Islamic Finance: What Can We Learn from the Other One Percent?

Guidance & Lessons for the Sustainable Investment Community

From The
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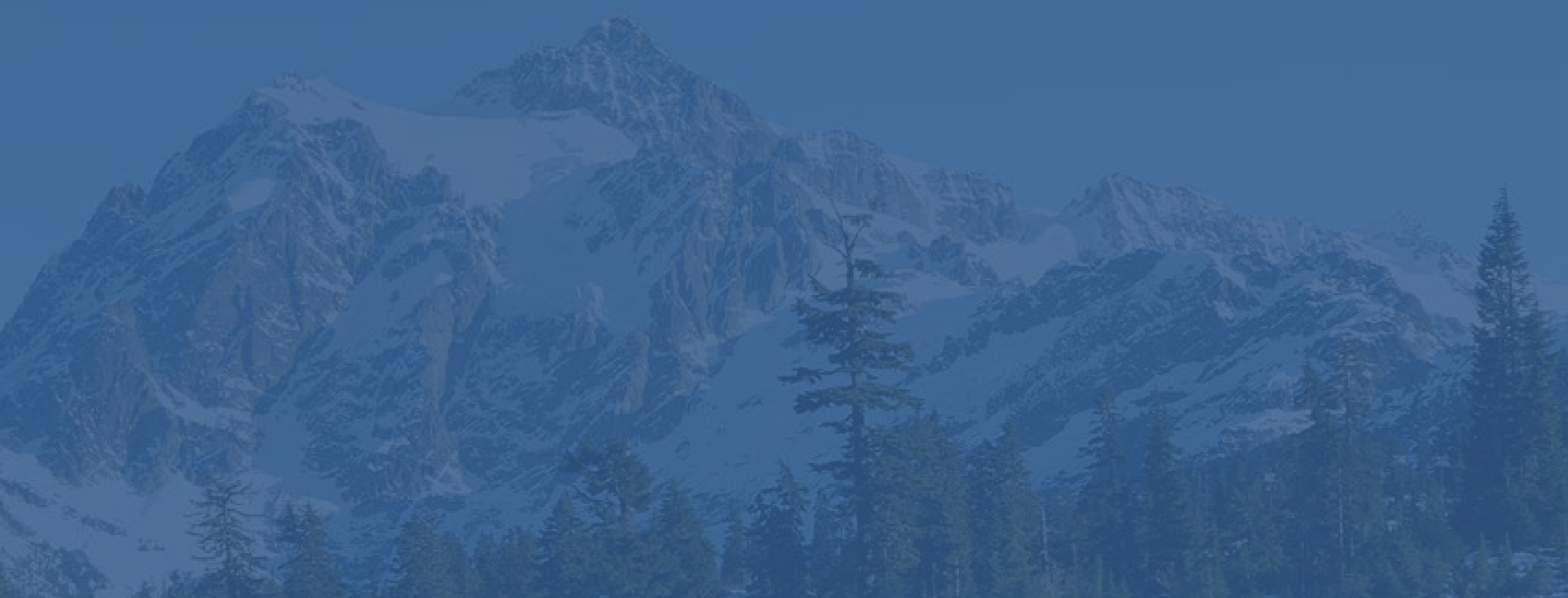

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Saturna Capital, manager of the Amana, Saturna Sustainable, Sextant, and Idaho Tax-Exempt Funds, uses years of investment experience to aid investors in navigating today's volatile markets. Founded in 1989 by professionals with extensive experience, Saturna has helped individuals and institutions build wealth, earn income, and preserve capital.

We are long-term, values-based, and socially responsible investors. We view consideration of environmental, social, and governance (ESG) factors as essential in forming portfolios of high-quality companies that are better positioned to reduce risk and identify opportunities. We believe that companies proactively managing business risks related to ESG issues make better contributions to the global economy and are more resilient.

At Saturna, we believe in making your investment dollars work hard for you and that your interests always come first. Saturna strives to not only offer the best investment opportunities from mutual funds to IRAs, but to match those sound investments with superior customer service.

