Sustainability Insights | Research

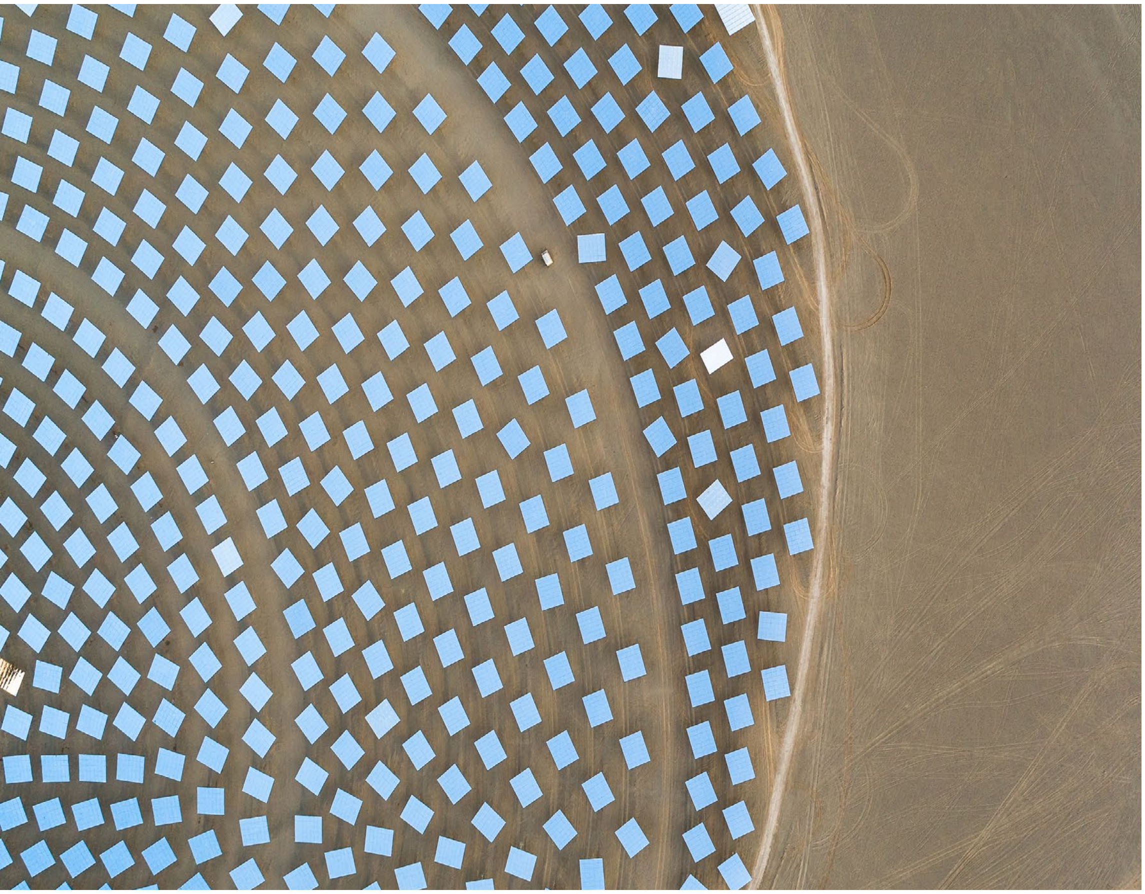
Islamic Finance's Role In The Climate Transition

Nov. 14, 2023

Global harmonization of Islamic finance principles could smooth the process for issuing sustainable sukuk to fund climate change mitigation measures in core markets.

This research report explores an evolving topic relating to sustainability. It reflects research conducted by and contributions from S&P Global Ratings' sustainability research and sustainable finance teams as well as our credit rating analysts (where listed).

