General Council for Islamic Banks and Financial Institutions

CIBAFI

المجلس العام للبنوك والمؤسسات المالية الإسلامية

Sustainability Guide for Islamic Financial Institutions (IFIs)

(Guidelines for Islamic Banks)

Consultative Document

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General Council for Islamic Banks and Financial Institutions
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About the General Council for Islamic Banks and Financial Institutions (CIBAFI)

CIBAFI is an international organisation established in 2001 and headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organisation of Islamic Cooperation (OIC).

CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives.

With over 130 members from 34 jurisdictions, representing market players, international intergovernmental organisations, professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance.

In its mission to support the Islamic financial services industry by being the leading industry's voice in advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of the Islamic financial services industry and sound industry practice, CIBAFI is guided by its Strategic Objectives, which are, 1) Advocacy of Islamic Finance Values and Related Policies & Regulations; 2) Research and Innovation; and 3) Training and Professional Empowerment.

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ACRONYMS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
BoD	Board of Directors
CIBAFI	General Council for Islamic Banks and Financial Institutions
CSR	Corporate Social Responsibility
ESG	Environmental, Social and Governance
ESMS	Environmental and Social Risk Management System
GDP	Gross Domestic Product
GRI	Global Reporting Initiative
IFIs	Islamic Financial Institutions
IIFM	International Islamic Financial Market
IILM	International Islamic Liquidity Management Corporation
IIRA	Islamic International Rating Agency
ILO	International Labour Organisation
ISO	International Organisation for Standardization
MDGs	Millennium Development Goals
NDCs	Nationally Determined Contributions
OECD	Organisation for Economic Co-operation and Development
OIC	Organisation of Islamic Cooperation
SC	Sustainability Committee
SCO	Sustainability Compliance Office
SDGs	Sustainable Development Goals
SIGMA	Sustainability Integrated Guidelines for Management project
SOP	Standard Operating Procedure
SRI	Sustainable, Responsible and Impact Investing
UN	United Nations
UNDP	United Nations Development Programme
WBCSD	World Business Council for Sustainable Development

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ACKNOWLEDGEMENTS

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We trust that the Guide will provide valuable insights to the Islamic banking institutions around the globe on the significance of sustainability. In addition, it will be a helpful tool to understand, fulfil, and communicate their role in making the Islamic financial services industry more inclusive and sustainable.

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About This Guide

Purpose of the Guide

The Sustainability Guide for Islamic Financial Institutions (IFIs) was developed to promote sustainable development in the Islamic banking industry by supporting Islamic banks in integrating sustainability in their business activities while considering environmental, social, and economic objectives. The Guide is structured around five Principles of Sustainability, which are as follows:

The Five Principles of Sustainability

Who and What is it Meant For

The Guide is designed and developed as a guidance tool for the Islamic banking practitioners working at various levels in Islamic banks. Implementing the Five Principles of Sustainability can drive sustainability in the Islamic banking industry while fostering collaboration between Islamic banks, regulators, standard-setting bodies, and other international institutions who share the same goals of sustainability.

Scope of Application

This Guide is considered a general reference for Islamic banks. Each Islamic bank operates in different jurisdictions with its own distinctive political economy, legal and regulative environment, and available economic and financial resources. Therefore, this Guide's Principles of Sustainability can be adapted depending on the bank's capabilities within the organisation and the macro environment.

While this Guide is intended for Islamic banks, the Principles may be applicable, with some modifications, to other segments of the Islamic financial services industry such as Islamic capital markets, Takaful, and Islamic social finance institutions. Moreover, this Guide makes only limited reference to procedures for sustainability integration in deposit services, product development, and some other services. CIBAFI will continue to work in these areas and may also revise this Guide to reflect market developments in the future.

Background

The magnitude of the issues the world has been experiencing, both economically and environmentally, is lost on no-one. The November 2021 United Nations Climate Change Conference (COP26) in Glasgow sought to devise compelling initiatives to combat the climate crisis. Later in 2022, a follow-up conference on this same issue will convene to discuss a global biodiversity framework. Exploitative production and unchecked consumption habits through the market economy have resulted in catastrophic environmental, financial, and socioeconomic impacts. Poverty remains a pressing issue; exclusion and disenfranchisement of the impoverished remains a critical challenge in the 21st century, despite the initial progress made by Millennium Development Goals (MDGs) in promoting liveable wages and equitable working conditions.

The emergence of the Sustainable Development Goals (SDGs) paradigm by the United Nations (UN), which has become part of national public policy in many countries, stands as an official declaration of the unacceptable economic and financial behaviour of individuals, firms, and corporations which have caused enormous disruption to natural and human life. The call for consideration in all economic and financial decision-making to contemplate the sustainability of all the stakeholders has been the central discourse and policies of multilateral organisations led by the declaration of SDGs by the UN. The SDGs comprise 17 goals, set out in Table 1, together with 169 targets and 232 indicators.

Table 1. The Sustainable Development Goals (SDGs)

Goal: 1	No Poverty
Goal: 2	Zero Hunger
Goal: 3	Good Health and Well-Being
Goal: 4	Quality Education
Goal: 5	Gender Equality
Goal: 6	Clean Water and Sanitation
Goal: 7	Affordable and Clean Energy
Goal: 8	Decent Work and Economic Growth
Goal: 9	Industry, Innovation and Infrastructure
Goal: 10	Reduced Inequalities
Goal: 11	Sustainable Cities and Communities
Goal: 12	Responsible Consumption and Production
Goal: 13	Climate Action
Goal: 14	Life Below Water
Goal: 15	Life on Land
Goal: 16	Peace, Justice and Strong Institutions
Goal: 17	Partnerships for the Goals

SDGs have taken a crucial step by binding all the countries globally and universalizing the expectations of sustainable development beyond the developing country focus of MDGs. Therefore, global mobilization for climate change and the SDGs have become the leading global policymaking issues in recent years. The nature of current challenges is not confined to a particular country or region, but instead requires organised, structural, and international mobilization. Every stakeholder must become involved, including banks and financial institutions. As part of the global mobilization, most UN member countries have become party to the SDGs and incorporated them in their public policy as a vital and positive sign for change.

While the financial sector has always been an essential instrument of prosperity and development throughout history, in recent years the growth and movement of capital within the financial sector have become objectives in their own right rather than instruments for facilitating economic activity, growth, and development. The financial sector has consequently expanded through artificial products and mechanisms, resulting in further disconnection from the real economy.

The growing asymmetry between the real economy and the financialised economy indicates the unsustainable nature of the global economy – World GDP was only 8.3% of the total financial assets in 2019, showing the enormous pressure exerted on the resources in the world. Moreover, banks and financial institutions have created demand far beyond the reasonable level through their lending and financing channels. The results are twofold: strain on global resources, and an escalation of the environmental crisis. Further, increased access to finance is not translating into equitable resources for the impoverished – an injustice that must be addressed.

In order to confront these challenges, the new consensus around SDGs, which has increased stakeholder expectations, should be considered as part of the rescuing process – rescuing humans, land, and labour – to prevent further deterioration of the conditions. An official UN-based index[1], other multilateral institutions and, unofficially, many indices and studies have been developed to measure SDGs' performance in all jurisdictions. A further important step, in 2021, was the creation by the International Financial Reporting Standards Foundation, with widespread governmental and international support, of a new International Sustainability Standards Board to create new disclosure standards – starting with a focus on the climate.

The public concern surrounding the aforementioned challenges has spurred the growth of so-called ESG investing, where ESG stands for Environmental, Social and Governance. Although the (older) ESG paradigm is capable of embracing the SDGs, it is broader and less precisely defined. In some areas, this has led to allegations of "greenwashing", in which businesses choose to be assessed under the definitions that most suit them. The term Socially Responsible Investing (SRI) is also used and overlaps with both ESG and SDGs.

In response to these trends, there have been important developments within the financial sector, including the emergence of green bonds and green Sukuk and initiatives by bank supervisors; for example, the Network for Greening the Financial System. Initiatives have also emerged from the sector itself, notably the promises made at COP26 by the Glasgow Financial

1. www.sdgindex.org.

Alliance for Net Zero, a coalition of banks, insurers, and major investors. This is part of a process in which banks and financial institutions are expected to align themselves with the sustainable development paradigm as part of a global community. Correspondingly, the increased focus in financial markets on sustainable development, and the initiatives, both private and public, that result present tremendous opportunities for sustainable finance in general and Islamic finance in particular.

To respond to these demands and opportunities, and for reasons of principle, Islamic banks and financial institutions have to develop the necessary frameworks, mechanisms, practices, and measurements to demonstrate their sustainable development credibility in economic, social, environmental, and governance spheres. This requires going beyond the common pattern of a purely negative Shariah screening process to one of the positive choices within an enhanced governance system.

Islamic Philosophical Foundations for Sustainable Development

An essential part of the Islamic worldview is that the universe and the Earth were created with a very fine balance (*mizan*) and that human beings are expected to maintain or sustain that balance. The term mizan is indicative of the connectedness of all the stakeholders within a sustainable world, including its economy. In other words, the universe, the Earth, humans, the environment, and the animal world as well as the physical world, are in balance within themselves and their interactions with each other. All of creation must be given equal opportunity space for their growth and development as the mizan or their nature (*fitra*) requires. Human beings are considered vicegerent, or Khalifah, and are therefore charged with the responsibility of preventing disruption to this balance and ensuring that everything and everyone can coexist in harmony. Islamic banks must fulfil this Islamic worldview and have their own part to play in preserving or restoring mizan; therefore, this is something that should permeate all their actions.

On the basis of this philosophical foundation, sustainable development within the Islamic worldview can be defined as follows:

> "Recognising the complementarity nature of all the stakeholders to reach unity (*tawhid*) within the balance (*mizan*), which requires the recognition and provision of an opportunity space for the development path for each stakeholder to reach their perfection (*rububiyah*), where the growth of each stakeholder has to be in harmony with other stakeholders' (*tazkiyah*) leading to inter-and-intra generational justice (*adalah*) through the equilibrium-based (ihsani) governance".
>
> This definition is reflected in the Five Principles of Sustainability suggested by the Guide as well as their implementation process.

Note that this view sees everything in creation as a stakeholder in the operations of every Islamic bank, and the position of these stakeholders needs to be recognised in the governance of the bank. Since it is not possible for these stakeholder interests to be articulated directly, the proposals in this Guide establish a Sustainability Function in the form of Sustainability Committee (SC) or a Sustainability Compliance Officer (SCO) at a high level within each bank essentially as a proxy representative for these stakeholders.