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Conventional finance is at an evolutionary crossroads. The integration of environmental, social, and governance (ESG) considerations are not only changing valuation techniques, but also how capital can be used. These changes are not without controversy.

On the positive side, ESG and sustainable investing have become broadly adopted into the mainstream. There were remarkable improvements in the expansion of traditional due diligence frameworks while raising the importance of broad stakeholder considerations. On the negative side, however, are significant challenges. ESG investing has been criticized for both going too far and for not going far enough to try to create positive outcomes. Despite efforts to improve data reporting, investors face large challenges with the social pillar of ESG investing, which is the most difficult pillar to analyze and integrate. According to a 2021 ESG Global Survey sponsored by BNP Paribas, 51% of participants rated social factors as the most challenging.[1] The social component of ESG is becoming more important to investors, but its data is difficult to measure and there is an acute lack of standardization around social metrics.

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Recently, sustainability-related investment trends have come into the political spotlight, leading to heightened regulatory attention. As the financial industry tries to address these challenges, it may be timely to look to other financial frameworks. One such framework represents approximately 1% of global financial assets, and it could offer valued guidance for the ever-evolving financial industry, particularly as it relates to the broad sustainability community: Islamic finance.

Defining the 1%

As of December 31, 2021, the total value of global financial assets was estimated at $274.4 trillion, a 7.8% year-over-year increase.[2,3] The total value of Islamic-compliant financial assets was estimated at $3.06 trillion, an 11.3% year-over-year increase.[4]

The United Nations estimated the world's population to be 7.9 billion as of year-end 2021.[5] The Pew Research Center estimated the global population would grow to 9.3 billion by 2050. In the 2010 census, Christianity was the world's largest religion, and Islam was the world's second largest religion. Christians accounted for 31.4% of the global population, while Muslims represented 23.2%. Pew estimated that by 2050, the Muslim community will grow to 29.7% of the world's population while the Christian demographic is likely to stay at 31.4%. Pew attributed the Muslim population's higher growth rate to its younger demographic profile. From 2010 to 2050, the Muslim population is projected to grow 73%, significantly higher than the rate of growth of the general population at 35%.[6] In fact, Islam could easily become the world's largest religion by 2050.

Islamic-compliant financial assets are relatively underrepresented, given the size of the Muslim population and the amount of assets aligned with Islamic principles. The Gulf Cooperation Council (GCC), a community of six Middle Eastern countries that include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates, controls over 34% of the world's sovereign wealth fund assets, estimated at over $8.1 trillion.[7] Considering the size of the Muslim population, its projected growth, and the size of its financial assets, it would not be a surprise to see Islamic-compliant investments experience higher rates of growth and obtain a larger market share of the world's global assets.

Lessons and Insights from the 1%

Based upon the presented information, what can we learn from an investment standpoint? Islamic-compliant investing offers valuable insights for sustainable-aligned investors. The principles of Islamic finance can also help finance professionals coordinate ESG-related investment inputs with positive outcomes. In this edition of From The Yardarm, we will explain how Islamic finance can be used for social justice and social good.

Sustainable Roots

"Use of Money," the sermon given by Methodist evangelist John Wesley in 1872, is often viewed as the founding of early faith-based investing. "We may not engage or continue in any sinful trade, any that is contrary to the law of God, or of our country," Wesley preached.[8] His sermon also mentioned avoiding behaviors that could harm his congregants' minds or bodies or those of their neighbors, including business activities engaged in gambling, alcohol, tobacco, or weapons production. Wesley's sermon was an early framework for exclusion-based investing that later evolved into shareowner activism and engagement.

