AN ETHICAL BRIDGE BUILT ON SHARED VALUES BETWEEN ISLAMIC FINANCE AND ESG

Prof. Sava Dimov, PhD
Burgas Free University

Abstract: *The article discusses the shared values between Islamic finance and the concept of environmental, social and corporate governance. The ESG framework underpins flexible, sustainable and responsible investing. In that regard, some contemporary views on reconciling Sharia with sustainable investing are considered. The author utilizes materials from CFA Institute, World Bank Group, PricewaterhouseCoopers, Deloitte & Touche and new research by Islamic scholars to prove their point. Sectors of the Islamic finance industry show more sustainable rates of development. The author has reason to assume that the presumed projections (2030-2050) of Islamic finance will confirm such a tendency. Islamic finance is therefore more adaptive and demonstrates flexible resilience to ESG investing, good environmental, social and governance outcomes*.

Keywords: *ethical bridge, shared values, islamic socio-economic system, islamic banking and finance, environmental, social & governance, green and circular economy, global value chains.*

Introduction

Islamic finance is the fastest growing and most profitable industry globally. Islamic finance is equity-based, asset-backed, based on ethical, sustainable, environmentally and socially responsible governance. It is an effective tool for investing in many projects to tackle poverty, increase shared prosperity, financial inclusion and social well-being of people.

From the author's point of view, Islamic finance is not a new area of research. Objective knowledge of them gives us new light on the development of world financial realities. This allows us to rethink some notions about the fundamental foundations for them. The author's challenge is strengthened by the fact that in the Republic of Bulgaria this matter is less studied.[1] In terms of scientific development, the Islamic financial system is widely represented in Arabic, Anglo-Saxon and Russian literature. Islamic finance refers to investments that are permissible in accordance with the Shariah.[2] Shariah law views - money as a tool for measuring value, not as an "asset"; prohibits receiving and paying "riba" (interest), "gharar"

[1] Yordanov, Y. (2002) Specificity of Islamic Banking. *Banks, Investments, Money*, 3, 24-30; Dimov, S. (2018) Projections of Islamic finance. *Bulgarian journal of Business Research*, Issue 1; Dimov, S. and K. Koishibekov (2019) New trends in the development of the Islamic banking and finance toolkit by 2050, *Bulgarian journal of Business Research*, Issue 2; Kamdzhalov, M. (2023) *Islamic Economics and Finance*, Varna : Gea - Print.

[2] "The religious law of Islam is seen as the expression of God's command for Muslims and, in practice, constitutes a system of duties that are incumbent upon all Muslims by virtue of their religious belief". (Shamsy, A. and N. Coulson, 2023)

(excessive uncertainty), "maysir" (gambling); short selling or financial activities that are "harmful" to society.

In a modern aspect, companies' business models are built on the basis of corporate social responsibility (abbr. CSR), environmental, social and corporate governance.[3] It is at the heart of sustainable and responsible investing. (IFC ESG Guidebook. 2021, p.13).

ESG is therefore an environmental, social and governance standard that includes related to, but not limited to, environmental, social and governance factors (also referred to as pillars or core thematic areas). It is a set of societal and corporate performance indicators that can be used to better understand the material risks and opportunities associated with sustainability.

In this annotated aspect, ***the author defends the thesis*** *that there are bridges of shared ethical values between Islamic finance and sustainable investing.*

Part One
Ethical values of the Islamic socio-economic system

The Islamic socio-economic system came into circulation relatively late - in the late 1950s and early 1960s. Initially, Islamic universities debated how the enlightened ideas laid down in the Koran and the Prophet Muhammad could be combined with the economic concepts of capitalism and socialism. Islamic economics rests on and is aimed at achieving the goals of Sharia. According to one of the most significant thinkers of Islamic economic thought, Muhammad al-Ghazali, the purpose of Sharia for people is reflected in the following five directions:

– preservation and development of the Islamic religion;
– preservation of their life;
– preservation and improvement of their mind and reason;
– preservation and reproduction of offspring;
– preservation and multiplication of wealth.