To put this understanding of the Islamic cognitive system into action, Maqasid al-Shariah (the objectives of Shariah) is an important methodological tool. Classically, Maqasid al-Shariah is interpreted in terms of humans. However, on the basis argued above, it should in fact be interpreted as the well-being of all stakeholders so that the mizan-based worldview is reflected in the outcomes of any actions.

One modern view of Maqasid al-Shariah classifies it within four objectives and eight corollaries[2], which are useful to provide a sustainability approach.

- (i) Invigorating the value of human life
  - (a) Faith
  - (b) Human rights
- (ii) Invigorating the human self
  - (a) Self
  - (b) Intellect
- (iii) Invigorating the society
  - (a) Posterity
  - (b) Social entity
- (iv) Invigorating the physical environment
  - (a) Wealth
  - (b) Environment (Ecology)

Appendix A sets out some details on the Islamic philosophical foundations for sustainable development and provides a more detailed view of how a Maqasid-based approach might be used within the process suggested in this Guide to analyse the activities of an Islamic bank in pursuit of sustainability.

Sustainability Guide Implementation Process

The implementation of the Sustainability Guide should be based on an integrated approach in incorporating the Principles in the Bank's business plans and activities. This consists of several stages with key action areas per stage, as depicted in Figure 1:

2.Bedoui and Mansour (2014)

Figure 1. Bank's Integrated Approach in Incorporating the Principles

Source: CIBAFI

For the internal assessment of Sustainability Focus Areas, a Bank should refer to the national development plans and strategies as well as any priority sectors set by the respective governments where the Bank operates. These could include the national commitments under the 2015 Paris Agreement, its SDGs agenda, the Nationally Determined Contributions (NDCs) targets, national taxonomies, national visions, national development strategies, etc.

The Sustainability Focus Areas should be aligned with the Bank's vision, mission, and strategy. The Bank should also establish a Sustainability Strategy with specific and measurable targets. Table 2 provides examples of focus areas and the corresponding sustainability targets:

Table 2. Examples of Focus Areas and the Corresponding Sustainability Targets

Sustainability Focus Areas	Sustainability Targets
Climate Action	• Align the Bank's financing portfolio with the goals of the Paris Agreement. • Promote energy efficiency financings. • Promote responsible business practices such as zero-waste, zero-emissions, community impact, etc. • Develop green financial products such as green home financing, green cards, etc. • Issue green and SRI Sukuk.
Reduced Inequalities	• Expand Islamic social financing to support low-income communities and promote financial inclusion. • Invest in projects targeting the education sector.
Clean Water and Sanitation	• Allocate a percentage of the Bank's financings to clean water and sanitation projects.
Women's Economic Empowerment	• Support women's economic empowerment projects. • Support financial literacy programs for women entrepreneurs.

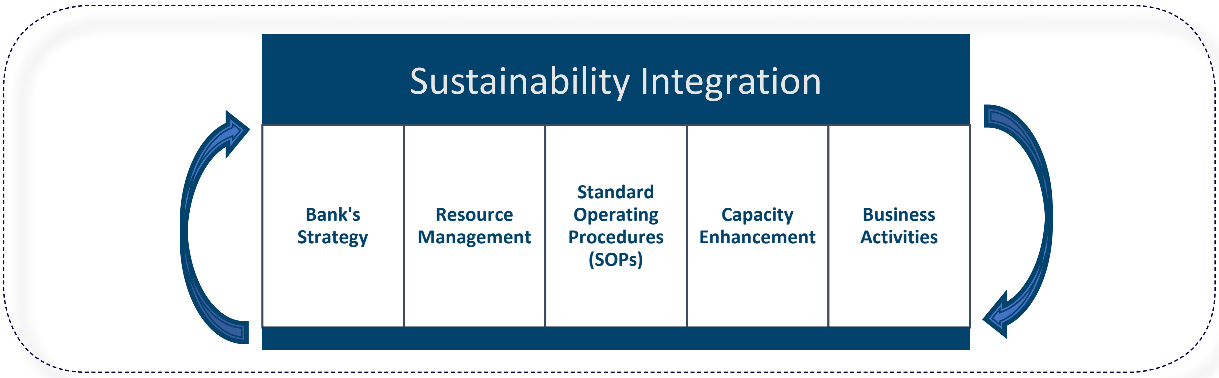
The following section of the Guide presents the Five Principles of Sustainability and detailed guidance on the operational integration of sustainability targets for each Principle.

Sustainability Integration – 1 Principle

An Islamic bank should consider the impact of its business activities by adopting a proactive integration approach whereby sustainability objectives are identified, implemented, and assessed. This may be based on the Maqasid al-Shariah Evaluation Framework discussed in Appendix A.

This approach should encompass five key areas, as depicted in Figure 2:

Figure 2. A Top-Down Approach for Sustainability Integration in Banks' Business Activities



The following section provides practical steps in integrating sustainability in the five areas mentioned in Figure 2.

Guidelines on the Implementation and Assessment of Principle 1

The Bank's Strategy

An all-embracing vision that incorporates sustainability objectives into the strategic planning process should guide the Bank's strategy. This requires a top-down approach in incorporating sustainability into the Bank's overall business strategy, guiding principles, values, and business development targets.

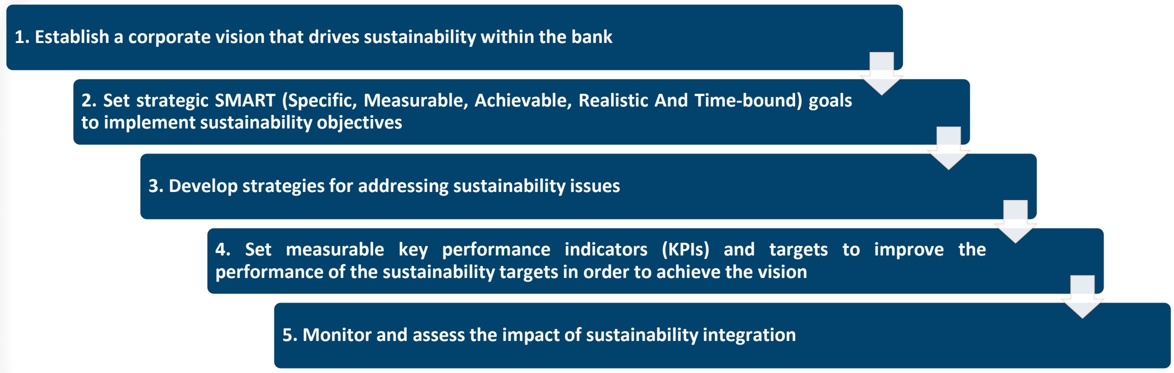
A strategy that incorporates sustainable development should provide a framework to guide investment and financing, drive performance, manage risks, and engage stakeholders. Successful implementation of the strategy depends on how the Bank prioritises its sustainability objectives and monitors their implementation to contribute to business growth while promoting impact.

To do so, the board and senior management should first understand the values and relevance of sustainability to their business. Management's support is fundamental to nurturing a supportive culture to drive the sustainability agenda and initiate sustainability-related activities across a Bank. This is particularly significant as Islamic logic requires the incorporation of stakeholder interest to achieve sustainability.

It is also vital for a Bank to clearly communicate its approach to sustainability integration, so all its key stakeholders are clear on how the Bank views and interprets sustainability integration.

Figure 3 highlights the key steps to sustainability integration in a Bank's strategy.

Figure 3. Steps to Integrating Sustainability in a Bank's Strategy



Source: CIBAFI

The Bank's Resource Management

A Bank can manage its environmental footprint by ensuring efficient use of materials and resources such as energy and water consumption, effective waste management in physical operations, and supply chains. The Bank should also develop a common understanding of the circular economy concept by promoting a culture of responsible business through waste reduction and material reuse by minimizing the use of resource inputs and creating waste, pollution, and carbon emissions.

The Bank's Standard Operating Procedures (SOPs)

A Bank should provide guidance for sustainability integration in its business activities. This can be achieved through its standard operating procedures (SOPs). SOPs should clearly outline the scope and plans for sustainability objectives integration, implementation, and assessment. The SOPs should apply to all processes and staff of the Bank and should periodically be reviewed in the internal auditing process.

A Bank can also develop a corporate sustainability policy that details its approach, principles, and commitments regarding sustainability integration, as well as the framework for its implementation.

The Bank's Capacity Enhancement Initiatives

A Bank should develop dedicated sustainability teams and training programmes for its personnel to better understand its sustainability strategy and integrate it into the Bank's business activities. The sustainability team should also inform the decision-making process, including the Shariah Committee/Shariah Supervisory Board, on the sustainability impact of product development and financing lines. In addition, capacity enhancement should comprise the following activities:

- Setting clear roles and responsibilities at different stages of the sustainability integration process.
- Making sure specific personnel are accountable for assessing and monitoring sustainability objectives implementation.
- Identifying business functions (e.g., internal audit) involved in reviewing and verifying the sustainability SOPs implementation.
- Providing necessary training on sustainability understanding, integration, and assessment.

The Bank's Business Activities

Overall, the Bank should consider the following criteria in assessing sustainability considerations in projects, business activities and customers:

- In general, any activity that promotes good and prevents harm is acceptable.
- Business activities that have positive environmental and social impacts should be prioritised; these could include:
    - Sustainable energy infrastructure
    - Energy efficiency
    - Clean transportation
    - Islamic social finance mechanisms
    - Water and waste management
    - Qard al-Hasan programs
    - Green and social credit lines
    - Impact investing
- Business activities that support the achievement of national sustainable development plans and strategies should be integrated into the Bank's focus areas.

To do so, the Bank should develop a broader sustainability integration strategy for its business activities, which consists of the systematic inclusion of ESG objectives in the following activities and services:

Financing and investment activities

A Bank should:

- Systematically consider sustainability considerations as part of its investment and financing decisions.
- Apply qualitative and quantitative ESG analysis to inform financing and investment decisions. Consideration of ESG factors can be made at the portfolio level and/or investment decision level. Therefore, when deciding between financings and investments, all factors being equal, those with better ESG performance should be selected. In addition, banks can rely on their internal analysis or third-party research to assess environmental, social and governance issues[3].

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3. ESG analysis frameworks vary. Some apply "hard" thresholds in particular areas, for example to exclude certain activities like fossil fuel development, but within permitted areas will choose the activities with the best scores. Some apply a scoring approach across the board. Other variants are also possible.

- Consider financing and investment activities with lower environmental and social risks and, hence, should optimise between financial risk and environmental and social risks.
- Develop a sustainability framework that identifies a regularly reviewed list of sector-specific and/or country-specific material sustainability issues. These issues are then assessed, prioritised, and integrated into the Bank's financing and investment models and strategies.