In the 1970s, civil rights leader and Baptist minister Leon Sullivan was on the board of General Motors. Sullivan managed to convince General Motors to become the first major US corporation to take a bold anti-apartheid position. The company withdrew its business activities in South Africa in 1986, marking a new a period of corporate activism.[9]

There are normative frameworks that came even earlier than "Use of Money." Documented instances of early commerce that adhered to Islamic principles can be found in practices of the Islamic Umayyad Caliphate between 661 to 750 CE.[10] Modern Islamic-compliant finance was established with the first Islamic-compliant bank in Egypt in 1964.[11]

Defining Islamic Compliance & Applications for Modern-Day Sustainability Frameworks

The core concepts of Islamic financial principles are to promote trade, commerce, fairness, and social justice.[12] Islamic finance "merges the ethical teachings of Islam with finance as a means to meet the needs of society and to encourage socioeconomic justice."[13] All the operators of the financial system in Islamic finance are "specifically assigned a key socio-economic role, above the principle of profit maximisation."[14]

The term *halal* denotes practices, behaviors, and actions that are made in accordance with Islamic principles. If such practices, behaviors, and actions are not *halal*, then they are deemed *haram* – not being in congruence with Islamic principles.

Islamic finance uses both a principles-based process and an exclusionary process in investing. Islamic principles promote the concept of risk-sharing. Investors share in both the potential for profits and for losses. *Gharar*, or the sale of what is not yet present, is discouraged. This applies to gambling, short-term speculation, and excessive risk-taking. Islam also prohibits giving or receiving interest payments, also known as *riba*. The respective sacred texts of the three Abrahamic religions (Judaism, Christianity, and Islam) all prohibited usury, or lending with interest, because it fostered economic inequality and social injustice.[15]

Within Islamic finance, debt-related instruments are deemed *haram* due to their interest payments, lack of risk-sharing attributes, and that they are usually structured to guarantee fiscal performance regardless of the issuer's circumstances. Debt obligations are viewed in Islamic finance as "risk-transferring" instruments rather than risk-sharing instruments. Bond-like instruments in Islamic finance do exist, but they have been structurally modified to incorporate risk-sharing attributes. These instruments are *sukuk* or *murabaha*; the underlying instruments are tethered to the performance of the underlying assets, rather than a debt obligation.[16] Payments of income from *sukuk* and *murabaha* are profit-sharing distributions, not interest payments.

Equities generally do not offer performance guarantees based on future results. They expose the investor and issuer to both profits and losses depending on the future performance of the underlying asset. Equity investments naturally incorporate the risk-sharing principles of Islamic finance between the issuer and the investor.

The interpretation of Islamic law is nuanced and can differ between different sects and denominations. However, the primary criteria and exclusionary aspects tend to be consistent. This also applies to the application of investment management in Islamic finance. For example, companies typically raise and use debt for normal day-to-day functions such as working capital and lines of credit. An investor with an Islamic-compliant portfolio would seek companies that have low debt characteristics. Islamic-compliant asset managers employ financial screens that seek to eliminate companies with the following characteristics:

- greater than 5% of their revenue comes from *haram* sources
- greater than 33% total debt, as compared to their market capitalization (trailing 12-month average)
- greater than 45% accounts receivable, as compared to their total assets (trailing 12-month average)

If a company fails the screening process, it is considered an unacceptable investment. However, *halal* investment screening is not always straightforward. When deciding whether an investment is *halal*, it is necessary to examine the company's business activities to understand how that company makes its money.

The point of the screening process is to find companies with low debt profiles and resilient balance sheets, led by management teams that engage in behaviors aligned with fiscal prudence. Many firms tend to prioritize the maximization of a company's income statement at the expense of its balance sheet, which can potentially undermine the firm during periods of economic turbulence and downturns.

Intentions & Outcomes: A Precarious Balance of Aligning Inputs with Outcomes

Islamic finance strikes a balance between its inputs (principles-based and exclusionary processes) and outputs (doing good for society) while promoting commerce. A symbiotic relationship exists between a business and its community of stakeholders, as neither exist in a vacuum.

When comparing the approaches of conventional finance and Islamic finance, usually the inputs are examined to shed light on similarities and differences. It's not as typical to examine their outputs. Comparing the outputs, or deliverable results, of these differing frameworks could provide a more comprehensive picture for readers.

Older models of sustainable and ESG frameworks tended to emphasize exclusionary processes and were additive to traditional financial-centric models. Over time, sustainability and ESG investment practices began to focus on positive outcomes and some sense of "doing good." Modern sustainability and ESG investing have shifted from being focused on inputs to now include scrutiny of outputs. The broad interpretations and applications have left many investors disillusioned with their outcomes.