Consequently, everything that contributes to and contains in itself the preservation of these foundations is classified as good, benefit or interest ("maslaha" - receiving benefits and avoiding harm, Arabic فائدة), *and everything that threatens and affects negatively is vicious or immoral, leading to corruption - harm ("mafsada", Arab* فساد).

The Shariah is a guide of action for the believer. It covers all aspects of his life activity - spiritual, individual, social, political, cultural and economic. In this sense, there are hierarchical relations of his types of actions "al-ʾaḥkām al-khamsa", which regulate economic behavior: obligatory "fard/wajib", recommended or encouraged "mustahab/sunnah", permissible or neutral "mubah", not recommended "makruh" and forbidden "haram".

The "cornerstones or three whales" regulating the effective functioning of the Islamic economic system are based on:

– prohibition of "riba", Arab ربا ,الربا، الربٰوة as usury is categorically condemned by the Koran; [4]

[3] In 2004, the United Nations Global Compact and the Swiss Federal Foreign Office published a report, Who Cares Wins, which introduced the term "environmental, social and governance factors". (*Who Cares Wins,* 2004, p. ii).

[4] "Allah emphatically forbade Riba in all its forms and declared its practice equal to disbelief in Him".

– building a unified Islamic tax system based on “zakat” (Arab زكاة, synonym زكوة), i.e. a compulsory annual tax for the benefit of needy poor people, for the development of projects to spread Islam and knowledge about it. It is also called “one of the five pillars of Islam” or “mechanism to prevent poverty in Muslim countries”;

– compliance with the rules of succession.

The Islamic law “fiqh or fiķh” is divided into two areas: “ibadat” (acts of worship, Arab عبادة), including prayer, fasting, almsgiving, and penance; and “mu'alamat” (Arab فقه, understanding, knowledge), family, criminal, public law and other types of relations between people. (Badawi, N., 2009, 2).

Main sectors of the Islamic economic system are Islamic banking and finance, the halal industry (Arab حلال - allowed, i.e., all that is permitted and permissible in Islam) and Sharia compliant tourism.

Consequently, the main feature that distinguishes the Islamic financial model is the rejection of the basic postulate of the traditional Western system - the interest rate. It is not without reason that we should mention Silvio Jean Guezel, who for the first time proposed an economy free of interest, exploitation and trade restrictions. It is called “free economics” and Gesell “founded the doctrine of free economics”. (Kennedy, M., 2012, 14).

Ultimately, we need to summarize that Islamic finance is based on the following important values: prohibition of riba, lawful activities, ethical and moral values, profit and loss sharing, prohibition of gambling and prohibition of speculation.

Part Two

An ethical bridge built on shared values

Section A.

If we refer to Abdul Qoyum, Muhammad Sakti, Hassanudin Thaker and Rizqi AlHashfi[5], who examine evidence of Shariah compliant firms in Indonesia and Malaysia, *we will argue that the Islamic values label offers good environmental, social and governance outcomes, which is at the core of the ESG strategy*.

Environmental, social and governance influencing factors are considered universal in the implementation of corporate social responsibility of Islamic institutions:

– Shariah Compliant Stocks and bonds face less risk. The screening process excludes firms that offer high interest and are highly leveraged. *A logical consequence of this is that non-Muslim investors concentrate in Shariah compliant institutions*;

– Governments support in promoting Islamic finance and capital markets. This creates good interest among firms seeking sustainability of results;

– Shariah Compliant Corporations and institutions are regulated with an effective regulatory framework, which enhances the credibility of institutional investors;

– The Islamic finance industry is experiencing definite and sustained growth;

– A large Muslim population in the world and a pronounced process of rejuvenation. (Qoyum, A., M. Sakti, H. Thaker and R. Hashfi, 2022, pp. 306-320).

In the context of the latter two, Professor Sava Dimov and Kairat Koishibekov PhD outline the following few new trends for the development of the Islamic finance industry by 2050, namely:

1. New demographic structure in perspective.

[5] ESG Value Creation Journey, 2022, p. 6.

