Looking over the fence

Summary

- Islamic finance involves investing according to Islamic principles, namely the exclusion of certain sectors and the inability to receive interest.
- Both the ethical investing and Islamic finance markets have grown significantly in recent years.
- Their similarities mean there is an opportunity for Shariah funds to target broader ethical investors but have yet to do so.
- Pension schemes should ensure they offer Shariah funds to not lock out Muslims from retirement saving. This diversity of fund choice could also meet the 'S' goal in ESG.
- The Islamic finance sector is starting to offer ESG-friendly Shariah funds.

Laura Blows explores how the separate worlds of ethical investing and Islamic finance are starting to converge

Ethical investing, incorporating environmental, social and governance (ESG) considerations into investment decisions, and divesting from fossil fuels to help carbon emissions eventually reach net zero have all grown significantly in importance for pension fund investors (and beyond) in recent years.

Just as ethical investing has grown, so too has another type of investing with many similarities – that of Islamic finance.

"The growth of ESG investing in pension funds has been significant in recent years across all types of investments, including passive screened funds, active integration of ESG principles, and impact strategies. In line with this, we have seen a growing interest in the HSBC Islamic Fund, especially with the UK DC schemes who offer this as a self-select option," HSBC UK institutional business development director, Jasvir Virk, says.

Like ethical investing, Islamic finance has its own rules and plethora of terminology.

In the context of finance, 'Islamic', 'Halal' or 'Sharia/h' investing are used somewhat interchangeably, with nuances between the terms. 'Islamic finance' is often the umbrella term for investment that complies with the values of Islam. Shariah funds have been screened by Islamic finance scholars to ensure the end portfolio is compliant with Shariah principles.

This involves the removal of non-Shariah-compliant sectors, such as alcohol, pork products, gambling, firearms, financial institutions and adult entertainment, with investments that provide interest (known in Islamic finance as 'riba') also not allowed. Investment opportunities also must not be overly uncertain or risky.

In recent years, the term 'Halal economy' or 'Halal finance' has also gained traction.

According to Options UK Personal Pensions director, Christine Hallett, in the context of finance, Halal is all about the ethical side of investing, which happens to also be Shariah compliant.

She notes that over the past 12-18 months, its Shariah-compliant fund offered within its master trust has increased focus on the Halal, 'ethical' aspect of not investing in drink or tobacco, for example, "so the message has changed".

Overlap

According to Bedford Row Capital CEO,

Scott Levy, by their very nature, Shariah/Halal funds are ethical "because one of the basic principles of Islamic finance is to do no harm".

While Islamic finance is faith based, ethical investing integrates personal values and societal concerns with investors' financial needs and the impact on society as a whole.

"Both ESG and Shariah-compliant pensions aim to maximise returns for investors, but in a way that follows particular ethical or religious guidelines. Shariah-compliant pensions in particular are fundamentally driven by faith. Therefore, there are many additional faith-based restrictions that are used in Shariah-compliant pensions, such as prohibitions on interest being earned, that are not ordinarily found in ESG-compliant pensions," PensionBee CEO, Romi Savova, explains.

While Shariah funds may purely implement negative screening, ethical investing may also involve positive screening, where the fund chooses to invest in agreeable sectors, or may actively engage with 'unsuitable' companies to help it improve its ESG considerations.

According to Halal investment fintech firm Wahed's *Halal Investing vs. Ethical Investing* 2018 blog, both Halal and ethical investing focus on protection of natural and environmental resources, except for institutional financial sectors, and invest in the same economic sectors, "namely industrials, healthcare, consumer goods, utilities, consumer services and basic materials such as technology.… In a nutshell, Halal and ethical investing are closely related but are not similar. It is submitted that Shariah principles often go beyond the requirements of ethical investment…"

As demand for both types of investment increases, "there is an opportunity here for both sides of the equation to develop and grow", Simply Ethical CIO, Stuart Hutton, states.

Missed opportunity?

So, as Shariah funds can meet – or even go beyond – the criteria for ethical investing, an area of such interest and importance within 'conventional' investing, has the Islamic finance sector considered targeting its funds beyond its traditional market of Muslim investors?

According to Levy, it has not.

"This is the biggest missed opportunity right now," he says. "The Islamic finance industry has been very, very slow to recognise that opportunity.

"I've noticed in the last year a little bit of 'looking over the fence' to see what's going on, on the 'other side'. There are many more discussions about 'what are they doing over there'? 'What's happening in the conventional world and why are we not attracting the same inflows'?"

Therefore, the opportunity to appeal to ethical investors broadly has begun to be discussed, he adds, but "still lacks understanding of how strong ethical considerations are in the conventional pensions industry and therefore the potential for the application of Islamic products into the conventional ethical investing world".

To appeal to ethical investors, Levy recommends Islamic finance products "rewrite their pitch book" by slightly dialling down its Arabic terminology and instead highlighting its ethical credentials.

He notes the emergence of some new fintech UK companies doing this on their crowdfunding platforms, but "the problem is the biggest, typically Gulf-based, Islamic fund managers are not doing so".

Ethical investment interest in Islamic finance

There has not been much peering over the fence on the ethical investment side either. The reason why not, Levy says, is due to the relatively small number of Shariah funds available and their lack of representation in the UK.