Sustainable and ESG investing have been criticized for either going too far or not going far enough to make positive change. Recently, the state of Texas has begun to "boycott the boycotters" in response to the belief that ESG investing has gone too far. Local and state government entities in Texas are now prohibited from doing business with financial firms that avoid investing in the oil and gas industry in favor of renewable energy.[17] Florida's Board of Administration trustees, led by Governor Ron DeSantis, has taken even more pronounced action to ban ESG considerations from being included from state pension investment plans.[18,19]

"Little is known about the actual impact investors make through SI [sustainable investing]," according to the article "Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact," which was featured in the peer-reviewed journal, *Organization & Impact*. According to the article, sustainable investing usually means avoiding harmful industries and choosing companies that have exhibited positive past performance in ESG metrics. However, "this is a static approach, which ignores that impact is fundamentally about change."[20]

In an InfluenceMap report from August 2021, 593 equity funds were surveyed in the broad ESG category. The report found that 71% of those funds had a negative Portfolio Paris Alignment[21] score, which meant that the companies within their portfolios "were misaligned with global climate targets."[22] Sanjay Bhagat, in his Harvard Business Review article from March 2022, "An Inconvenient Truth About ESG Investing," found that companies that were added to ESG portfolios did *not* subsequently improve compliance with labor or environmental regulations.[23]

Despite these controversies, sustainable funds experienced material growth in 2022. Almost $70 billion was invested in funds that claimed a sustainable investing mandate this year. According to Morningstar, "There are five times as many sustainable funds in the US today than a decade ago, and three times more than five years ago." [24]

Adding to the tension of the ESG debate is the cynicism that sustainable or ESG investment strategies are more concerned with the appearance of seeming environmentally conscious but do not achieve anything more than favorable marketing. This is called "greenwashing," where an investment process or company asserts itself as either environmentally or socially conscious for marketing purposes but isn't making any notable efforts. DWS Group, a German-based asset management firm, and Goldman Sachs were both investigated this year after failing to fulfill their sustainable mandates.[25,26]

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Gary Gensler, the Chair of the US Securities and Exchange Commission, released a statement on March 4, 2021, noting the size of the ESG market and the potential need for heightened scrutiny and regulation. "I think investors should be able to drill down to see what's under the hood of these funds," said Gensler. "As there's not a standardized meaning of these sustainability-related terms, I've asked staff to consider recommendations about whether fund managers should disclose the criteria and underlying data they use." [27]

As modern conventional capitalism evolves to incorporate a broader framework for positive change and impactful outcomes, its efforts appear confined by the vestiges of Milton Friedman's doctrine, which elevates capitalism above all else.[28] Larry Fink, the CEO of BlackRock, published a "Letter to CEOs" in January of 2022, in which he emphasized a shift toward stakeholder capitalism to formalize long-term prosperity along with heightened attention to climate policy.[29] "Fink is not interested in saving the world," wrote Nives Dolsak and Aseem Prakash in a Forbes article in response to Fink's letter. "He is interested in making money while pursuing climate goals."[30]

Sustainability and ESG investing struggle under the loose construct of their many different interpretations and applications. Investors are disillusioned with ESG investing for its perceived failure to solve aspirational goals such as stalling climate change, social agendas, and governance misdeeds. With fairness, ESG was never originally meant to take on this missionary role; it is merely an enhanced due diligence framework—a term intended to ascertain how environmental, social, and governance factors may impair an issuer's financial performance. The genesis of early ESG was to expand upon traditional security valuation methodologies. ESG investing's original construct was not, in fact, about the greater good.