– over the next four decades, Islam will grow faster than any other major world religion. The relative proportion of the so-called young population will increase proportionately at the most accelerated rate;

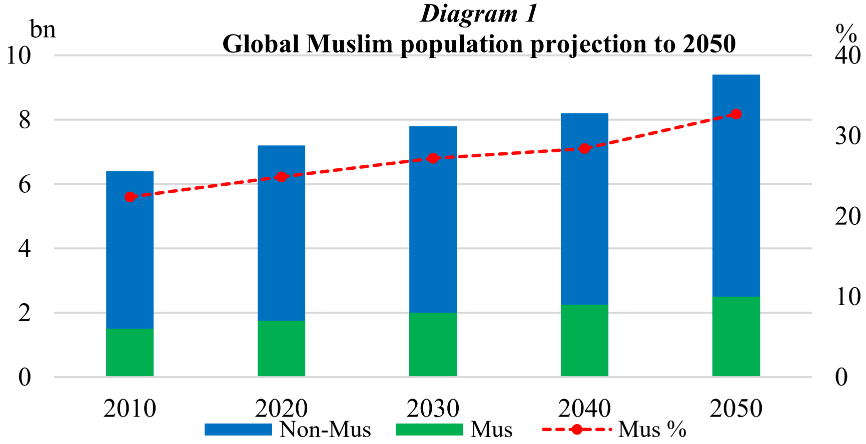
– by 2050, Christians and Muslims will make up equal shares of the world's total population structure - Muslims 2.8 billion, or just over 30% of the population, and Christians 2.9 billion, or 31%. (*See more forecasting the future*: Thani, N. N., 2018, pp. 20-21);

– if both religions continue at this rate of growth, by 2070 Islam will have a greater number of followers and worshippers.

Consequently, Muslims are projected to rise from 23% of the world’s population in 2010 to over 30% in 2050. (*See*: Diagram 1).

Diagram 1

Global Muslim population projection to 2050



Author's estimates.

It should also be noted that young Muslims aged 18-19 years will be 44%, 30-49 years 37% (total over 81%), 50-64 years 13% and over 65 years 5% of the total number of Muslims in the world. This will reflect in higher consumption of Islamic financial products and services.

2. Sustained demand for Islamic financial products.

3. Higher share of Islamic banking model.

4. New challenges for Islamic banks - intensifying competition and new competitive environment; slowdown in growth rates; declining profitability; changes in balance sheet structure (Islamic banks have higher equity levels); Islamic banking will demonstrate sustained change;

5. Change in status quo configuration for Islamic Finance Country Index, IFCI:

– the promising future of this index is in countries with large Muslim populations - Indonesia, Saudi Arabia, Malaysia and Iran;

– islamic finance industry to reach nearly US$4.0 trillion in total assets in 2021 with a 17% growth from 2020.

6. A breakthrough through Islamic financial derivatives by expanding the scope of implicit and explicit derivatives.

7. Islamic finance is developing steadily in continental Europe - the leaders in this respect are Luxembourg, the UK, Switzerland and Italy. (Dimov, S. and K. Koishibekov, 2019, pp. 32-39).

Referring to an empirical study[6] that investigated the effect of Islamic etiquette on environmental, social and governance outcomes, *the following results stand out*:

First, Islamic firms in Indonesia and Malaysia that are characterized by lower debt, lower income, and are not Shariah compliant are expected to have higher ethical standards and better contributions to the environment and society.

Second, Testing these firms reveals a significant difference in overall environmental and social performance, but not in the quality of governance.

Third, Reporting a significant effect on performance of using Islamic criteria for leverage, receivables and cash.

With this in mind, we come to the following conclusion: Islamic finance and ESG investing, are complementary sustainable capital raising systems with very common principles, standards and regulations. With many more similarities, both offer products that serve Muslim and non-Muslim investors, possess strong practices and policies from which they can learn from each other. Beyond the point, it is necessary to emphasize that Islamic finance and ESG investing are complementary approaches to raising capital and investing with many common principles, such as being a good steward to society and the environment.

Shared values between Islamic finance and ESG can be specified as follows:

– Islamic finance shares the principles of sustainable finance, for example financial stability and economic growth, poverty reduction and equitable distribution of wealth, financial and social inclusion, and environmental protection. A case in point is the steady growth of Islamic green finance.