This report does not constitute a rating action



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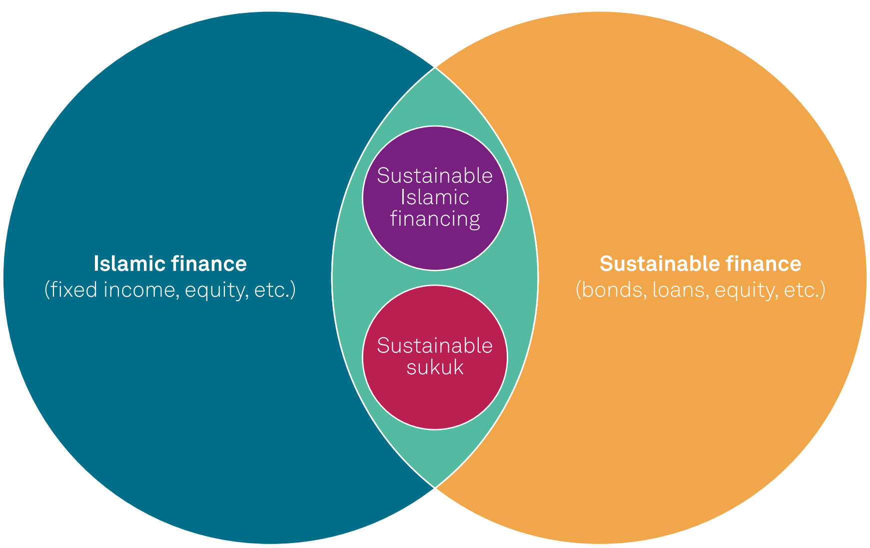
In this research, we explore why and how Islamic finance can be a useful source of funding for climate transition strategies and sustainable development, and what challenges remain to unlock its full potential. We examine the extent of the sustainable sukuk market globally, its growth drivers, and how these differ in Southeast Asia versus the Gulf Cooperation Council (GCC). We also discuss sustainable principles and frameworks in some of the large Islamic finance countries. In this research we draw on data from Environmental Finance Data.

Key Takeaways

- Islamic finance and sustainable finance share common features and both markets are expanding, with sustainable sukuk comprising a nonnegligible proportion of annual sukuk issuance.
- Islamic finance is typically concentrated in economies reliant on hydrocarbons that have greater exposure to energy transition risks, which potentially creates higher demand for sustainable sukuk to execute the transition of these countries, in our view.
- We see progress in Southeast Asia and the GCC to create local definitions of what constitutes sustainable Islamic finance.

Sustainable sukuk intersect Islamic finance and sustainable finance

See appendix for further information on the terms as used in report



Source: S&P Global Ratings.

Islamic And Sustainable Finance Have Common Features, But Are Distinct

In our opinion, there are parallels between the objectives of sustainable finance and some of the underlying principles of Sharia, particularly with respect to climate transition and sustainable development. The core principles of Islamic finance call for the creation of a sustainable, stakeholder-focused, and socially responsible financial system. Islamic finance must abide by the objectives (Maqasid) of Sharia, which broadly revolve around the protection of faith, life, mind, wealth, and dignity. (see appendix for further information on the term Islamic finance as used in this paper).

In many respects, we believe these overlap with sustainable finance's focus on the integration of sustainability objectives into investment decision-making. They also add considerations concerning the longer-term economic sustainability of the organizations that are being funded. Furthermore, they help show the role and stability of the overall financial system in which they operate as defined by the International Capital Market Assn. (ICMA). For example, the Islamic finance protection of life goal aligns with sustainable finance principles, which emphasize environmental and social protection. That includes either refraining from developing or financing operations that could adversely affect the environment and/or the health or wellbeing of humankind.

There are also parallels between the social focus and the principle of profit-and-loss sharing. Ultimately, both aim to adopt a stakeholder view, increase social cohesion, and ensure that no one is left behind.

Both Islamic and sustainable finance include principles to review the allocation of proceeds from issuance. The tracking of the allocation of proceeds to eligible projects is a principle that we also observe for sustainable bonds and loans, and specifically use-of-proceeds ones. Sharia requires that tangible and identifiable assets back Islamic finance transactions.

There are different approaches for developing Islamic sustainable finance

In Southeast Asia, the development is top-down. We saw, for example, the launch of the Sustainable and Responsible Investment (SRI) Sukuk framework in 2014 or the Value Based Intermediation (VBI) framework in Malaysia in 2019. The SRI framework aims to facilitate the creation of an ecosystem that promotes sustainable and responsible investing for SRI investors and issuers. The VBI framework aims to facilitate the implementation of an impact-based risk management system for assessing the financing and investment activities of Islamic financial institutions, in line with their respective VBI commitments.