ESG was never meant to take on the missionary role of solving aspirational goals

In January 2004, former UN Secretary General Kofi Annan invited the CEOs of major financial institutions to join an initiative to decide how to integrate ESG into the capital markets. One year later, "Who Cares Wins: Connecting Financial Markets to a Changing World," a report on this initiative, was published. The report found that integrating ESG considerations into the market "makes good business sense and leads to more sustainable markets and better outcomes for societies."[31] This report was the first to coin the term "ESG." Also in 2005, the United Nations Environment Programme (UNEP) Finance Initiative published their own report, identifying the scope of ESG as the "materiality of environmental, social and governance (ESG) issues to securities valuation."[32]

The concept of ESG later evolved into a broader framework known as "double-materiality." This approach extended upon ESG's original focus to examine how an issuer's actions could affect its broad community of stakeholders, including shareowners, consumers, suppliers, employees, and the environment. In 2019, the European Commission (EC) was the first to formally describe the concept of double-materiality in the context of sustainability reporting and the need to get a full picture of a company's impacts.[33] The concept of double-materiality was not new, but the EC formalized a reporting framework.

A more recent iteration of the ESG investing framework seeks to create "good" or "positive" contributions toward either the environment or a social outcome. In this approach, investors seek sustained excess returns on a risk-adjusted basis while also targeting positive real economy impacts.[34] This mandate is gaining traction and mirrors the efforts of the European Union's (EU) Taxonomy Regulation, which is designed to support the EU economy in meeting its European Green Deal objectives. Within the EU's Taxonomy, the potential "greenness" of a given investment strategy is determined based on sustainability criteria and the strategy's objectives. The EU framework also requires sustainable funds to incorporate at least one of the six environmental objectives[35] identified within their Taxonomy, while doing "no significant harm" to any of the other environmental objectives and respecting basic human rights and labor standards.[36]

Intentions & Outcomes: Examination of Islamic Economy Outcomes

As noted earlier, Islamic finance successfully balances the application of its inputs (principles-based and exclusionary-based frameworks) and its outputs (doing good for society) that broad sustainability and ESG models struggle to address. Islamic finance promotes commerce while emphasizing outcomes that are distinctly different when compared to conventional finance. We previously noted how Islamic finance emphasizes risk-sharing, but the framework also differs from conventional finance through its grounding in the real economy. "Islamic Finance Guide," a white paper published by international law firm Addleshaw Goddard, explained that Islamic finance "places an emphasis on the need for financial transactions to be supported by genuine trade or business related activities; this provides an active boost for economic activity and, consequently, the economy."[37]

Greater economic stability can be fostered by placing emphasis on the real economy and societal impacts. This framework limits potential overextension caused by excessive debt and usury. Tariq Alrifai, in his book *Islamic Finance and the New Financial System*, identified the overuse of debt as "the core of our problems. Governments and central bankers' inability to solve this problem is creating more instability in our system and making it even more fragile." This is particularly cogent given that sovereign debt sustainability is taking center stage in the post-pandemic environment. "In Islamic finance," Alrifai noted, "if there are no assets to back up the transaction, then there is no transaction. There is no promise to repay without assets being involved."[38]

There are other attributes of Islamic finance, beyond being an asset-based economy promoting social good, that can be lost to the untrained eye. Islamic finance also includes heightened attention to contracts and the goal to minimize asymmetric information.

Risk-sharing fosters important benefits, such as mutual trust on a societal level. According to "Advances in Islamic Economics and Finance," people understood the advantages of risk-sharing finance as far back as the Middle Ages.[39] It dominated the known financial world for centuries before giving way to risk-based financing. Recognizing trust to be "an effective instrument of social cohesion," Munuwar Iqbal said the likelihood that "the breakdown of trust in Europe and elsewhere was a major factor for the loss of dominance of risk-sharing finance by the end of the Middle Ages."[40]

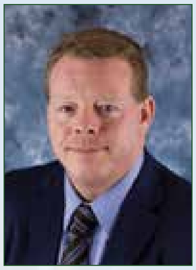
It makes sense why Islamic finance emphasizes symmetry of information in financial contracts. It promotes a relationship built on trust in which all parties can mutually benefit from the shared economic profits. One of the principles of Islamic law is to prevent one party from benefiting from the loss of the other party. "A zero-sum exchange encapsulates precisely what is to be avoided: it is an exchange in which one party gains at the expense of another leading to a win-lose outcome."[41]

Risk-sharing contracts and symmetry of information are what ultimately help promote fairness and social justice. Islamic finance appears to achieve the outcomes that ESG investors hope to reach. Conventional finance may continue to struggle to fulfill its aspirations to integrate the elevation of social good as long as its fiduciary duties largely prioritize shareowner maximization. Modifications to create positive outcomes may come into play, but this is more likely to be a result of cultural differences in their applications or enacted by legislative changes, such as those being employed by the EU through its Sustainable Financial Disclosure Regulation (SFDR), which is likely to drive one trillion euros ($1.19 trillion) into green investments over the next decade.[42] These venues may help bring about different outcomes.