– Islamic finance and ESG investing are complementary approaches to raising capital and investing with many shared principles, such as being a good steward of society and the environment.

– On the other hand, ESG investment strategies assess the financial value of environmental, social and governance factors, also used by Islamic financial institutions.

Consequently, Islamic finance fully or partially shares basic principles of environmental, social and governance decision standards such as sustainability, financial stability, economic growth, poverty reduction, financial and social inclusion and others.

Section B.

Referring to a research study by Deloitte & Touche (M.E.)[7], nine pillars of the Digital Islamic economy stand out:

– Halal Food.[8] There is a growing demand for healthy organic halal foods, both in the Muslim and non-Muslim world. This is driving digital opportunities across the value chain.

– Halal Travel. There is a shortage of Halal-compliant holiday amenities and services as this is a relatively new concept in Organisation of Islamic Cooperation (OIC) countries and beyond. Digital initiatives are focused on online bookings, ratings and accreditation.

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[6] Qoyum, A., M. Sakti, H. Thaker & R. AlHashfi, 2022, pp. 306-320.

[7] The Digital Islamic Services landscape, p. 20.

[8] More than 50% of the world's Muslim population lives in South Asia and the Asia-Pacific region. The number of Muslims from this region is expected to reach 1.3 billion by 2030. Potential Value for the Halal Market ($US). Total Value for Halal New Growth Clusters 274.1 bn. (The Global Halal Industry, pp.143-148; The Pew Forum on Religion, pp. 156-166).

– Islamic Art and Design (A&D). The A&D market is fragmented but growing. Online sales are expected to grow by 19%, through online galleries, online auctions and 'bricks and clicks' portals.

– Islamic Finance. OIC populated countries are emerging as high growth markets for Islamic finance but low penetration and GDP per capita. This reinforces the need to access digital services for Islamic finance.

– Islamic economic education. This vector is generally less developed. Digital service providers include conventional academic institutions, Islamic finance universities and certification centers.

– Modern Design. Current digital initiatives range from simple information portals to local and global e-commerce, talent development and networking platforms.

– Smart Mosques. Primary research among mosque users reveals a huge need for more efficient management and administration, a need for smart solutions that can include all mosque information services.

– Islamic Media. Islamic media content plays a unifying role across the Islamic world, addressing common values and catering to target demographics.

– Standards and certification. Efforts to create a single global halal standards and certifications for producers, consumers and suppliers.

It is also necessary to note that the *Islamic Fintech market* size in the OIC $49 Bn in 2020, and is projected to grow at 21% CAGR to $128 Bn by 2025.

If we take Malaysia as an example, as a leading country in the region, we will note the following phases of digital transformation:

First phase, 2021 to 2022 aims to accelerate adoption towards strengthening the digital foundation needed for the rapid and smooth rollout of Phase 2 and Phase 3.

Second phase, 2023-2025 the focus shifts to driving digital transformation and inclusion across the digital economy, emphasizing inclusivity among the rakyat[9] and all levels of businesses.

Third phase, 2026-2030 will chart the pathway for strong, sustainable growth in the decades to come, positioning Malaysia to become a regional market producer for digital products and digital solutions provider. (Malaysia Digital Economy Blueprint, 2021, p. 12).

In the aspect of implementing ESG standards, Cassey Lee focuses on Broadband infrastructure, Industry 4.0 and Digital Economy and Digital Investments Future 5 Strategy.[10] The objective is well defined - to attract foreign investment including from China and develop Malaysia's digital economy.

As an example of the link between sustainable finance and Islamic finance, we can point to the issuance of Green Sukuk in Malaysia as of April 2018: – Tadau Energy, – Quantum Solar Park (Semenanjung), – PNB Merdeka Ventures, – Sinar Kamiri and UiTM solar energy.

Using the DiGiX 2022 Multidimensional Digitization Index and Tracking Digital Evolution, we can track the evolution of the process for different countries, including the Muslim leaders Singapore, Malaysia and Indonesia, at an average value of 0.57. (Diagram 2).