In 2022, the ASEAN Capital Markets Forum released a sustainability-linked bond standard, which covers sukuk. In turn, the Securities Commission Malaysia (SC) expanded its SRI Sukuk and Bond Grant Scheme to sustainability-linked instruments to help cover issuance costs, a perceived barrier for some potential issuers. More recently, we also observed calls by market participants to shift the paradigm of Islamic finance from what is permissible or Sharia compliant (halal) to what adds value or focuses on Sharia outcomes (tayyib).

In the GCC, the development is rather bottom up, particularly from leading regional financial institutions and corporates. First Abu Dhabi Bank PJSC, for example, has an objective of facilitating up to $75 billion of sustainable financing by 2030. We also saw a significant increase in conventional and Islamic sustainable bond issuances--mostly green issuances--by GCC issuers in the first nine months of 2023 (see: "Middle East Sustainable Bonds May Expand Further," published Nov. 14, 2023) This trend is supported by local regulators. For example, in June 2023 the United Arab Emirates (UAE)'s Securities and Commodities Authority announced an exemption from registration fees for companies that list their sustainable bonds or sukuk in the local market during 2023.

Sustainability taxonomies are expanding in core Islamic finance countries

We find the current principles for sustainable Islamic finance to be largely consistent with sustainable principles and frameworks available in developed countries. For instance, they all list examples of eligible projects for the use of proceeds alongside recommended disclosures. The latter include criteria used by issuers to select projects financed, reports on the environmental and social impacts of projects, and how proceeds are allocated among projects.

Regulators have released local sustainability standards and taxonomies with the aim of providing additional clarity for potential issuers and investors. Central banks and regulators in Indonesia, Malaysia, Qatar, the UAE, Bangladesh, and other countries, have published taxonomies and principles for what constitutes a sustainable finance activity. Some recommend using ICMA or Climate Bonds Initiative (CBI) principles (see table 1). Still, approaches differ. Malaysia's SRI taxonomy is principles-based and includes green and social principles; it is not a list of economic activities like the EU's green taxonomy.

Table 1

Sustainable finance taxonomies and principles in Islamic countries

	Local taxonomy	Local principles	Sukuk features
Bangladesh	Yes	No - recommends ICMA	
Indonesia	Yes	No	
Kuwait	No	No - recommends ICMA or CBI	
Malaysia	Yes	Yes	Grant scheme
Qatar	No	Yes, ICMA-based	Recommends sustainable fixed-income assets
Saudi Arabia	No	No	
Türkiye	Expected	No	
UAE	No	Yes, ICMA-based	

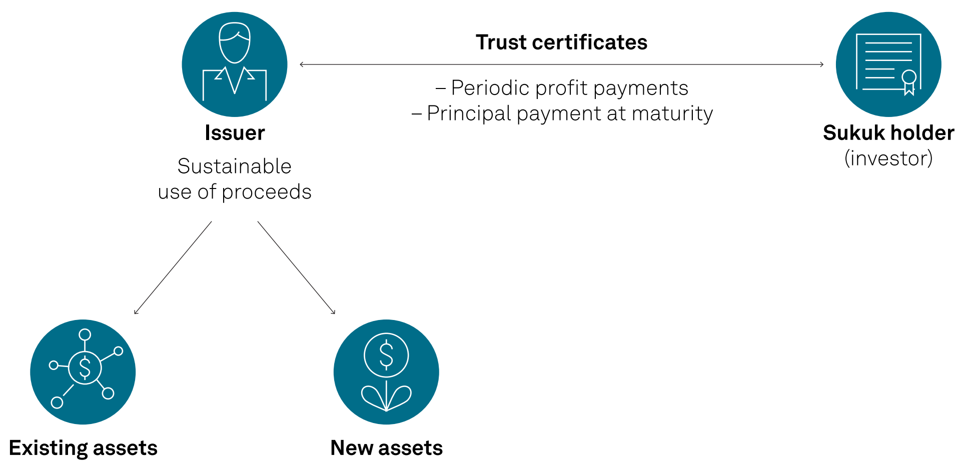
ICMA--International Capital Market Assn. CBI Climate Bonds Initiative. UAE--United Arab Emirates.
Source: S&P Global Ratings.