Table 3 lists examples of ESG criteria assessed in investment decisions:

Table 3. Examples of ESG Considerations in Financing and Investment Decisions

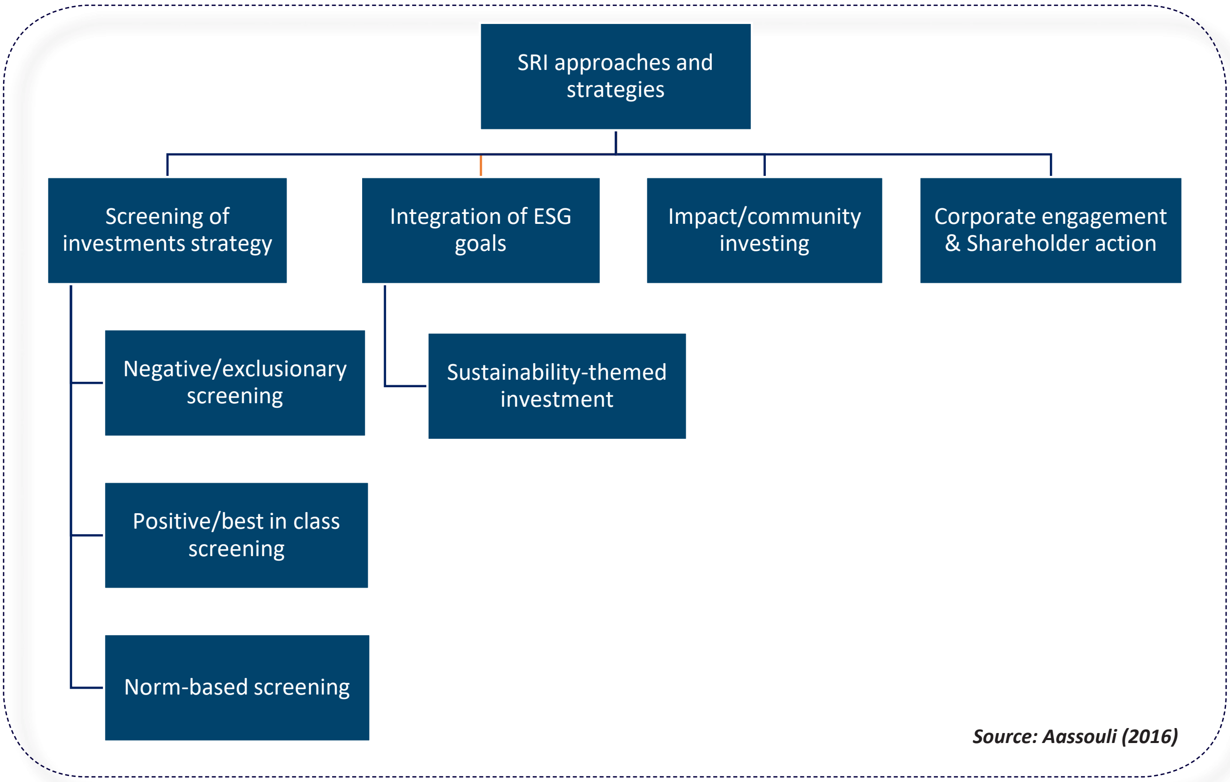
Type[4]	Category	Example
E	Climate change	Carbon emissions, climate change mitigation, climate change adaptation, environmental strategy Sustainable agriculture
E	Pollution	Air polluting emissions, spills, waste prevention and management
E	Water	Use of water resources, water management and conservation
E	Energy	Energy consumption Energy resources management
E	Biodiversity	Land, flora, and fauna diversity
E	Animal welfare	Animal testing
S	Financial inclusion	Islamic social financing Diversity and inclusion
S	Women empowerment	Women entrepreneurs' access to finance
S	Community involvement	Social impact of business operation, products and services Community development
S	Human capital	Diversity and inclusion, training and development
G	Corporate governance	Board skills, the balance of power and authority within the board, quality of accounting and audit, management turnover, shareholders' rights, disclosure of remuneration Board independence and expertise
G	Market behaviour and business ethics	Blocking competition, short-selling, transparency for investors Business Integrity Executive pay
S and G	Involvement in controversial situations	Corruption, violation of human rights
S and G	Human rights in the workplace	Work conditions, health and safety, non-discrimination

Source: CIBAFI adapted from OECD, 2020

4. E = Environment, S = Social and G = Governance

Several types of strategies can be used to integrate sustainability factors in investment portfolios. These investment approaches include impact investing, sustainable investing, green investing, ethical investing, socially responsible investing, etc. Figure 4 outlines these approaches, which are explained in more detail in Appendix B.

Figure 4. SRI Approaches and Strategies [5]



Source: Aassouli (2016)

For financing decisions, the Bank should prioritise sustainable finance strategies and instruments such as green Sukuk, SRI Sukuk, sustainability Sukuk, green loans, etc.

5. The publication from which the figure is taken used the SRI paradigm, but the approaches are equally applicable to SDGs or ESG paradigms.

Internal credit assessment

The traditional bank credit analysis involves verifying and determining the creditworthiness of a potential client by looking at their financial state, credit reports, and business cash flows. The assessment criteria include leverage, liquidity, profitability, coverage, operational efficiency, earnings quality, and other quantitative and qualitative indicators.

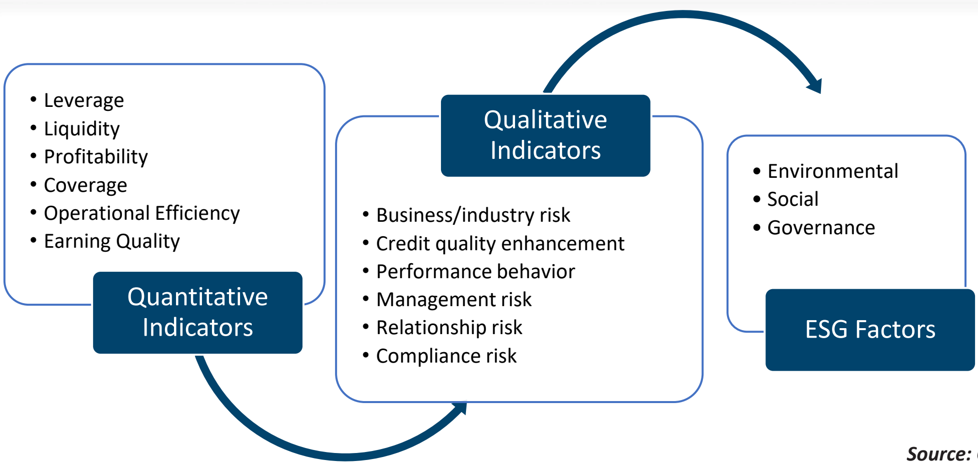
The Bank can incorporate sustainability considerations in the credit analysis process by conducting an ESG performance analysis along with traditional credit analysis when making investment and financing decisions. This analysis would evaluate a company's creditworthiness on its ability to pay its debt obligations and liabilities, and assess the impact of ESG using either in-house ESG research and scores, third-party ESG scores, or proprietary ESG scores.

Traditional credit assessment criteria should be revisited to integrate environmental and social sustainability criteria in addition to the economic sustainability criteria. These include the cost of environmental measures, the use of renewable energy, resource protection, conservation of workplaces, employees' social security, etc. To facilitate information-gathering, the Bank should also consider adding ESG information into the loan/financing application form.

Where financing is sought in relation to a particular project, the approach to the ESG factors will be slightly different. In particular, while governance can only be considered prudent at the level of the client, it may well be appropriate to consider environmental and social criteria at the level of the project. This will allow the Bank to encourage positive moves by clients to improve environmental and social performance; for example, a fossil fuel company diversifying into solar energy.

Figure 5 presents the components of the credit risk analysis-integrating ESG factors:

Figure 5. Integrating ESG Factors in the Traditional Internal Credit Assessment



Source: CIBAFI

Deposit services

Deposits from savers are an essential source of financial strength for Islamic banks. These include current accounts deposits, often based on *Qard or Wadiah*, savings deposit accounts, and investment deposits, which are generally based on *Mudarabah or Wakalah*. A Bank's investment decisions of profit-sharing accounts should be informed by thorough ESG analysis to ensure sustainability compliance. In addition, the Bank should clearly communicate its investment approach to its depositors by detailing the particular sustainability criteria that are considered in their investment strategy, beyond negative screening based on *Shariah* compliance.

Product development

Financial innovation implies seeking new products with unique features for existing financial needs. It necessitates multidisciplinary considerations involving a deep understanding of Islamic jurisprudence. Financial innovation in Islamic finance must be within the *Shariah* parameters and tested against the *Maqasid al-Shariah*, both in form and substance, where the primary objective is to realise benefits to all the stakeholders.

As part of the product development strategy, a Bank should develop new products or enhance existing products that positively impact the environment and society and align with its corporate mission and values. The ESG assessment process should be incorporated alongside the *Shariah* governance mechanism during the product design and development phases. This should be based on various factors such as customer needs, the broader stakeholder needs, social and environmental impacts, local development challenges, etc.

Other services

A Bank should also incorporate sustainability objectives in the other services it offers – advisory services, wealth management, remittance management, etc. For example, in addition to the traditional financial analysis in the selection process of investments, ESG criteria should be integrated into the wealth management practices, excluding industries and companies with poor ESG performance. ESG analysis consists of assessing the impact of all material factors, including ESG factors, on the companies' performance. In analysing ESG information, a Bank can rely on external ESG research providers, companies' information, internal ESG research, etc.

Social responsibility

Social responsibility through profit redistribution is one of the key dimensions of IFIs' social responsibility compared to conventional financial institutions. It encompasses almsgiving (*zakat*), endowment (*waqf*), charity (*sadaqah*), and interest-free loans (*qard al-hasan*). Sustainability considerations should also drive Islamic banks' profit redistribution activities.

Principle 2 – Sustainability Governance

The emergence of Islamic banking should be hailed as a crucial development in modern Muslim history. However, Islamic banks have generally been organised around the institutional logic of the existing system as part of their corporate governance. This corporate governance system is dominated by shareholder value maximisation, rather than broader concepts of stakeholder governance.

Islamic banks, so far, have aimed to fulfil the requirements of Islamic logic by incorporating *Shariah* governance into their corporate governance. However, *Shariah* Committees/*Shariah* Supervisory Boards are generally focused on transaction-based negative screening. On the other hand, as set out in Appendix A, sustainable development requires a more proactive role representing the interest of all the stakeholders in everyday operations, including resource allocation.

As already noted, the Islamic worldview sees everything in creation as a stakeholder in each Islamic bank, and their interests need to be represented, by proxy, within the governance system of the bank. While it is heartening to see that some Islamic banks, albeit on a limited scale, have institutionalised a Sustainability Committee (SC) or Sustainability Compliance Officer (SCO) at the same level as the Risk Committee and Audit Committee, as practised by some conventional banks, this should be the standard practice. The SC/SCO should provide opinions on the sustainability compliance of any financing line or operation of Islamic banks.

