade-off between responsible investing and Islamic investing on one hand and performance on the other. If strong research can be utilised to demonstrate that these restrictions, which essentially amount to negative screening, can add to performance, the sector will have a convincing argument in favour of further consolidation between these two investment approaches.

Dr Azmi Omar: It is only natural that Islamic finance has followed the development pathway of the conventional finance industry, with the banking side coming first. Only now are we seeing growth and interest in this area in regard to Islamic investing.

The investment side has always focused on negative screening and, as a result, the principles of positive screening have not been fully developed. Thus, stakeholders have been raising the issue of Maqasid al-Sharia, or the objectives of Islamic law, and it is becoming increasingly prominent because investors are unhappy with a framework solely focused on negative screening.

In the context of banking, particularly development banking, the IRTI, which is a member of the Islamic Development Bank (IDB) Group, is now looking into this issue by incorporating certain principles within its operations. This includes implementing a process known as 'development effectiveness', in which we assess the IDB's project funds in its member countries and then fully measure their impact.

We truly believe in the importance of this kind of research approach and I urge all other actors to consider the benefits of contributing to these kinds of investigations.

Sarah Marten: One of the reasons why I became involved with the RFI Foundation is precisely the issue of perception relating to Islamic investing compared with conventional investing. Crucially, Azmi's point about promoting positive screens is fundamental for disseminating a more favourable image of Islamic finance and its associated benefits. For example, positive screening can be linked directly to the environmental component that is clearly lacking in this segment. Such efforts will also help to promote socio-economic development models, for example, IRTI's development effectiveness.

The key to this is how we, the industry players, disseminate the message. For example, Islamic finance has traditionally courted Muslim media and I think it is important that concerted efforts are now made, by institutions like the RFI Foundation, to target and become embedded in conventional media frameworks and titles, such as *The Wall Street Journal* and the *Financial Times*.

Lieberman: I know of certain financial institutions that are genuinely interested in incorporating Islamic finance practices into their operations. Unfortunately, they simply lack the knowledge about how to get things started.

There is definitely a receptive audience out there. Our task, as industry stakeholders, is to reach a consensus on the content of the message to send out.

Gueckel: At SEDCO Capital, we must frequently overcome negative perceptions from markets, such as Europe and the US, with regard to Islamic investing.

Bringing up the concept of prudent ethical investment helps in this regard because it speaks to conventional investors in their language and makes it easier for those coming from a responsible investment background. In fact, the prudence concept is particularly effective in gaining investors' attention, so designing a similar notion for Islamic finance will help to improve the perception of investors in developed markets.

Lieberman: Regarding the use of language, in the traditional asset management world, negative screening has an even worse reputation than values-based investing. Negative screening essentially conveys the message that the parties involved dismiss companies operating outside of the Islamic world and that they are giving up on performance, which is not a solid position on which to begin proceedings.

Ideally, I would like to be able to show that rather than shariah screening leading to negative performance, they actually help to reduce risk. Ultimately, the prudence of shariah screening removes certain risk elements associated with investing, and that is a very powerful argument, if it can be proved with evidence.

Gueckel: SEDCO Capital has been looking at investment portfolios from a risk and portfolio construction perspective. Take, for example, a comparison between two separate portfolios, one that is conventional and the other that removes certain stocks using shariah screens. If you connect the two in terms of risk factors and style attribution, which is a common approach in portfolio construction, you will see that with a constrained portfolio, there is a bias towards quality that stems from the cash leverage constraints, as well as a slight bias towards growth.

A huge amount of research shows that these style factors relating to growth, value and quality can result in compensation and also generate a positive return expectation. This enables investors to tap into style premiums while also having a constrained investment approach.

Blake Goud: Positive screens will be crucial going forward. In contrast to the size of the Islamic banking market, which is approximately US$1.2 trillion, total assets from all banks that are signatories to the Equator Principles from Organisation of Islamic Cooperation (OIC) countries are approximately US$200 billion. This is relatively small, so if Islamic banks are able to identify ways to integrate the positive approach alongside more established practices, the possibilities are enormous.

Daud: The conversation so far has successfully defined a number of potential short-term steps, particularly in regard to the role of Islamic finance within the wider responsible financing segment.