Sukuk can be based on existing or new assets. That's why the Qatari regulator, for example, suggests that for sukuk to be seen as sustainable, the underlying asset should be sustainable or at least have no net negative environmental impact. Under ICMA principles, the proceeds from sukuk should be used to purchase sustainable assets. This is similar to how a secured collateral green, social, and sustainability (GSS) bond label would require the underlying collateral pool of assets to also be sustainable. That said, for a secured standard GSS bond label--for example in mortgage-backed securities--only the use of proceeds is considered under ICMA principles (see "Green Mortgages And Green RMBS: What Are The Challenges?," published June 28, 2021).

The GCC is set to develop green taxonomies. In March 2023, the Arab Monetary Fund released guidance for sustainable sovereign instruments including sukuk. The guidance recommends issuers follow the ICMA principles and that a regional environmental, social, and governance taxonomy should be developed.

Whether a sustainable issuance is sukuk or a conventional bond does not influence our second party opinion (SPO) analysis. In our SPOs on sustainable sukuk, we consider the local context of the eligible projects for the use of proceeds when assigning a shade of green--our qualitative opinion of how consistent an economic activity or financial investment is with a low-carbon climate resilient future. This includes considering the extent to which the projects being financed support local climate transition plans and go beyond local standards and regulations. For example, in our SPO on Saudi Awwal Bank's sustainable debt framework (see "Second Party Opinion: Saudi Awwal Bank's Sustainable Debt Framework," published Oct. 31, 2023), we view it as a strength that the financing of eligible project categories tightly aligns with national policies (see "Analytical Approach: Second Party Opinions: Use Of Proceeds," published July 27, 2023).

Example of sustainable sukuk



Source: S&P Global Ratings.

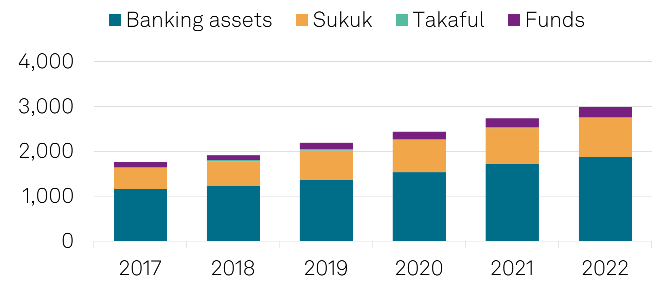
We Expect The Islamic Finance Industry To Expand 10% In 2023-2024

Islamic finance industry growth continued last year, with assets up 9.4%, compared with growth of 12.2% in 2021 (see chart 1), supported by increases in banking assets and the sukuk market. At year-end 2022, the total assets of the global Islamic finance industry reached about $3 trillion (excluding Iran), dominated by the Islamic banking industry (about 62% of total assets as of Dec. 31, 2022) and the sukuk market (29% at the same date). The industry remains concentrated in the GCC countries, which contributed about 68% of total assets at year-end 2022, followed by Malaysia (13%; see chart 2).

Chart 1

Islamic finance assets reached almost $3 trillion in 2022

Total assets by sector (mil. $)

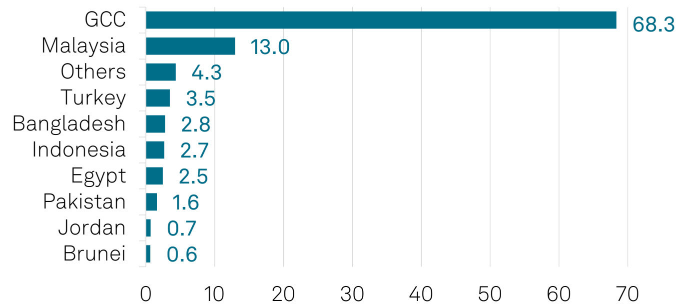


Sources: Central Banks, CIBAFI, Eikon, S&P Global Ratings, S&P Global Market Intelligence.

Chart 2

Islamic finance is concentrated in oil-exporting countries

Distribution of Sharia-compliant banking assets (% of total)



GCC--Gulf Cooperation Council. Source: Central Banks, S&P Global Ratings, S&P Global Market Intelligence. Data as of year-end 2022.