The SC/SCO should also work closely with the *Shariah* Committee/*Shariah* Supervisory Board, as well as other committees, to ensure sustainable development and advise the *Shariah* Committee/*Shariah* Supervisory Board on the sustainability consequences of their potential decisions. The SC/SCO's relationship with the Shariah Committee/*Shariah* Supervisory Board should be formulated in a structural manner. It is suggested that SCO or SC provide direct input on the Shariah compliance process relating to product development, financing lines, and all operations of Islamic banks so that necessary infrastructure for sustainability or ESG can be ensured. This will ensure negative screening is complemented with positive screening whereby Shariah objectives are achieved and will provide a significant development on the current governance structure to elevate the position of Islamic banks vis-à-vis sustainable development.

Having the SC/SCO located at a significant hierarchal level and tasking them with auditing the sustainability consequences of products, financing and other operations and providing input to the Shariah Committee/Shariah Supervisory Board should be considered a significant improvement towards the mizan ideal of the Islamic worldview. It is expected that in time, SC/SCO can become an essential office with a 'Chief Sustainability Officer'.

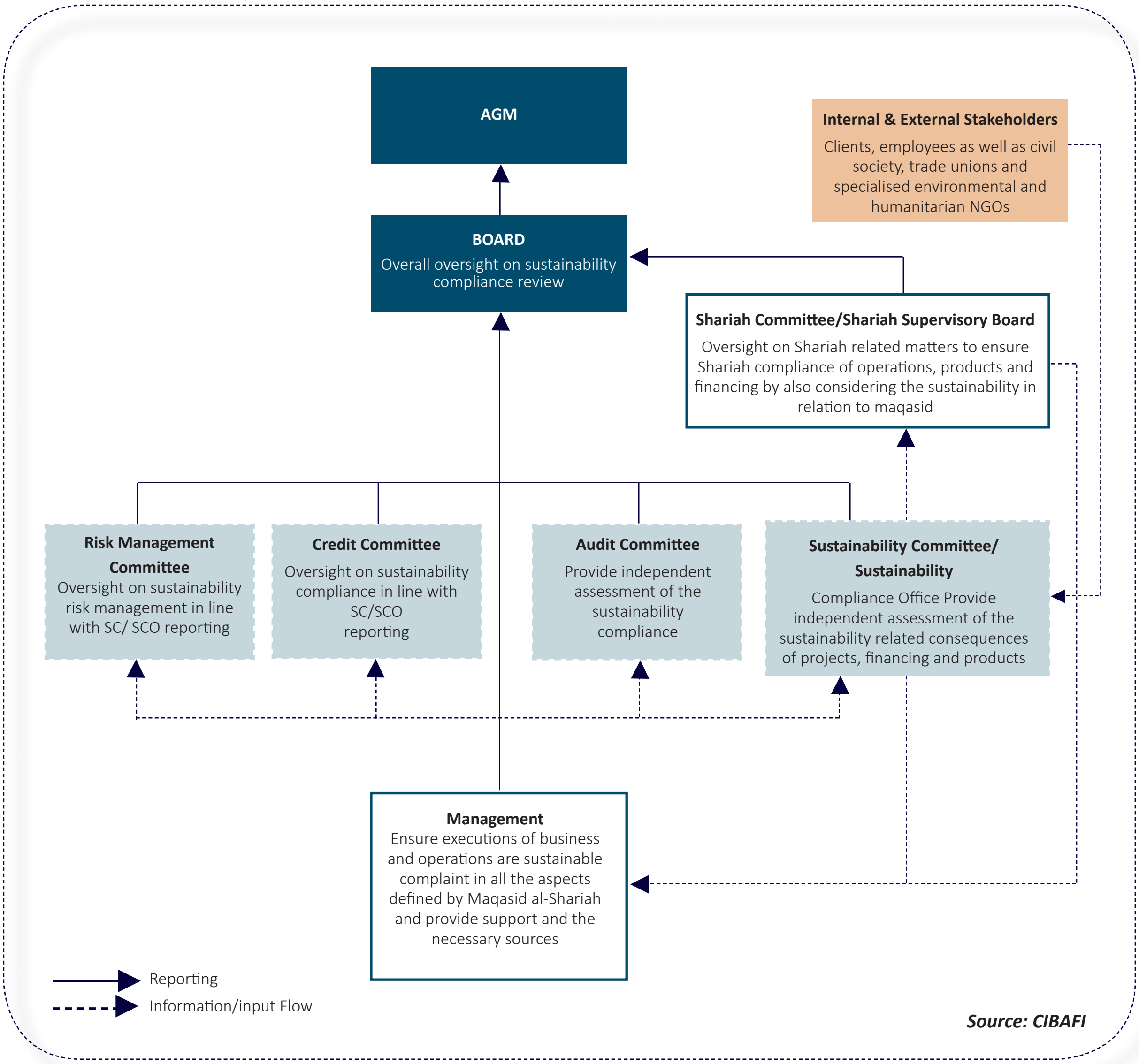
Guidelines on the Implementation and Assessment of Principle 2

In line with the Islamic worldview regarding sustainable development in general, and the Sustainability Governance principle presented above, this section aims to provide guidance on the implementation of the Principle and identify the sustainable development governance model and procedure. The rationale is provided for a specific and specialised SC/SCO, and its working mechanism is identified.

Sustainable Development Governance Model and Procedure

The sustainable development governance model for Islamic banks, as described above, is articulated in Figure 6.

Figure 6. Stakeholder Interest Augmented Sustainability Governance Model



As responsible institutions, Islamic banks are expected to develop the necessary governance framework for practising and reporting sustainable development in the following ways:

- Moving towards recognition of all the stakeholders within the Islamic normative worldview (as described in Appendix A);
- Crafting mission and vision statements of banks that are reflective of the commitment to sustainable development;
- The BoD setting up a sustainability governance policy framework and the rationale for an SC/SCO;
- The BoD creating the necessary sustainability governance responsibility framework;
- The BoD developing the necessary institutional body (SC/SCO) to ensure sustainability compliance as defined and directed by the ESG framework;
- SC/SCO tailoring sustainable governance policy to meet the recognised best practice;
- SC/SCO planning the necessary strategy and governance mechanism for sustainability integration;
- SC/SCO forming the necessary framework for the relations between different stakeholders; including clients, employees as well as civil society, specialised environmental, climate and humanitarian NGOs, and trade unions;
- Establishing necessary strategies and practices to ensure the Bank's operations and product development initiatives are in line with sustainable development as defined by SC/SCO;
- Advancing policies and strategies to ensure that the financing/credit policy of the banks is in line with sustainable development;
- SC/SCO organising and overseeing all sustainable development policies, strategies, practice development, and implementation;
- SC/SCO reporting to the BoD regularly on the sustainable practices of the Bank and the sustainability impact of its operations and financing lines;
- SC/SCO providing input to the Management on the evaluation of operations and financing lines vis-à-vis sustainability consequences;
- SC/SCO keeping the Credit as well as the Risk (Management) Committees informed so steps can be taken to identify the risk management of sustainability-related outcomes of operations, products, and financing lines;
- SC/SCO notifies the *Shariah* Committee/*Shariah* Supervisory Board on the sustainability consequences of the operations, products, and financing lines on which they are required to make a decision. The *Shariah* Committee/*Shariah* Supervisory Board should be trained to take into account sustainable development consequences of operations, products and financing lines through the input provided by the SC/SCO;
- SC/SCO establishing the necessary sustainable development-related risk management processes, including environmental and social risk management;

- SC/SCO structuring communication channels with the internal and external stakeholders and must consider the input provided with them in ensuring the sustainability development consequences of the operations and financing lines;
- SC/SCO complying with internationally recognised sustainable development standards;
- SC/SCO creating a framework to effectively disclose the sustainability performance and communicate to the related parties;
- Developing the methodology for evaluating sustainable development compliance;
- Producing a clear and informative annual sustainability report to identify the strategies, policies, practices, and activities as well as the consequences of operations, products, and financing lines; and
- SC/SCO undertaking a training process on the Bank's sustainability processes for effective sustainability implementation and monitoring.

The SC/SCO should carry out its sustainability governance functions concerning their Bank in the following areas concerning their operations and credit and business lines:

- Environmental sustainability;
- Poverty and economic empowerment;
- Social empowerment and human rights;
- Advancement of knowledge and art;
- Financial inclusion and empowerment;
- Social sustainability;
- Capacity building in society and environment;
- Collaborative partnerships; and
- Coordination of the sustainability activity between various committees.

Reporting:

The Bank should keep its external stakeholders up-to-date on its performance in the above categories through an annual report devised by the SC/SCO under current reporting standards. A quarterly reporting system should be developed to ensure the sustainability performance progress towards best practices in relation to the existing committees and the Board.

Principle 3 – Environmental and Social Sustainability Risk Management

Environmental and social sustainability is an essential consequence expected to be delivered by Islamic banks. The social sustainability aspect of sustainable development practice by Islamic banks may seem to be a novel concept, but it is normatively defined within the Islamic worldview. Islamic banks must consider individuals and other stakeholders as part of their extended stakeholders as expected by the Islamic worldview and must aim to ensure equilibrium in the society implying that everyone receives an equitably distributed wealth, and that natural environment is allowed to grow and develop as intended. Furthermore, social aspects of sustainability are prominent within the SDGs and will therefore figure within any SDG-based framework.

Environmental and social risks negatively affect banks' reputations. Therefore, integrating social and environmental considerations into financing and investment decisions requires appropriate risk management tools, which improves the risk perception of activities integrating sustainability considerations.