In terms of empirical research into Islamic investing, additional conversations are required to define precisely what areas to cover. My own institution, INCEIF, accounts for approximately 11% of the world's accredited research on Islamic finance, so I know we can certainly contribute in this regard.

We have also reached a consensus about the need for existing institutions to adopt new ways of approaching investment research findings, as well as encouraging them of the value-creating benefits of Islamic investing.

Attracting prominent non-Muslim advocates, who have no religious reason for engaging with Islamic finance, is certainly another key takeaway. By incorporating the voices of respected and preeminent thinkers who understand the financial and social benefits of Islamic finance, the segment will receive a welcome entry into spheres of conventional market discourse.

Interfaith discussions are also important here. As such, initiatives are underway to extend the influence of SRI, including from Hindu groups, the Church of England and the Catholic Church.

Cox: It is also imperative that industry players remain aware of the

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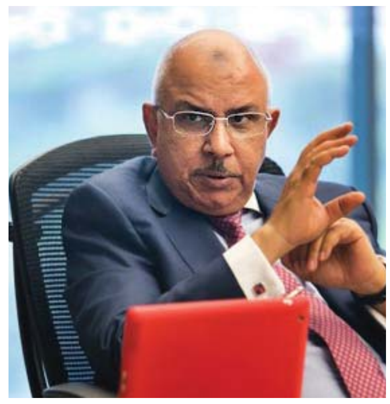
Marten: The entire issue of interfaith finance is interesting because one of the fundamental tenets of responsible finance is to improve the world through acting responsibly

Goud: Islamic finance places a huge emphasis on not simply doing finance for the sake of finance but, rather, for the sake of the economy



Rifaat: It is important to convince the regulators first regarding any guidelines, and the banks will then fall in line behind their directives

different sensitivities in terms of what is being done and what is possible and permissible in the Islamic finance space.

From experience, I know that some participants and commentators within the Islamic finance industry are sceptical about aligning, to any degree, with the responsible finance movement. They argue that efforts in that direction are diluting the unique proposition offered by Islamic finance. In terms of the collective effort to devise a value proposition and associated framework that can be shared by practitioners of both Islamic finance and responsible finance, it is vital that any attempts to further define commonalities and potential engagement approaches take full account of this reticence.

Daud: That leads smoothly on to the next topic of forming alliances. Should the Islamic finance sector be seeking partnerships with other organisations that have similar values, whether this would be the Catholic Church or other decision-making bodies within the Islamic space?

Goud: Linking this to awareness and the general public, there is a huge untapped market waiting for access to the financial system. Currently, the largest group, globally speaking, yet to experience their first interaction with the financial sector is Muslims. In fact, 70% of all Muslims around the world are unbanked, compared to 50% of the non-Muslim population.

Consequently, I think that forming partnerships with bodies such as the Alliance for Financial Inclusion will certainly help to facilitate broader policy reach and, moreover, engender the financial inclusion of growing numbers of Muslims across the globe.

Marten: The entire issue of interfaith finance is interesting because one of the fundamental tenets of responsible finance is to improve the world through acting responsibly. As the world is not entirely Muslim, there is tremendous scope for inter-religious alliances based on the single aim of using money to improve not only yourself, but also your neighbour and the wider world.

Daud: Returning to the short-term action plans, is there anything else the Islamic finance industry should be doing?

Gueckel: One of the aspects that I most like about the principles for responsible investment (PRI), which is supported by the United Nations (UN), is that signatories receive a full suite of guidelines, research publications and monitoring and evaluation tools to help them implement responsible investing.

Thus, one way in which organisations such as the RFI Foundation might be able to broaden its member base is, once the necessary research has been conducted and published, to provide implementation guidelines for Islamic institutions about how to integrate Islamic finance with responsible finance. SEDCO Capital has experience in this area, and so we could be helpful in this regard.

Goud: That is an interesting idea. Inventories of responsible investment assets in Asia show that Islamic assets account for approximately one-third of all Asian responsible investment assets. If you add to these the Malaysian Islamic banking assets, they are about 4½ times larger than the overall responsible investment market across the whole of Asia. Islamic finance undoubtedly constitutes a significant part of the responsible finance market in Asia.