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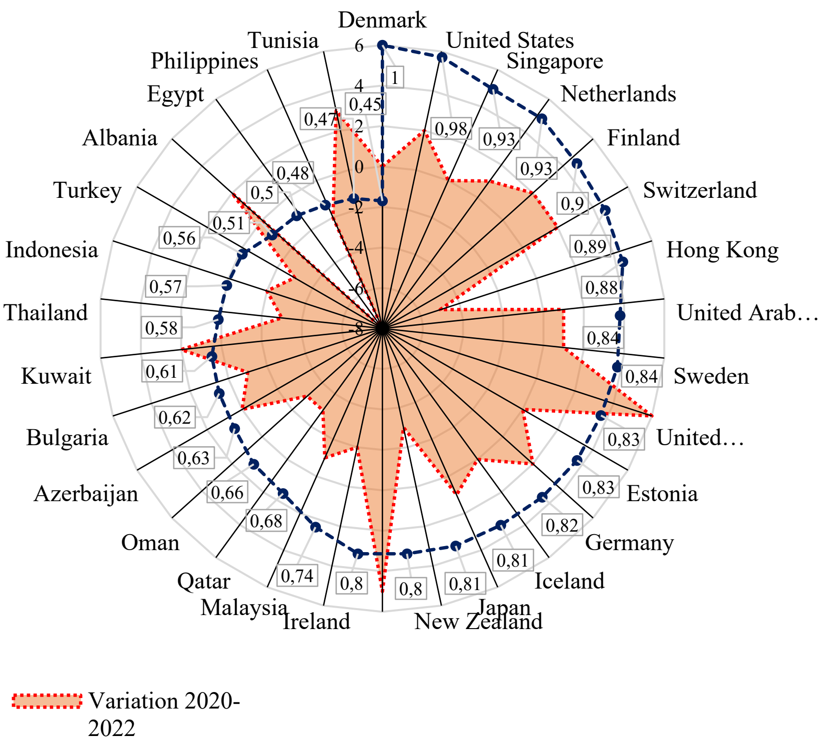
[9] iRakyat (Malaysia, Singapore, Indonesia) provides the convenience of online banking to business customers, allowing them to control finances easily in a safe and secure environment.

[10] Lee, C., 2022, pp. 7-18.

Diagram 2
Country rankings according to the Global Digitisation Index



Author's construction, database: DiGiX 2022 Update.

The radar or “spider” diagram shows some new trends:

First, The distribution of the global digital index by spins resembles Fibonacci resonance and other new discoveries of the golden section in mathematics, architecture, quasicrystals, metamaterials, etc.;

Second, Islamic countries, with the exception of Singapore and the United Arab Emirates, are in the second half of the ranking;

Third, Leading scores on the Variations 2020-2022 indicator are shown by the Russian Federation +10, South Africa +9, the United Kingdom +6, Hungary +6, while negative scores are reported for Luxembourg -11, the Philippines -8, Pakistan -5, Georgia -5 and Hong Kong -5.

Section C.

The term “global value chains” (GVCs) is relatively recent in scientific literature. Under such a chain, the American economist Michael Porter understood “the totality of various types of company activities aimed at the development, production, marketing, delivery and service of its products”. The value-added chain consists of the main and auxiliary activities - infrastructure, personnel management, information technology, logistics.

National value added contained in a country's exports includes:

– the value added in the export of intermediate and final products and services consumed by the importer;

– the value added that the importing country exports to another country; and

– the value added that the importing country re-imports to the country of origin. (Porter M. 1998, p. 592).

The Organization for Economic Co-operation and Development defines global value chains as the full range of "activities that firms engage in to bring a product or service to market, from their conceptual framework to end use. They range from design, production, marketing, logistics and distribution to end-customer support". (*See for details*: Dimov, S. et al. 2021, pp. 166-177).

In a more pragmatic aspect, global value chains divide the production process between counterparties. Firms specialize in a specific task and do not produce the entire product. More recently, there has been a shift in global value chains as they increasingly move beyond traditional manufacturing processes to services and other intangible assets. Digitization is a leading factor in this transformation, which has been accelerated by the coronavirus pandemic.