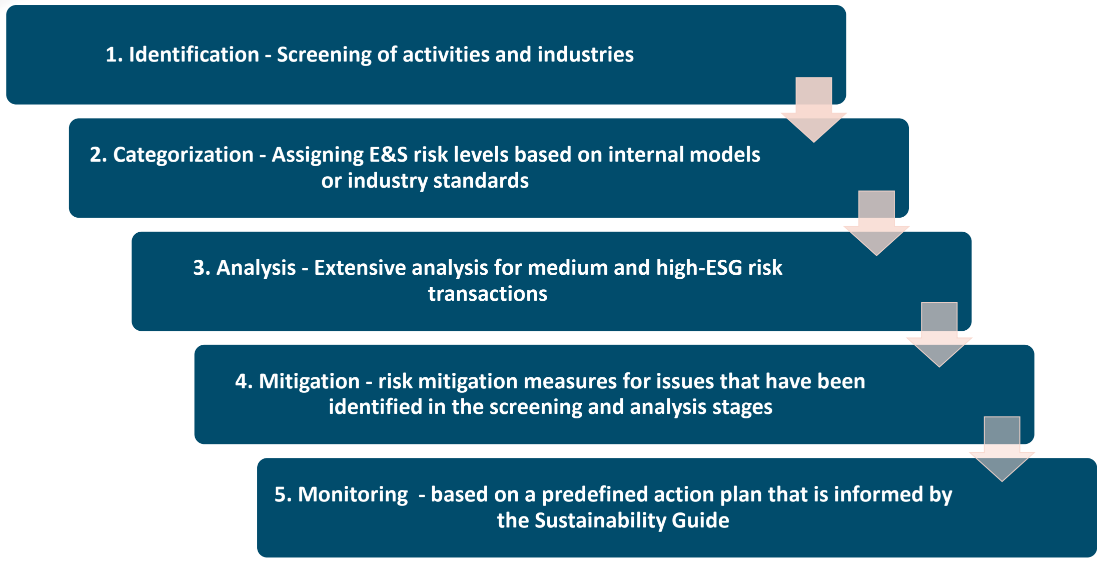
Guidelines on the Implementation and Assessment of Principle 3

In applying the principle, a Bank should:

- Integrate ESG risks in its existing risk management framework;
- Develop a clear understanding of environmental and social risks associated with its financing and investment activities;
- Assess the potential impacts of the identified environmental and social risks; and
- Implement an environmental and social risk management system (ESMS) to systematically identify and address environmental and social risks in investment and financial transactions.

In this regard, a Bank should adopt an integrated approach for environmental and social sustainability risk management, as shown in Figure 7.

Figure 7. Environmental and Social Sustainability Risks Management Process



Source: CIBAFI

A. Environmental Risk Management

Environmental risk can arise from the provision of financial services to business customers operating in sensitive sectors. Environmental issues include climate change, biodiversity loss, pollution, waste storage and disposal, hazardous substance, etc. In addition, environmental risk can translate into several other risks to banks. These include credit risk, market risk, liquidity risk, operational risk, and reputational risk. Therefore, for effective environmental risk management, the Bank should:

- Develop a clear understanding of environmental risks associated with its business activities and establish an integrated assessment to identify environmental impact. In addition, the Bank should take a consistent approach to environmental risk and issues across different business lines (e.g., financing contracts, profit-sharing investment accounts, product development, etc.), where possible;
- Inform its risk management department to consider using data from both publicly available and proprietary sources; and
- Disclose all relevant information on its material environmental risk exposures to relevant stakeholders to promote transparency and facilitate decision-making.

Identification:

- The Bank should identify material environmental risks at both customer and portfolio levels. This consists in identifying sectors with higher environmental risk and assessing their potential impact on the Bank. Table 4 provides examples of sectors with higher environmental risk.

Table 4. Sectors with Higher Environmental Risk

Sectors	Environmental Risks
Agribusiness and commodity foods	• Water availability for communities and the ecosystem • Biodiversity loss • Waste risks • GHG emissions
Aerospace and Defence	• Aircraft engine emissions
Building Materials	• GHG emissions • Waste risks
Chemicals	• Water use, scarcity, efficiency, and decontamination risks • Climate change • Waste, pollution, and toxicity
Metals and mining	• Water and electricity risks • Air pollution • Waste risks
Oil and gas	• GHG emission • Pollution from wellhead • Transport spills and leaks • Water use and contamination risks

- For sectors with higher environmental risk, the Bank should develop industry-specific environmental guidelines, which explain the environmental risk assessment process based on the sector of operation. The Bank can also rely on internationally-recognised sustainability standards to manage its environmental risk.

Categorization:

- In order to identify sectors with higher environmental risk, the Bank should develop specific risk criteria such as the level of greenhouse gas emissions, deforestation and pollution, biodiversity loss, waste risks, climate change risks, etc.
- The Bank should then use these criteria to characterise the magnitude of potential environmental impacts associated with each transaction or at a portfolio level.

Analysis:

- The Bank should conduct an environmental risk analysis for customers as part of its credit analysis for financing transactions based on its own analysis or external assessments.
- In assessing the customers, the Bank should consider their capacity and experience in managing environmental risks.

Mitigation:

- A due diligence process should be implemented for transactions with higher environmental risk, including a more advanced environmental risk assessment of the customers.

- The Bank should also develop and implement a specific internal approval process in the case of transactions and customers with high environmental risks.

Monitoring:

- The Bank should actively manage and monitor its environmental risk exposures on an ongoing basis at both customer and portfolio levels.
- At the portfolio level, the Bank should develop quantitative and qualitative indicators to monitor and assess its exposures to environmental risk.
- At the customer level, the Bank should request relevant environment-related disclosures from customers and monitor their exposure to environmental risk.
- In the case of a customer with high environmental risk, the Bank may request the customer to mitigate his environmental risk exposure.
- The Bank can consider reducing its exposure to the customer in case of persisting high environmental risk. In addition, the Bank could also re-assess the customer relationship.

B. Social Sustainability and Social Risk Management

Social sustainability, as discussed above, is one of the essential consequences expected from any economic and financial activity conducted by Islamic banks.

The Guide, therefore, identifies three main areas where social sustainability can be articulated and categorised:

- Poverty and economic empowerment
- Social empowerment and human rights
- Advancement of knowledge and art

Regarding these three categories for Islamic sustainable development vis-à-vis social sustainability, relevant benchmarks in the form of social targets and corresponding risk management requirements are determined as follows:

Poverty and Economic Empowerment

The Bank should:

- Develop sharing and participatory financing through innovative product development and offerings to reduce debt in society. This will help sustain individuals and society by expanding stakeholding in society and enabling Islamic banks to reach their distinctive potential;
- Develop innovative product and service offerings to ensure that necessary funds can be generated to invest in equity financing and extend Qard al-Hasan financing offerings to empower individuals and society;
- Innovate the necessary institutional arrangements and product development for Micro- and SMEs (MSMEs), such as creating specialised funds to provide equity financing for MSMEs;

- Develop funds for financing start-ups;
- Strategically select financing choices of sectors by prioritising productive sectors over less productive sectors in order to meet the initial need of people, alleviating economic challenges and poverty and helping job creation which is essential for economic empowerment. For example, sustainable agriculture and manufacturing sectors could be considered as part of prioritising so that food prices can be normalised for lower-income people;
- Innovate products and financing mechanisms tailored to low income and disadvantaged groups, including microfinancing;
- Prioritise poverty alleviation and economic empowerment through credit and risk management committees as part of positive screening;
- Develop financial inclusion strategies to empower individuals rather than contribute to their financialisation by indebting them;
- Improve accessibility to financial facilities and services, as part of financial inclusion policies;
- Contribute to public policy on financial literacy strategy to educate and train customers and clients so that they can develop the capacity to understand how they can benefit from the facilities and services and develop skills to avoid indebtedness;
- Develop economic empowerment related projects so that individuals can live with their dignities by earning a livelihood instead of leaving such an area to only *zakat* and charitable disbursement;
- Create a waqf or partner with an existing *waqf* to empower vulnerable groups and support poverty alleviation projects;
- Develop collaborative economic empowerment related engagement with civil society to contribute to empowerment and inclusiveness;
- Develop direct strategies to be more women inclusive in their operation, financing, and business;
- Support and help the disadvantaged and excluded groups and communities with their economic empowerment. For example, communities that do not have access to energy should be supported to overcome energy poverty;
- Develop training sessions and projects in entrepreneurship to help empower the youth and develop their skills;
- Develop innovative educational financing products and facilities to provide equal opportunities;
- Develop education-based initiatives to empower poor and vulnerable groups;
- Develop and sponsor work experience and placement programmes for students;
- Support health service provision related initiatives to prevent destitution; and
- Express a willingness to join governmental and multilateral institutional projects aiming for economic empowerment.

Reporting:

The Bank should disclose strategies, policies, and practices related to economic empowerment and poverty as listed above in the Bank's sustainability reporting.

Social Empowerment and Human Rights

The Bank should:

- Treat all individuals as equals and with dignity and respect, irrespective of their religion, race, colour, age, gender, or nationality;
- Develop diversity and inclusion policies to ensure everyone is respected in the workplace and no client is excluded;
- Develop equal opportunity policies;
- Uphold human rights for 'good life' in operations and financing;
- Recognise and respect the labour and social standards in line with Islamic norms and international good-practices within the Bank concerning operations and financing;
- Develop positive screening criteria for human rights, environmental, cultural and labour rights;
- Provide training on human rights and inclusiveness for its staff;
- Express willingness for policies towards universal basic income;
- Contribute to education and health provision related initiatives for social welfare;
- Develop policies to avoid financing weapons, ammunition and related industries and technologies;
- Collaborate with organisations and institutions that benefit society through activism for social inclusion;
- Sponsor and support community programmes, such as sports activities and educational activities and training projects that empower youth;
- Express a commitment to a social role within the view that the Bank is situated in society;
- Develop and apply self-regulatory practices and management systems that foster a relationship of confidence and trust between the banks, businesses and the community;
- Work closely with the local community in line with local initiatives;
- Support employees' involvement in charities;
- Extend its charitable activity to vulnerable communities, including refugees;
- Develop policies for compliance with customer protection legislation;
- Develop policy and compliance mechanisms to deal with consumer compliance effectively; and
- Develop policies concerning data management to respect privacy.

Reporting:

The Bank should develop disclosure strategies to communicate its performance in relation to social empowerment and human rights.

Advancement of Knowledge and Art

The Bank should:

- Allocate funds for research and development within the Bank and in other reputable research centres;
- Support establishing educational and research institutions;
- Undertake knowledge dissemination related initiatives such as conferences and publications in Islamic economics, finance, banking, management and governance, as well as support such initiatives;
- Support arts-related activities that contribute to the embellishment of society;
- Funding and sponsorships for training in general and in specific areas (such as banking, Shariah and ethical areas), including sustainable development and financial literacy; and
- Establish a waqf or join an existing waqf to advance knowledge and finance art-related activities.

Reporting:

The Bank should develop disclosure policies and measurements to communicate the advancement of knowledge and art-related activities to the larger society.

Table 5 presents examples of social targets and corresponding risk management requirements.