Regarding UNEP FI (United Nations Environment Programme — Finance Initiative), their focus is on banking, whereas the responsible finance movement is more geared towards asset management. Thus, a potential quick win would be to target UNEP FI, while simultaneously pursuing a commitment to new guidelines from the Islamic banking community.

Azmi: I like the idea of conducting the research and then devising a set of guidelines. A related branch would be to ensure that Islamic banks are involved in drawing up these guidelines. For example, securing an agreement from the International Association of Islamic Banks to commit to these guidelines would really help in pushing this agenda.

Similar steps can be pursued with the Association of Banking Institutions of Malaysia, which would certainly help build momentum, as it would involve bringing about 25 financial institutions on board in one go. From there, efforts can turn to the asset management side.

Rifaat: Crucially, banks require regulatory approval before engaging in any new form of activity. It is therefore important to convince the regulators first regarding any guidelines, and the banks will then fall in line behind their directives.

Cox: Prof Rifaat makes a good point. However, Malaysia has a history of setting precedents and of doing things differently, hence its specific shariah-compliant framework was implemented with input from the top down. Replicating this kind of approach in many other countries and jurisdictions is a huge challenge.

Daud: The Malaysian model is certainly unusual in that it is more top down than many others and there has been a genuine will to pursue a shariah-compliant approach in the country, coupled with forceful regulators.
As Prof Rifaat said, there is a need to target regulators in order to facilitate the rollout of any guidelines relating to the integration of Islamic finance with responsible finance. Let's move on to discuss the topic of governance and how the Islamic finance and responsible finance industries can attract responsible capital. Are there any noticeable gaps or is it a case of simple fine-tuning?

Rifaat: I think the reality is somewhere in the middle. In order to really push things forward, it is important that industry practice moves away from its focus on networks of individuals and personalities and concentrates more on efforts to embed the issues we have discussed at an institutional level.

Strong leadership is what is needed more than anything else to fully institutionalise a mindset geared towards research and awareness raising.

Goud: One thing that Islamic finance could do is step back a little and focus on meeting the needs of stakeholders. In this context, it is important to repeat what Emir Muhammadu Sanusi II, the Emir of

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Need for industry players to identify specific research areas

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Kano, Nigeria, and former governor of that country's central bank has publicly stated: finance does not exist in a vacuum.

The industry will benefit from addressing the multi-stakeholder perspective that plays such a crucial role in making the financial sector work for the real economy. Indeed, Emir Sanusi has also highlighted the need to look beyond the financial sector and stressed how governance within institutions has to look at everyone affected throughout the long chain of operations.

Islamic finance places a huge emphasis on not simply doing finance for the sake of finance but, rather, for the sake of the economy. Thus, in discussions about governance, the engagement aspect beyond the financial sector, which includes reaching the common man, is even more critical than elsewhere in the conventional system.

Lieberman: This kind of engagement is precisely what Magni does. One of the failings of both traditional finance and ESG in recent years is that the 'e' and 's' sides have been thoroughly addressed, whereas the 'g' side has been largely ignored. Stakeholders and market participants are now beginning to take this into account.

Islam is especially helpful here because it adopts a point of view that is highly compatible with the best practices in the world of corporate governance. The overlap between the two is almost total. In fact, there are two specific areas in which Islamic finance goes further than best practices in conventional corporate governance: the beneficial use of the product and nurturing the family. The former relates to the company producing something that is good for mankind, while the latter prescribes that the company not only behaves well towards the worker and his or her family, but also towards the other families in the community.

Within the conventional field of corporate governance, one often debated issue relates to how every single product can, theoretically, be misused and how a company should be treated as a result. Within this debate, the argument goes that it is not enough for a company to simply produce a product that is beneficial; efforts must also be made by the company to mitigate the potential for misuse and, when misuse occurs, the company must reduce its impact and frequency.

Daud: So, does governance of Islamic finance and responsible finance broadly differ because one is Islamic, or do they share similar outlooks in terms of their goals?

Lieberman: My view is, yes, they do share common ground because there are numerous governance overlaps between the two. In fact, the majority of the questions raised across, say, the three corporate governance models of secular, Catholic and Islamic, are identical. Any differences are simply nuance, which illustrates the high level of compatibility in terms of governance between the segments.