Conclusion

While the Islamic financial community only represents a small portion of global assets, its constructs offer valuable takeaways for the rest of the financial community. As conventional finance evolves, it is likely to benefit from the principles of Islamic finance. The numerous broad sustainable and ESG constructs may offer some solutions to achieve this desired balance.

About the Author



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Patrick T. Drum, Senior Investment Analyst and Portfolio Manager, joined Saturna Capital in October 2014.

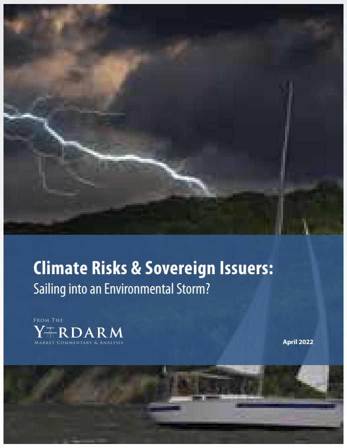
He is a former adjunct professor of Finance for the Sustainable MBA Program at the Bainbridge Graduate Institute (BGI), currently known as Presidio Graduate School. Mr. Drum holds a BA in Economics from Western Washington University and an MBA from Seattle University Albers School of Business. He is a Chartered Financial Analyst Charterholder, a Certified Financial Planner®, and holds a Sustainability and Climate Risk (SCR®) Certificate through the Global Association of Risk Professionals.

Prior to joining Saturna Capital, Mr. Drum led environmental, social, and governance (ESG) research and was director of fixed-income portfolio management since 2007 with a private account group at UBS Institutional Consulting Services, specializing in investment management for global conservation and national wildlife park endowments as well as sustainable-social screened client portfolios. He is a former Chair of the United Nation's Principles for Investment (UNPRI) Fixed Income Outreach Subcommittee and a current member of the UNPRI's Bondholder Engagement Working Group (BEWG), an advisory committee working to elevate important ESG considerations and best practices among issuers and investors.

Mr. Drum's past experience also includes business valuation at Moss Adams and portfolio management at Washington Mutual Bank. Mr. Drum is a member of the Board of Trustees to the Museum of Glass in Tacoma and a member of Rotary.

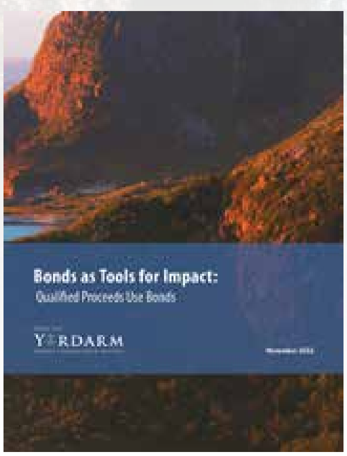
More by Patrick Drum

Climate Risks & Sovereign Issuers: Sailing into an Environmental Storm?



This edition of From The Yardarm examines how effectively ESG ratings firms assess sovereign ESG factors, especially concerning the environment. We will discuss climate initiatives formed by the United Nations and examine how sustainability regulations and investors' behavioral biases are potentially increasing risk rather than reducing it.

Bonds as Tools for Impact: Qualified Proceeds Use Bonds



Bonds are a major component of building our society, and while they are largely invisible to the average investor, they are woven into the fabric of life on this planet. Sovereign governments use the debt markets to finance spending programs. Local municipalities access the market to build infrastructure such as roads and water systems that serve entire communities. Schools, universities, and hospitals need the debt markets for improvements and expansion.

Available at www.saturna.com

Footnotes

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