Table 5. Examples of Social Targets and Corresponding Risk Management Requirements

Target	Requirement (Examples) in Operation and Financing Activities	Risk Management and Monitoring
Poverty and Economic Empowerment	• Improvement in the share of PLS financing • Increasing Qard al-Hasan financing • Increasing MSMEs financing • Financial inclusion of the un-bankable sector of the society • Increased financing to value-added sectors for job creation • Innovative product development for financing to lower-income groups • Waqf, zakat and charitable giving for poverty alleviation and empowerment projects • Diversity and gender empowerment • Entrepreneurship and internship/ work placement	The SC/SCO should develop targets and measures for: • PLS financing percentage • Qard al-Hasan financing percentage • MSMEs financing percentage • financing for value-added sectors in percentage • financial inclusion-related financing percentages • financing extended to lower-income groups • women working in every level in terms of percentage • number of youths trained in entrepreneurship • number of start-up financings • number of students in work placement
Social Empowerment and Human Rights	• Recognition of all the stakeholders • Equal opportunities • Diversity and inclusion • Human rights and good life • Labour standards in the Bank • Labour standards in financing and projects • Sponsoring vulnerable communities • Contributing to health and education provision • Supporting and sponsoring sports activities • Upholding customer protection • Community and charity	The SC/SCO should establish definitions and targets for: • the active stakeholders • promotion process and equal opportunities • working hours, holidays etc. • the working conditions of labour in the financed projects • universal income and minimum wage • number of sponsorships for sport • number of customer complaints
Advancement of Knowledge and Art	• Research and development • Sponsoring research and education • Product development for education financing • Supporting and sponsoring art	The SC/SCO should develop targets and measures fo: • research and development spending percentage • sponsoring research and education percentage • funding percentage for art and fine art

Principle 4 – Monitoring, Reporting and Communication

The development of measuring, monitoring, and reporting tools enhances the credibility of a Bank in terms of sustainability integration. The objective is to measure how banks can and should have a positive impact by deploying capital and resources.

While banks report on their sustainability in various ways (sustainability reporting, integrated reporting, CSR reporting, etc.), it is important to harmonise reporting practices at the Islamic financial industry levels to promote transparency and accountability. International guidelines for corporate sustainability reporting include the Global Reporting Initiative (GRI), the International Organisation for Standardization (ISO), the World Business Council for Sustainable Development (WBCSD), the Sustainability Integrated Guidelines for Management (SIGMA) project, AAOIFI Governance Standard on CSR, Conduct and Disclosure for IFIs, etc. It is, however, likely that in due course most of these will be superseded by standards emerging from the International Sustainability Standards Board.

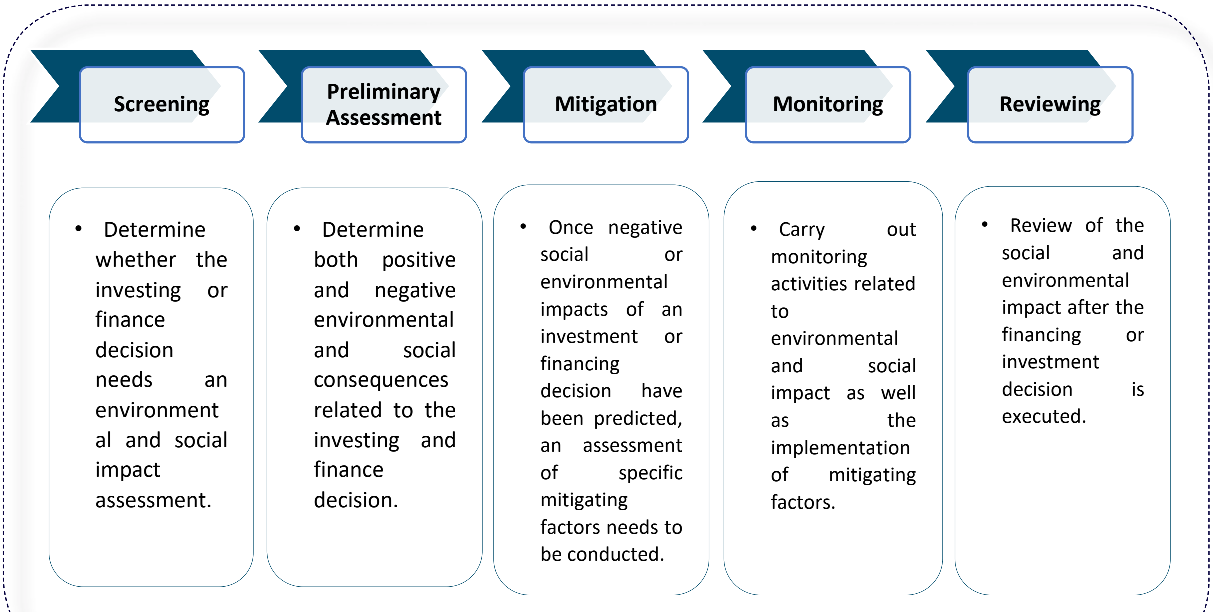
The following section provides guidance on sustainability integration monitoring, reporting and communication.

Guidelines on the Implementation and Assessment of Principle 4

In applying the principle, the Bank should:

- Report its sustainability practices and how it targets specific groups of stakeholders in its sustainability reports;
- Regularly monitor, review and report on the compliance to these Principles;
- Develop sustainability and impact assessment criteria for its financing activities. The impact measurement should include quantitative as well as qualitative metrics, taking into consideration sector specifics. Figure 8 below provides an example of the impact assessment process for financing and investment decisions. The process can be adapted to other Bank decisions;
- Develop scorecards incorporating qualitative and quantitative criteria to measure the economic, social, and environmental impact of its business activities; and
- Communicate its sustainability policies and requirements to relevant stakeholders, including clients, investors, regulatory authorities, Shariah Committees/Shariah Supervisory Boards, rating agencies, suppliers, etc.

Figure 8. Impact Assessment Process for Financing and Investment Decisions[6]



Source: CIBAFI

The Bank should report on its sustainability integration via a Sustainability Report, which will demonstrate the Bank's commitment to sustainable development and ultimately achieving human well-being.

- Sustainability disclosure should be divided into five sections according to the integrated approach in incorporating the Principles:
    - i. The Bank's approach in assessing the Sustainability Focus Areas;
    - ii. How the Bank ensures the alignment of the Sustainability Focus Areas with its vision, mission, and strategy;
    - iii. The operational integration process of sustainability in the Bank's business activities;
    - iv. The Bank's internal and external capacity building and awareness initiatives to promote sustainability integration; and
    - v. The monitoring and reporting mechanisms to ensure the quality of reported sustainability information.
- Sustainability disclosure should comprise both financial and non-financial information. Non-financial information can be quantitative or qualitative. Table 6 provides examples of financial and non-financial disclosure.
- The Bank should also implement internal assurance arrangements to ensure the sustainability information disclosure's quality, completeness, and accuracy.

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6. Adapted from the Environmental Impact Assessment (EIA) process.

Table 6. Sustainability Disclosure Examples

Information Type	Examples
Financial	• Clean energy expenditure • Total green financing in the previous year • Amount of green Sukuk issued • Amount of Islamic social financing • The total amount of solid waste generated
Non-Financial	Quantitative • Metric tons of greenhouse gas emissions • The total amount of energy used/revenues • The total amount of solid waste/revenues • Energy saved due to conservation and efficiency improvements
	Qualitative • Governance processes • The organisation's impact on the state of biodiversity • Waste minimisation and management • Natural resources conservation • Employment creation • The organisation's impact on financial inclusion

Principle 5 – Coordination and Collaboration

A Bank needs to leverage local, regional, and international partnerships to accelerate the integration of sustainability objectives in its business activities while supporting the achievement of national visions and strategies as well as international standards.

The section below provides guidance on coordination and collaboration activities to accelerate sustainability integration in Bank's activities:

Guidelines on the Implementation and Assessment of Principle 5

To implement this principle, a Bank should:

- Commit to relevant international standards and best practice initiatives to accelerate the contribution of the Islamic financial industry to sustainability;
- Support and participate in the CIBAFI sustainability initiatives to promote sustainability integration at the Islamic financial industry level;
- Collaborate with other Islamic financial institutions locally, regionally and internationally to further the implementation of the Principles; and
- Contribute to stakeholder engagement and dialogue on sustainability-related issues and initiatives. Key industry stakeholders include the AAOIFI, the IIFM, the IILM, the IIRA and the IFSB.

Examples of relevant international policies and standards include:

- The International Labor Organisation (ILO) Declaration on Fundamental Principles and Rights at Work;
- The Global Reporting Initiative (GRI);
- The Equator Principles;
- The Universal Declaration of Human Rights;
- The Rio Declaration on Environment and Development; and
- The United Nations Convention against Corruption.

Conclusion

This document presents a Sustainability Guide for Islamic banks to develop the necessary capacity to address sustainability issues prevalent in their jurisdictions and in the global society through methodology, process, and content inspired by Islamic normative principles. However, it is an indicative document that does not mandate standards for Islamic banks, as these banks operate in different regulatory and legal environments as well as in different political economies.

This Guide is predicated on the argument that sustainability embeddedness requires an integrated approach. It provides a unique definition of sustainability within Islamic philosophy and the Islamic moral economy. In such an approach, negative screening based on Shariah compliance that has been practised in Islamic banks must be extended to internalise positive screening as part of sustainable development. Islamic banks' governance mechanisms, generally based on shareholder value maximisation, should expand towards the broader stakeholder governance model.

At its core, sustainability is a requirement of Islamic logic which is expected to be produced by aligning with Maqasid al-Shariah. Islamic banks should not treat sustainability as an exogenous necessity, but as an embedded imperative and actualisation of Maqasid al-Shariah.

Questions on the Sustainability Guide

CIBAFI welcomes feedback and comments from all stakeholders. More specifically, we request feedback on the following questions:

1. Do you agree with the Five Sustainability Principles outlined in this Guide? If not, what do you believe should be the overarching Principles to create a meaningful impact?
2. What is your overall assessment of the Sustainability Guide Implementation Framework and Measurement suggested?
3. Do you agree with the articulation of the Maqasid al-Shariah basis of the Sustainability Guide? If not, what do you believe should be the Shariah basis for the Guide?
4. Do you agree with the methodological approach of the Maqasid al-Shariah Evaluation Framework? If not, what do you believe should be the correct methodological approach for the Guide?
5. Do you have any additional comments or suggestions on the Sustainability Guide?

Appendixes

Appendix A. Islamic Theological and Economic Perspectives on Sustainable Development

In the course of preparing this Guide, CIBAFI sought input from a number of academic experts in Islamic theology and economics. While not all the material we received was included within the main sections of the guide, it did help to shape out thinking, and it provides valuable perspectives on what sustainability means and why it matters in the context of Islamic finance. We have therefore brought the material together in this Appendix. In order to do so, we have had to edit and reshape it, but we hope we have stayed true to the original intentions of those who contributed it.

Not all of the opinions expressed necessarily represent consensus views. However, debate and challenge have always been valued as part of Islam, and readers of an Appendix like this should be able to judge for themselves whether they agree with the views set out here, and how they might apply them in their own institutions.