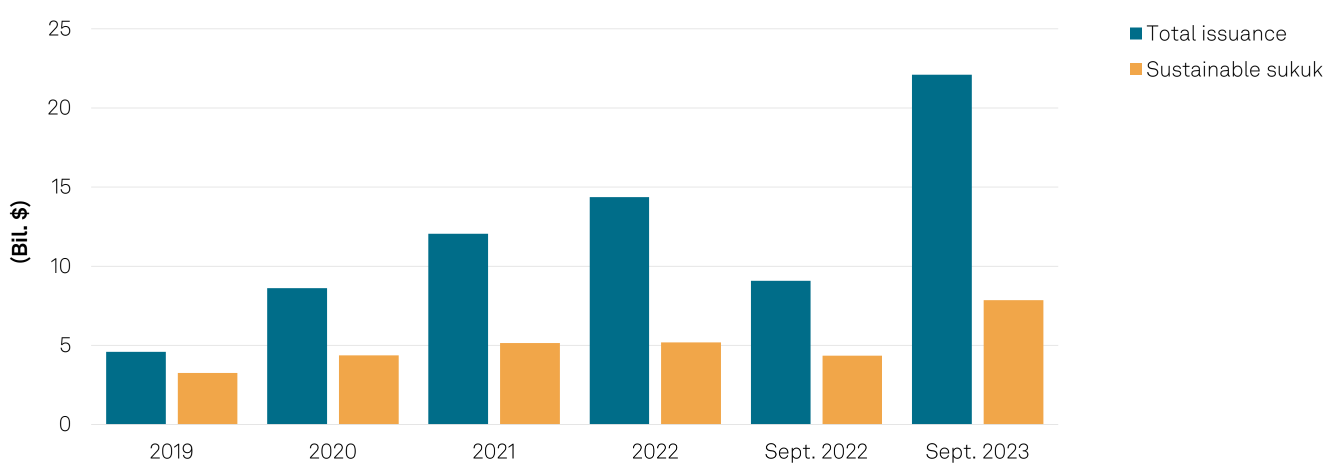
Sustainable finance will contribute to Islamic finance growth

We expect the Islamic finance industry to continue expanding through to 2024. In our view, the GCC countries, and particularly Saudi Arabia, will remain supportive of industry growth in the next 12-24 months. This is partly thanks to the implementation of Vision 2030, which is likely to create additional growth opportunities for the Saudi banking system and the sukuk market. While we generally believe that sukuk issuance volumes have reduced in 2023, we are of the view that new issuance will exceed maturing sukuk, resulting in another positive contribution to industry growth this year. The Islamic funds and takaful (a form of Islamic insurance) sectors are also likely to continue to expand.

Sustainable finance issuance is increasing in the core Islamic finance countries. In these core countries, the volume of sustainable finance issuance (both conventional and Islamic) reached $22.1 billion as of Sept. 30, 2023, compared with $9.1 billion for the same period in 2022 (see chart 3). We expect the volume of sustainable finance issuance, both conventional and Islamic, to continue to increase in the next 12-24 months.

Chart 3

Sustainable sukuk issuance is increasing



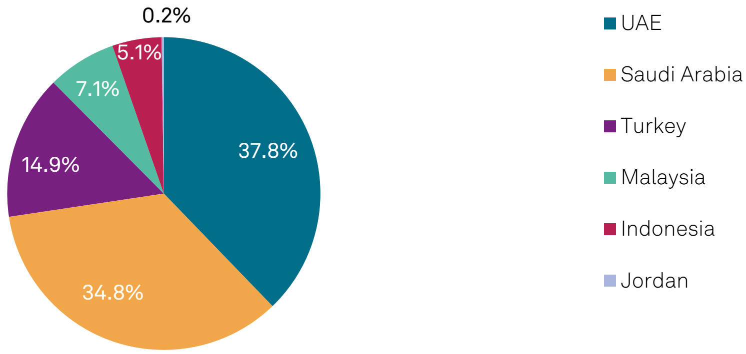
Note: Islamic finance core countries include: Bangladesh, Brunei, Egypt, Indonesia, Jordan, Kuwait, Malaysia, Oman, Pakistan, Qatar, Saudi Arabia, Türkiye, and the UAE. Sources: S&P Global Ratings, efdata.