In this context, a country's exports can be divided into: value added produced in the country and imported (foreign) value added, which is included in exported goods and services.

The main source of data used to measure countries' participation in international production networks or global value chains has Conventional international trade statistics and Trade in Value-Added.

It needs to be strongly emphasized that global value chains provide access to:

– foreign research, development and productivity;

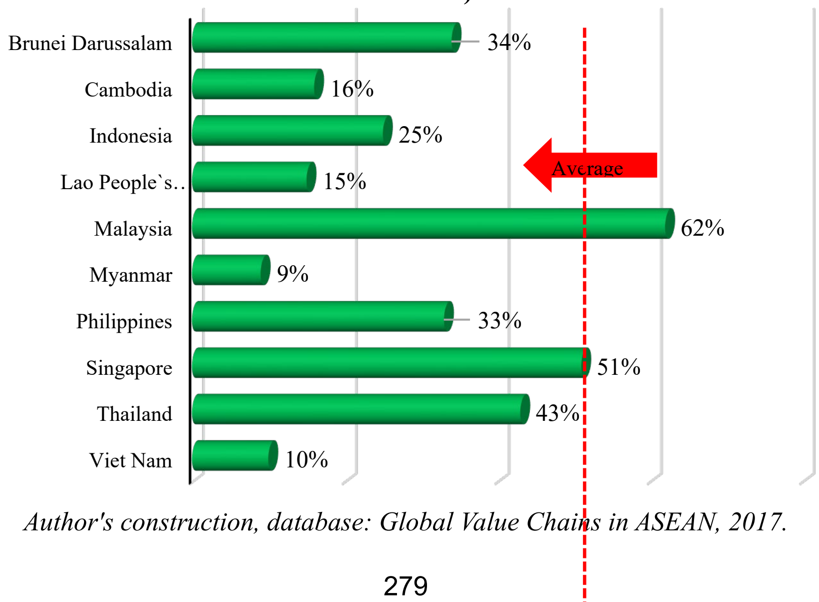
– foreign research, development and internal innovation; and

– foreign direct investment by multinational corporations.

In this commentary, we can illustrate the indicator "Domestic value added in export as a share of GDP", by means of the following diagram 3.

Diagram 3

Domestic value added in export as a share of GDP (Per cent)



Author's construction, database: Global Value Chains in ASEAN, 2017.

It is clear that Malaysia with 62% of Domestic value added in exports as a share of GDP, Singapore (51%) and Thailand (43%) are leaders because they are far above the average of 35%. All other Islamic economies are below the emerging average. Prospectively, Brunei Darussalam at 34% and the Philippines at 33% are approaching it. Lower participation in global value chains is reported for Myanmar at 9% and Viet Nam at 10%.

Conclusion

The author's research provides a solid basis for reaching the following more important conclusions:

First, Unlike the development of banking in continental Europe in the 13th century, autonomous banking in Muslim countries emerged relatively later. In fact, the establishment of Islamic financial institutions began in the presence of an existing conventional banking system. In this context, the Islamic banking market is the leading player in the Islamic finance industry. It accounts for about 83% or a total of over US$ 2.5 trillion of the Islamic socio-economic system. It is no exaggeration to say that it dictates the fashion of global Islamic development.

Second, Modern Islamic finance and banking are characteristic not only of countries whose populations profess Islam, but also of much of the conservative Western world. The ethical bridges built on shared values, the growth of the Muslim population and the wide diversification of Islamic financial products are evidence of the thesis defended. To a large extent, this is due to shared values around enhancing wealth or benefits “maslahah” and preventing harm “mafsadah”.

Third, Islamic finance industry sectors have shown high and sustained growth rates, especially in periods of global crises and pandemics. Islamic financial institutions are adaptable, demonstrate flexibility in terms of ESG investments, good environmental, social and governance performance. They are successfully participating in the new global transformations related to digitalization of socio-economic processes, value chains and building green business models.

Ultimately, Islamic finance and ESG investing are complementary approaches to capital accumulation and new investment. Thanks to shared ethical values, they offer products that serve both Muslim and non-Muslim investors, have best practices and strong policies.

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