The fundamentals of Islamic finance and economics

"Finance is not about 'making money' per se. It is a 'functional' science in that it exists to support other goals – those of the society. Therefore, the better aligned a society's financial institutions are with its goals and ideals, the stronger and more successful the society will be"[7] .

In essence, Islamic finance emerges from a set of Islamic normative principles as identified by the Islamic economics movement in the 1950s, as the colonial period was drawing to an end. In its development, a process of Islamisation was considered as a methodological base, rather than returning to Islamic ontology, i.e., its understanding of the true nature of being and relationships. As a result, the institutional logic of conventional banking has been opted and its operations are subjected to Shariah compliance. This resulted in an eclectic institutional logic: religious logic represented by Shariah compliance combined with a conventional banking logic. However, instead of such an eclectic methodology resulting in a so-called "emergent" pattern, Islamic norms beyond Islamization could, it is argued, have provided the main thrust and base to develop a sustainable development oriented Islamic economics.

Islamic Philosophical Foundations for Sustainable Development

Economics has traditionally been regarded as a descriptive science devoid of value judgements, and therefore not concerned with ethical issues. However, relegating economics to the science of optimization without normative features and focusing on efficiency and maximisation has resulted in the unsustainable nature of the present economy and society. Due to its focus on optimisation, economics aims at efficiency and does not consider equity, and consequently, economics does not consider substantive justice beyond the legality of the transactions. Within this 'economics' worldview, sustainability remains at best a possible outcome of a philosophical foundation that does not consider sustainability as an essential quality.

7. (Shiller, 2012: 7)

Shaping Islamic economics around the term 'economics' and its worldview has prevented the Islamic worldview from shaping the understanding of the economy and finance. Instead of the Islamisation approach described above, emergent methodology based on Islamic ontology should have been used to develop authentic and organic theories, institutions, and practices in the economy and finance spheres. Theoretically, Islamic banking and finance should be shaped by Islamic ontology, which, as discussed below, has as an essential feature of sustainable development through extended stakeholding governance. However, due to operating within conventional institutional logic with additional Shariah compliance, they have not developed sustainable practices through Islamic logic in their operations and financings[8]. In other words, until now, Islamic banks and financial institutions declared their ethicality through negative screening, which involves removing interest (*riba*), excessive uncertainty (*gharar*) and avoiding the sinful industries. However, the new paradigm requires positive screening such as environmental and social consequences along with the negative screening shaped by Shariah-based prohibitions.

In addition, the incorporation of sustainability in the form given by Islamic substantive morality as set out below requires certain adjustments in the corporate governance discourse, structure, and practice of Islamic banks beyond shareholder value maximisation. For example, the initial change has to start with Islamic banks' mission and vision statements, as most of the Islamic banks have firm shareholder emphases[9] and market economy-oriented mission and vision statements which avoid making references to stakeholders in the widest sense.

From Islamic ontology to a wider view of sustainability

While there are positive developments in the rescue process of people, planet and profit, neither the conventional SDG nor indeed the ESG paradigm questions the prevailing economic and business model, as they only consider moderating the consequences of the existing system. The Islamic worldview, on the other hand, aims to tackle the problem at the core by proposing an extended stakeholding-based balance (*mizan*) worldview within the Islamic ontology of development under tawhid (the indivisible oneness concept of monotheism in Islam).

For this worldview, the concept of *iqtisad* (an Arabic term for a broader term of economics) will be an essential guide and the reference point, as *iqtisad* located within the Islamic worldview directly, makes sustainability an essential requirement. Although *iqtisad* is commonly translated as 'economics', in its origin it goes beyond the maximizing and efficiency worldview of 'economics' and instead speaks to a substantive moral outcome of its process. Examining the word itself shows the ethicality to be considered in economy and finance spheres; iqtisad as an Arabic word comes from the roots of '*qasd*' and '*qist*'. '*Qasd*' means and implies 'directing towards an objective', 'true path', 'in line with an aim', '*equable*' and '*temperate*', while '*qist*' refers to 'just share' and hence 'justice[10]. Therefore, iqtisad is defined as 'giving the right of everything', 'to locate everything in its place', and hence 'establishing justice'. *Iqtisad* also refers to directing towards an objective, which implies emancipation and empowerment of all stakeholders within

8. (El-Gamal, 2006; Asutay, 2012, 2019; Abdullah and Asutay, 2021; Khan, 2019; Mergaliyev et al., 2021; Sencal and Asutay, 2021)
9. (Rudnyckyj, 2014; Sencal and Asutay, 2021)
10. (Al-Hasani, 1989)

stakeholder-centred development. Within such a semantic world, which should shape the attitudes of Muslims and their organisations, ethicality and sustainability are thus embedded in the process and outcome.

Within the moral perspective of Islam, *iqtisad* aims to maintain an inherent balance, or '*mizan*'. Humans are considered the custodians who ensure this balance is maintained. The term 'balance' indicates the connectedness of all the stakeholders within a sustainable world, including its economy. All aspects of the physical realm – humans, the environment, the animal world – sustain mizan within themselves and in their interactions with each other. Therefore, Islamic development ontology as informed by iqtisad relates to sustaining this balance and order (see for example Qur'an 55:1-9).

Within this view, development requires all stakeholders to be given equal opportunity space for their growth and development as the balance (*mizan*) or their nature (*fitra*) requires. From this perspective, every creature in existence is given a development path as part of their nature to reach perfection in harmony with other stakeholders[11]. The Islamic worldview suggests that the disruption or transgression of mizan results in tension and crises. For example:

- poverty: denial of accessibility to resources created by Allah (swt);
- environmental crisis: denial of opportunity space of the environment to develop due to exploitation;
- social crisis: denial of the right of each actor to function;
- economic crisis: denial of each factor of production of the opportunity space to develop according to their due rights, etc.; and
- human rights violations: denial of individuals to develop as their nature or the nature of creation requires.

The Islamic ontological base through the axioms of Islamic economics provides us with the necessary tools to construct an economic system to sustain mizan and protect stakeholders by preventing transgression or departure from balance. The cognitive system of Islam has tawhid as an essential feature, interpreted as complementarity to reach unitarity. All creatures as stakeholders are connected and complement each other in the balanced world so that unitarity can be achieved. Hence, in the economic and financial worlds, the interest of all the extended stakeholders must be considered, as by creating all things that we have around us are considered stakeholders.

In this extended stakeholder model of the balanced (*mizan*) world, sustainability becomes essential through the axiom of rububiyah, which implies 'nourishment and correcting things towards perfection'. Thus, Islamic development ontology suggests that all stakeholders are created with the path of perfection, and therefore they should be given equal opportunity space to sustain their development; when there are barriers towards perfection, they should be removed. This is substantiated with the axiom of 'tazkiyah', which directly suggests as part of this balanced world that growth can only be in harmony; i.e. growth can only be achieved by

11. (Khan, 2019; Asutay, 2019)

considering the interest of all the stakeholders in having this opportunity space so that justice (*adalah*) can be achieved.

As part of this cognitive system, justice is considered an articulation of the nature of the relationship between all the stakeholders. Thus, recognising the rights of each of the stakeholders in any process is an imperative of the Islamic worldview. When justice is not enough to overcome the disruption of balance, in order to correct it and to bring to the balanced level, equilibrium and moderating role-concerning consequences (*ihsan*) are considered crucial to maintain sustainability. Ihsan in this process works by establishing the necessary equilibrium between different stakeholders. This organic emergence, therefore, suggests that when there is a disruption of balance (*mizan*), it can be overcome through ihsan.

It is also important to note that a further essential part of the Islamic cognitive system is that whatever we have around us is trust (*amanah*), implying that interest and development must be internalised. Thus, in this embedded sustainable development, human beings, as the custodians of nature and resources, are charged with the responsibility of ensuring the mizan; humans are considered vicegerent (*khalifah*), imbued with the duty of safeguarding this balance and preventing disruptions to harmonious coexistence.

Since Islamic banks and financial institutions have been operating within the existing banking and finance institutional logic, they have generally followed negative screening based on Shariah compliance. However, considering the pressing sustainability issues, the sector should move to the mizan paradigm, aimed at the well-being of humans and all the stakeholders and ensuring that Islamic institutional logic prevails in the operations and business activities. Thus, Islamic logic should not be limited to the negative screening of transactions, but the entire operations can work in line with the balanced worldview so that any *Shariah*-compliant financing or product development, for example, is at the same time sustainability compliant. Therefore, the logic of *Shariah* compliance risk should be expanded beyond negative screening-sourced risks to include risks that emerge from a lack of response to positive screening, such as noncompliance with environmental risk. In other words, for example, in the current Shariah governance, an Islamic financing line extended by Islamic banks could be devoid of riba, excessive gharar and sinful industries; however it may, for example, result in environmental damage or excessive CO2 emission. However, the tawhidi methodology aiming for mizan requires such consequences to be considered simultaneously, as intention (***niyyah***) cannot be divorced from the consequence in Islamic logic.

Based on the Islamic foundational philosophy described above, it is possible to produce an integrated definition of sustainability, which is based on the Islamic principle of public interest (*maslahah*) in promoting good and preventing harm across all processes and activities. Accordingly, sustainable development within the Islamic worldview can be defined as follows:

"Recognising the complementarity nature of all the stakeholders to reach unity (*tawhid*) within the balance (*mizan*), which requires the recognition and provision of an opportunity space for the development path for each stakeholder to reach their perfection (*rububiyah*), where the growth of each stakeholder has to be in harmony with other stakeholders' (*tazkiyah*) leading to inter-and-intragenerational justice (*adalah*) through the equilibrium based (*ihsani*) governance".

Sustainable development: the Maqasid al-Shariah approach

In order to actualise the Islamic cognitive system as explained so far, Maqasid al-Shariah (the objectives of *Shariah*) is considered as an important methodological tool. Maqasid al-Shariah is interpreted as human well-being by contemporary Islamic economists following the interpretation pioneered by Al-Ghazali. However, on the basis argued above, it should in fact be interpreted as the well-being of all stakeholders so that the *mizan*-based worldview should be reflected in the outcomes of any actions.

As regards the description of Maqasid al-Shariah, the seminal works[12] in the field mostly classify it according to the level of necessity. Hence, Maqasid are organised into three hierarchical level[13]:

- Necessities (*daruriyyat*), which must be protected and promoted. According to the Ghazalian description, being crucial for sustaining life and reaching salvation (falah) in this world and in the hereafter, necessities include the protection of faith, the soul, wealth, the mind, and offspring. These are considered the foundations of human life.
- Complements (*hajiyyat*), which are supplementary to the essential necessities which facilitate life; and
- Embellishments (***tahsiniyyat***), which will lead to improvement and the attainment of balance (*mizan*).