Islamic finance is concentrated in oil-exporting countries, many of which have established strategies to diversify their economies and reduce their carbon footprints. As such, opportunities are significant and could take the form of sustainable finance issuance (both conventional and sukuk) and financial products offered by financial institutions. We expect that climate transition and similar sustainability objectives will be the primary focus of these instruments.

Issuers in Saudi Arabia and UAE contributed more than 70% of sustainable sukuk issuance in the industry's core countries in the first nine months of 2023 (see chart 4). We expect to see more issuance from these two countries because the implementation of Saudi Vision 2030, and more generally GCC governments' commitments to diversify and enhance the sustainability of their economies, will create opportunities to tap the sustainable bond and sukuk markets. We note that 35% of sustainable issuance as of Sept. 30, 2023, was in the form of sukuk, suggesting that Islamic finance will play an important role, despite the overall small size of the industry.

Chart 4

Saudi Arabia and the UAE are the top issuing countries for sustainable sukuk



Data for the first nine months of 2023. UAE--United Arab Emirates. Sources: S&P Global Ratings, efdata.

Instrument complexity and diverging standards could hinder growth in sustainable Islamic finance

We believe that one of the main factors holding back sukuk, and Islamic finance in general, is the increased complexity compared with conventional instruments. The sukuk issuance process is more time consuming than for bonds and differences in the interpretation of Sharia can add to the complexity.

Scholars and Sharia standard setters seem to be pushing for more profit-and-loss sharing in sukuk structure. This could change the nature of these instruments and the dynamics behind them, including investor appetite. While profit-and-loss sharing can help achieve higher social equity, it could also significantly change the financial viability of projects because the cost of financing will be different, and likely much more expensive than a conventional fixed-income instrument. We note that the full spectrum of instruments exists in Islamic finance, from debt-like to equity-like.

We think that standards harmonization can enhance clarity and acceptance by a broader array of issuers and investors. This would ultimately lead to a more streamlined issuance process and could reattract the attention of some issuers to sukuk, sustainable or otherwise. Some of these players left the sukuk market after discovering the difficulty of issuing an instrument, particularly navigating the complicated issuance process.

Digitalization can also help to smooth the issuance process and make it more viable as a financing vehicle for issuers and investors. We believe digital disruption can follow as intermediaries streamline their platforms for issuance and investment. Digitalization may resolve the dual challenges of having standard legal documentation, which could be embedded in the platform of issuance, and reducing complexity, significantly decreasing the time to market. This may attract new issuers and investors to the market.

Looking Ahead

Harmonization could make issuance of sustainable sukuk more straightforward and available as a potential financing option for investors less familiar with Islamic finance. Robust oversight of the final use of proceeds raised from sustainable sukuk may strengthen the integrity of this small but expanding market. Leveraging technology could also play a role.

Related Research

- Middle East Sustainable Bonds May Expand Further, Nov. 14, 2023
- Analytical Approach: Shades of Green Assessment, July 27, 2023
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External Research

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- Bangladesh Bank Sustainable Finance Policy, Bangladesh Bank, Dec. 2020

Appendix

Islamic finance core countries include: Bangladesh, Brunei, Egypt, Indonesia, Jordan, Kuwait, Malaysia, Oman, Pakistan, Qatar, Saudi Arabia, Türkiye, and the UAE.

Terms Used In This Research

- Islamic finance is finance that complies with given principles. There are bans on interest rates, uncertainty, speculation, and financing certain economic sectors such as gambling. In addition, there is a profit-and-loss sharing principle where risks and rewards associated with the transaction are shared among participants. Furthermore, under the asset-backing principle, transactions must refer to a tangible, identifiable underlying asset.
- Sustainable bonds are bonds where the use of proceeds finances sustainable projects, which deliver sustainability outcomes such as reducing emissions or improving water quality.
- Sukuk are Islamic finance instruments with fixed-income characteristics. They are Sharia-compliant financial certificates with characteristics comparable to bonds.
- Sustainable sukuk are sukuk where the use of proceeds finances sustainable projects.
- For more definitions of Islamic finance terms see our "Glossary Of Islamic Finance Terms: August 2015 Update," published Aug. 10, 2015.

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