Goud: At the RFI Foundation, we place significant emphasis on this aspect, particularly within the context of promoting the similarities, rather than focusing on differences, between Islamic and non-Islamic finance practices. For example, despite Islamic finance focusing more on governance than the other areas, there are shared principles and highly complementary approaches in terms of practice.

Daud: With this in mind, in terms of governance within an Islamic institution, is shariah governance simply looking at the product development aspect or should it, rather, be looking at the modus operandi of the whole institution?

Azmi: It really depends on the country in question, although many countries embracing Islamic finance tend to adopt the Malaysian model of one unified shariah board. Furthermore, there is a general convergence across jurisdictions towards a unified shariah board, which will help to standardise the kind of different governance approaches you mentioned, Daud. However, in terms of investment criteria, the issue of Maqasid al-Sharia remains unaddressed in both banking and investment.

While the halal part has been discussed by the industry in detail, the tayyib part, which is something that is actually good or beneficial to the customer, has been largely ignored. It is important that it is discussed further and incorporated into the investment side.

Daud: In Malaysia, Islamic scholars want to incorporate the tayyib part but require direction from the regulators.
Furthermore, a shariah board may well deem a particular product to be legal under Islamic law, but the company itself may not have legal usage of the product. This takes us back to the point made by Kurt as to whether the product is actually good or beneficial for the customer, and this is something that shariah boards should also address.

Gueckel: From the perspective of the responsible investor and the asset management organisations, when due diligence is conducted on asset managers, the five 'Ps' are considered: performance, portfolio, people, philosophy and process.

I would suggest that on a shariah board, these five 'Ps' are not covered to the extent required to attract responsible capital. Thus, assuming that investors will have a similar sense of 'responsibility', it is crucial that this shortfall is addressed. This can be done by placing additional focus on the embedded culture of the organisation, including issues related to philosophy and style of the investments, as well as the people and the overall investment process.

Cox: Responsible investing, which can include Islamically principled investing, is an established discipline within the core asset management space. I am optimistic about how it can be further, and increasingly successfully, embedded within the screening and allocation processes already developed in accordance with shariah stipulation, given the focus, specialism and resources available.

The key point is to allow asset management experts to spearhead this move. The rest of the industry, including the banking practitioners, can then follow suit by joining the dots in relation to governance and stewardship, rather than trying to redesign everything from scratch.

This process will undoubtedly be facilitated by the presence and engagement of prominent Islamic banking industry leaders such as CEO of Abu Dhabi Islamic Bank, Tirad Al-Mahmoud. He is among those leading the way by showing how being ethical can be profitable and how responsible investment parameters can be included in the process of delivering shareholder return as well as the products that customers demand.

Lieberman: Resolving this point about asset managers and the banking segment is crucial in order to move Islamic finance forward.

In terms of responsible investing, there is a widespread belief that form is triumphing over substance regarding PRI, whereby signatories merely seek validation rather than pursuing concrete applications of responsible finance practices.

Conversely, most asset owners genuinely do desire the kinds of changes espoused by PRI, both inside and outside Islamic finance. The overriding sentiment is to allow it to grow, rather than to view it as a purely box-ticking exercise.

Ultimately, in terms of governance within the ESG space, the interoperability of the two systems is key. Moreover, if events like this strategic review roundtable can help to produce some kind of consensus regarding governance in Islamic finance, the demonstration effect previously mentioned by Daud will then help to solve governance issues in other spaces.

Daud: Let's wrap things up by going over a few of the key takeaways. We began by reaching consensus on the need for industry players to identify specific research areas in order to produce empirical evidence as part of the demonstration effect. This includes the involvement of non-Muslim research or engagement. Similarly, we agreed on the importance of addressing the lack of awareness and understanding in terms of the UN PRI guidelines within our various communities.

Another significant takeaway is the concept of beneficial use and family growth as the objective. Within this context arises the question of whether a product is genuinely good for a customer, and this is a particularly important aspect to this debate.

It has been a very positive discussion and I hope we can reconvene soon to check our progress. Thank you all for taking part. E