It should be noted that Al Shatibi (2004) regarded the hierarchical relationship between these categories as essential, meaning the completion of each level and hence protection of the previous level are necessary.

In searching for an articulation of Maqasid al-Shariah to reflect an extended stakeholding approach within *mizan*, Abdel Majid Najjar[14] provides a current view of Maqasid al-Shariah classified within four objectives and eight corollaries, which are useful to provide a balanced (*mizan*) or sustainability approach:

(i) Invigorating the value of human life
- (a) Faith
- (b) Human rights

(ii) Invigorating the human self
- (a) Self
- (b) Intellect

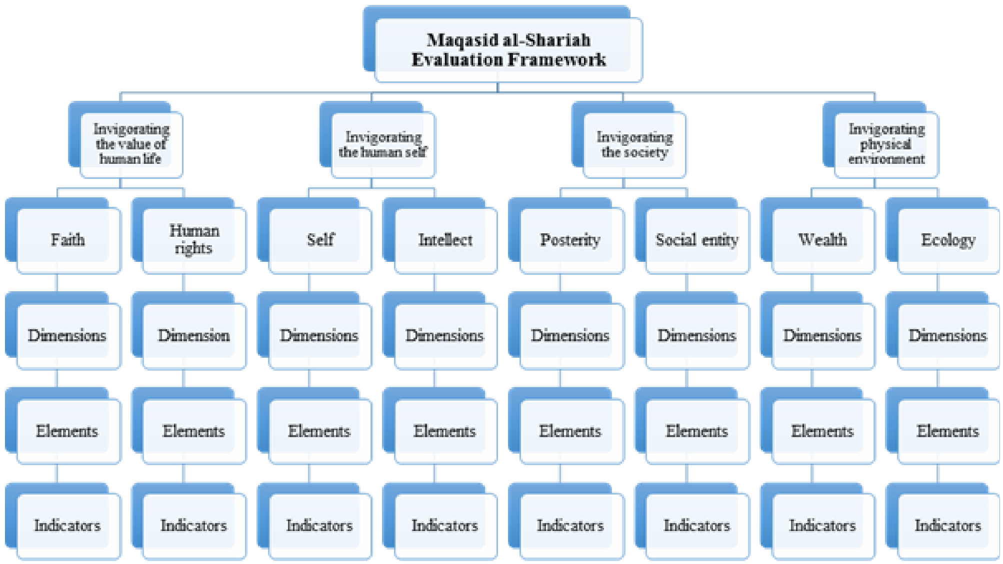
(iii) Invigorating the society
- (a) Posterity
- (b) Social entity

(iv) Invigorating the physical environment
- (a) Wealth
- (b) Environment (Ecology)

12. (Such as Al Shatibi, 2004)
13. (Hassan and Asutay, 2017)
14. (See: Bedoui and Mansour, 2014)

The accomplishment of both primary and corollary objectives is essential, and therefore all the objectives should be balanced and considered to be equally important. In order to operationalise this framework, the Maqasid corollaries are articulated and detailed in 'dimensions'. 'Dimensions' are then articulated in 'elements', and 'elements' are articulated in 'indicators'.

Figure 9: Maqasid al-Shariah Evaluation Framework



Source: Mergaliyev, Asutay, Avdukic & Karbhari (2021); Asutay & Harningtyas (2015)

Examples of how this table might be populated in an Islamic finance context might be as follows:

Example 1:

Maqasid Objective 1: Invigorating the value of human life

Corollary 1: Faith

Dimension 1: Elimination of negative elements that breed injustice in transactions

Element 1: Non-ribawi product

Indicator 1: Expansion of risk-sharing products

Example 2:

Maqasid Objective 4: Invigorating physical environment

Corollary 2: Ecology

Dimension 1: Elimination of financing projects creating environmental risk/hazard

Element 1: Financing screening through environmental impact screen

Indicator 1: Environmental screen reporting demonstrating environmental impact compliance

Islamic Banking and ESG within Maqasid Al-Shariah Methodology

The outlines of an ESG framework precede the SDGs, and therefore considerable work has been conducted to apply this framework to the business and operational activity of financial institutions and banks so that they can deliver sustainable development.

The Maqasid al-Shariah evaluation framework-based process defined in Figure 9 provides a structure to operationalise ESGs – even SDGs within the Islamic logic for Islamic banks. The matrix based on Najjar's Maqasid framework can be tilted to articulate sustainability objectives or ESG.

A correlation between the Maqasid methodology identified in Figure 9 and the ESG logic can be established, which can give an operational frame for Islamic banks and financial institutions to work towards Islamic logic and comply with ESG. Table 7 articulates in a new form an ESG augmented Maqasid al-Shariah Framework in line with Figure 9. In this Table, Maqasid goals are summarised in the form of 'Human Life', 'Economic', 'Environmental', 'Societal' and 'Governance' Goals. 'Faith' is not a core element of either ESG or the SDGs, but in this formulation needs to be added to them as the main Maqasid goal, which should be populated by the traditional Maqasid (objectives). This is done in the first column.

Table 7: Reconfiguring the ESG Augmented Maqasid Al-Shariah Framework

Faith ***(Maqasid Goal** **1 [Corollary 1])***	**Human Life** ***(Maqasid Goal** **1 [Corollary 2] & 2)***	**Economic** ***(Maqasid Goal** **4, Corollary 1)***	**Environmental** ***(Maqasid Goal** **4, Corollary 2)***	**Societal** ***(Maqasid Goal** **4)***	**Governance** ***(Maqasid Goal** **1 [Corollary 2] and 3 [Corollary 2])***
Substantiative: Sustaining Mizan Actualising Khalifah Role **Prohibitions:** Riba Gharar Maysir Sinful Industries **Mandatory:** Zakat **Voluntary:** Waqf Charity	Human Well-being Human Rights Consumer Protection	Responsible Investment Strategies	Climate Environmental Protection Invigoration of Environment Sustainable use of Resources	Harmonious Relationship between Stakeholders Diversity Human Rights Consumer Protection Animal Welfare	Managerial Structure Employee Relations Employee Compensation and Rights Executive Compensation Sustainability Disclosure

Figure 9 and Table 7 together are capable of offering a complete *Maqasid Al-Shariah*-based ESG assessment guide for Islamic banks.

Appendix B. SRI Approaches and Strategies[15]

- ***The screening of investments strategy:*** can be negative, positive/best-in-class, and norm-based. Whereas negative screening excludes some companies and sectors due to ESG criteria, under positive screening, "Best-in-Class" investments are made in firms to contribute to ESG goals. Norm-based screening uses international standards on best practices to make decisions on investment.
- ***The integration of ESG goals:*** ESG considerations are integrated into traditional financial analysis. A related strategy is sustainability-themed investments, which refers to financing sustainable industries such as clean energy, green technology, etc. This evaluation takes into consideration the specificities of each sector, and is based on the principle that long-term economic growth is not possible unless it is based on respect for the environment and humanity.
- ***Impact/community investing:*** whereby investments are made to solve social and environmental problems. Under this strategy, capital is invested in underserved communities or in businesses that have a social and environmental purpose.
- ***Corporate engagement and shareholder action:*** whereby shareholders influence companies to engage in ESG-related investments by explicitly expressing their views and preferences towards these issues.

Appendix C. The Guide's Approach in Integrating ESG Factors in Investment and Financing Decisions

Financial institutions can use different approaches, practices and tools to integrate ESG factors into their investment and financing decisions. Institutions can also incorporate the three ESG factors or focus on selected factors. The level of integration depends on various considerations, such as the institution's commitment to sustainability, its sustainability focus areas, internal expertise, long-term strategic goals, etc. Below are examples that summarise the ESG integration in financing and investment decisions in the context of financial institutions:

Financing and Investment Decisions	Examples of ESG Integration
Fundraising	Issuance of Green, Sustainable and SRI Sukuk
Capital Budgeting	Prioritise projects that have environmental and social impacts and good governance. ESG considerations can be embedded in traditional capital budgeting techniques.
Investments	Screening of investments using SRI strategies. Prioritise Investments with positive ESG scores.

15. Aassouli (2016).

Appendix D. Sustainability Guide Implementation Framework and Measurement

Sustainability Guide Implementation Framework	Strategic Goal	Nature of Assessment	Measurement
1. Internal Assessment of Sustainability Focus Areas	To assess Sustainability Focus Areas at the management's level	Qualitative	List of sustainability focus areas with the rationale behind selecting them.
2. Alignment with the Bank's vision, mission and strategy	To ensure that the Sustainability Focus Areas are aligned with the Bank's vision, mission, and strategy	Qualitative	Assessment of the Bank's Sustainability Strategy and sustainability targets by focus area.
3. Operational Integration			
• Corporate and Shariah Governance	To institutionalise sustainability by integrating sustainability in the corporate and Shariah governance structure of the Bank	Qualitative	Assessment of the Bank's Corporate and Shariah Governance structure.
• Sustainability Integration	To integrate sustainability considerations in the Bank's business activities	Qualitative/ Quantitative	**Financing and Investment Activities:** • ESG integration in investment portfolios and decisions (Examples: ESG analysis in equity and fixed-income analysis, statistical techniques using ESG scores, etc.). • Sustainable finance strategies (examples: % of green Sukuk, SRI Sukuk, sustainability Sukuk, green loans in total financing). **Internal credit assessment:** • ESG performance analysis (ESG research and scores, third-party ESG scores or proprietary ESG scores). • ESG information in the loan/financing application form.

• Environmental and Social Risk Management	To identify, categorise, analyse, mitigate, and monitor environmental and social risks	Qualitative/ Quantitative	**Identification:** • Assessment of material environmental and social risks. • Industry-specific environmental guidelines. • Sustainability standards to manage environmental risk. **Categorization:** • Risk criteria (Examples: level of greenhouse gas emissions, deforestation and pollution, biodiversity loss, waste risks, climate change risks, etc.). **Analysis:** • Environmental risk analysis (Example: capacity and experience of customers in managing environmental risks). **Mitigation:** • Due diligence process for transactions with high environmental risk. • Internal approval processes for transactions with high environmental risks. **Monitoring:** • Qualitative indicators (Example: risk mitigation strategies). • Quantitative indicators (e.g. carbon footprint).
4. Internal and External Education	To promote sustainability awareness internally and externally	Qualitative	Assessment of the Bank's internal and external capacity building and awareness initiatives to promote sustainability integration.
5. Monitoring and Reporting	To ensure that the Bank's sustainability disclosure complies with the Guide's Sustainability Implementation Framework	Qualitative	Assessment of the quality of reported sustainability information based on the Guide's Sustainability Implementation Framework.

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