Hutton agrees that Shariah funds are not considered by pension funds as another tool to meet their ethical investment goals.

"Pension funds have introduced Shariah-compliant funds primarily to meet the needs of Muslims who want to invest in pensions," he says, "but we cannot hide from the fact that it does offer the opportunity to see how you can invest in broad ESG and also meet your Shariah-compliance needs."

Underserved

Pension funds simply providing more Halal-based investment choices can meet some ESG goals in its own right, particularly on the 'social' side.

Despite the UK's first Islamic bank opening in 1982, there is still is not enough choice in the UK to meet the retirement saving investment needs of its Muslim population.

According to Levy, just one Shariah fund in the UK – the HSBC Amanah Global Equity Index Tracker – has 90 per cent of the market.

For those approaching retirement, having most, or even all, of their money in an equity index tracking fund "is the last place you should be", he says.

Hallett agrees there are a lack of diversified Shariah-compliant portfolios, and are instead "one-size-fits-all".

Currently most of the demand in the Islamic investment area has been in equity-based strategies, Virk notes, "but as the DC market matures and members approach retirement, we expect to see an increasing requirement for other, less risky alternatives. Examples would be

Sukuk (Islamic bonds) or multi-asset strategies".

Savova adds that "one-third of Muslims in the UK do not have a pension due to the lack of Shariah compliant options".

"We believe that the pensions industry should do more for Muslim consumers to prevent a large proportion of the Muslim population in the UK being left with no retirement options due to the majority of pension funds not taking account of religious considerations," she adds.

Broader appeal

Taking Muslim investor considerations into account is sure to increase as the UK Muslim population grows. According to Statista, as of 2016, there were 4.13 million Muslims in the UK; 6.3 per cent of the population. This is expected to grow to 17.2 per cent by 2050.

"Currently, the Islamic finance sector is growing at a rate of 15-25 per cent per year, with Islamic financial institutions managing assets worth over $2.2 trillion globally and expected to reach $4.94 trillion in 2025 according to Refinitiv," IslamicMarkets.com CEO, Shakeeb Saqlain says.

Shariah-compliant funds for the most part have performed in line with their unscreened peers despite the application of the exclusionary filters, Virk notes.

According to the UK's first Islamic finance compliant, peer-to-peer investment platform, Nester, because Islamic law insists on an avoidance of risk, portfolios are designed to deliver steady and reliable performance and are, therefore, less affected by extremes in market activity.

Therefore, it may not only be Muslim investors that see the appeal of Shariah-compliant funds.

"The underlying rationale of the [*Shariah*] fund is to promote profit and loss sharing to discourage the concentration of wealth in a few hands, in order to prevent greater inequality in society. This ethos may resonate with many people who have strong beliefs regarding such matters," Virk says.

Saqlain agrees that many non-Muslims have been investing in Shariah funds "not only for their ethical side but also for their stable returns in the long term and the limited downside during crises. Incorporating ESG and SRI criteria is predicted to attract more demand for [*Shariah*] funds, especially from sovereign institutional investors in Europe and North America," he says.

Ethical investing with Islamic finance

While the Islamic finance sector may not yet be trying to appeal to the general ethical investment market, efforts to make their own Shariah funds more ethically friendly have ramped up.

"There has been rapid evolution in the *[Shariah]* ESG investment space, especially as it has become more mainstream with investors having a greater awareness of how investments can be used to tackle key issues. As we see this evolution continue, we can expect there will also be demand from investors who are seeking Shariah-compliant investment versions of the same solutions, enabling them to align the principles of Islamic investing and ESG," Virk says.

Demand for ESG consideration within Islamic finance does seem to be increasing. For instance, Refinitiv states that $5.34 billion of ESG Sukuks was issued around the globe in 2021, more than any previous year, representing 3.2 per cent of the total Sukuks issued in 2021 globally.

In November 2021, the Islamic Finance Council UK (UKIFC) and HM Treasury, spearheaded the Global Islamic Finance SDG Taskforce to catalyse the engagement of Islamic finance with the UN's sustainable development goals (SDGs).

In August 2020, the research article *Exploring synergies and performance evaluation between Islamic funds and socially responsible investment (SRIs) in light of the SDGs*, found there was no statistically significant difference between the returns of Islamic funds and SRI funds, indicating that "embedding ESG/SDGs considerations into Islamic funds' investment decisions do not adversely affect their returns".

The research stated that Shariah-compliant SRIs would target a wider investor base, including both Shariah and impact investors, "which will support the achievement of the SDG agenda".

Gap closing

With the emergence of green shariah funds, the boundaries between Islamic finance and ethical investing are starting to blur.

"The convergence of Islamic investment and broader ethical investing has been going on for a while," Hutton says. "But we'll always have an element of clear differences as well, primarily because Islamic investing is there to meet the needs of one's faith, not just one's views on environmental and social impact.

"It's important for those with Islamic faith and other faiths to see the benefits of this investing in line with their beliefs. That's something we must not skip over," he adds.

Ethical investing and Islamic finance will never overlap as the two worlds are quite different, Levy says, "but I think they'll get close enough to be able to see each other across the other side of the fence".

Written by Laura Blows