ISLAMIC DEVELOPMENT BANK GROUP

Climate Change Financing: Role of Islamic Finance

November 2016

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1. Introduction

Islamic finance as a faith-based idea has come of age. Finance professionals view it largely as asset-based finance that is free from the elements of unjust and speculative gains[1]. It involves use of a range of tools that create debt, leases, equities and guarantees. Islamic bankers use them or combinations thereof for financing the needs of economic units, such as, the government, the corporate and the household sectors in the economy. Islamic finance has experienced steady growth over the past four decades as more and more countries and markets have come forward to experiment with this faith-based idea[2].

The frenetic pace of growth has however, raised concerns about a possible mission drift[3]. Islamic financial services providers, using debt-creating contracts have witnessed disproportionate growth, mostly addressing the needs of high-networth individuals and corporates. Most of these institutions are perceived to be similar to their conventional counterparts displaying a preference for short-term profit maximization over longer-term goals. Islamic economists are particularly concerned that Islamic finance has to contribute a lot more, towards addressing development-related issues, and societal concerns.

That the objectives of *Shariah* should drive Islamic finance is self-evident. Islamic economists invoke the framework of *Maqasid al-Shariah* (MaS) to chart a new trajectory for Islamic finance. While many classical as well as contemporary Islamic scholars have discussed and elaborated upon the *Maqasid al-Shariah* (MaS) framework, the Islamic Research and Training Institute (IRTI) has undertaken pioneering research that underlines the fact that many Sustainable Development Goals (SDGs) clearly align with *Maqasid al-Shariah* (MaS)[4]. The MaS-driven Islamic finance, therefore, would work towards achieving the SDGs.

There is a growing realization that Islamic financial institutions should align their goals with the SDGs so that they would be able to protect and promote MaS. Protection of the planet and the environment, climate management and adaptation, as organizational goals are clearly in conformity with MaS as well as with the SDGs. This paper takes the argument further and seeks to demonstrate how Islamic finance can significantly contribute to the global search for climate finance solutions.

2. Maqasid al-Shariah, SDGs and Environmental Goals

The purpose of this section is to demonstrate the convergence of SDGs in general, and the goal of climate management in particular with the MaS. Since the MaS

1. Freedom of riba and gharar are the two ethical foundations of Islamic finance that scholars define as profits made on debt and through speculation.
2. Some estimates place the aggregate size of Islamic finance market at over USD 2 trillion.
3. Abozaid Abdulazeem (2010), Contemporary Islamic Financing Modes: Between Contract Technicalities and *Shariah* Objectives, Islamic Economic Studies, Vol. 17 No. 2, January, 2010

4. Chapra, M.U. (2008) The Islamic Vision of Development in the Light of *Maqasid Al-Shariah*, Islamic Research and Training Institute, Islamic Development Bank.

should determine the trajectory of Islamic finance, the latter should be geared towards achievement of the SDGs in general and climate management goals in particular.

2.1. Shariah on Protecting the Planet

Any action with a view to protecting the planet and environment is also a step towards achieving the objective (*maqasid*) of *Shariah*. Below we briefly highlight some key Islamic norms of human behavior that underscore the above.

According to *Shariah*, human beings, as vicegerents of God, have the mission of faithfully observing the values given by their Creator. During their short life in this world, they should utilize the scarce resources of the planet as trustees. They must interact with each other in accordance with the divine rules. This would not only ensure the well-being of all humans but also, protect the environment, including animals, birds and insects[5].

This Islamic notion reinforces the scientific concept of 'chain of life,' and interdependence among species, maintaining the balance of life on earth.

> There is not an animal (that lives) on the earth, nor a being that flies on its wings, but (forms part of) communities like you. (Quran 6:38)

The planting of trees is highlighted as a significant pious deed in Islam. According to a widely known tradition, the planting of a tree is regarded as an act of continuous charity. There is another tradition, which says, if one has with him/her a sapling ready to be planted and the Day of Judgment arrives one should go ahead and plant it.

Islam forbids willful destruction of the planet as all creations of God, including animals and trees, glorify God in their own way and serve a certain purpose in His larger scheme of the world.

> Seest thou not that to Allah bow down in worship all things that are in the heavens and on earth,- the sun, the moon, the stars; the hills, the trees, the animals; and a great number among mankind? (Quran 22:18)

But waste not by excess: for Allah loves not the wasters. (Quran 6:141)

"Eat and drink, but waste not by excess; Verily He (Allah) loves not the excessive" (Qur'an:7:31)

The above verses highlights the importance of conservation and avoiding wastefulness. The same principle is underlined when a believer is required to be frugal in the use of water for ablution, an act of worship, even if s/he has a river at disposal. Water and other natural resources are thus to be seen as divine provisions.

> Corruption doth appear on land and sea because of (the evil) which men's hands have done, that He may make them taste a part of that which they have done, in order that they may return (Qur'an 30:41)

In the above verse, the Quran calls on human beings to recognize their own contribution to the crisis. A reversal in the deterioration of the planet would require some hard choices and change in practices.

God reminds humans in the Quran not to tamper with His divine balance (here referred to as 'measure') by reminding them:

5. Chapra, M.U (2008), p30

And the sky He hath uplifted; and He hath set the measure, that ye exceed not the measure, but observe the measure strictly, nor fall short thereof. (55:7-9)

There are numerous verses of the holy Quran and the traditions of the Prophet, which establish the inviolable rule to preserve and protect the environment and conserve resources. Maintaining the balance of life on the planet is a supreme duty of humans and therefore, forms part of the divine objectives of the *Shariah*.

Islamic finance aims to promote an economic concept that extends beyond being the component of a financial system, but as part of a total value-based social system. The *Shariah*, which governs the Islamic financial system, has ample injunctions which emphasize the need to care for the environment and forms of life on earth while ensuring the proper usage of natural resources.

3 Islamic Financing Instruments and Climate Finance

3.1 Islamic Financing Modes used at the Islamic Development Bank

Compared to conventional finance, Islamic finance offers a much larger range of instruments that are debt-based (e.g. qard, qard with service charge), sale-based (murabaha, muswama, bai-bithaman-ajil, salam, istisna, istijrar), leasing-based (ijara, ijara-thummal-bai), parternship-based (mudharabah, musharakah,). There are also products based on guarantee (kafala), agency (wakala), service charge (ujr) that are often combined to design composite products. Islamic green bonds or sukuk is one such composite product.

The following provides a brief snapshot of the modes of Islamic finance that are being used by IDB for development finance. This section heavily draws on Islamic Development Bank: Modes of Finance (2014)[6]. IDB plans to increase its financial support to Sustainable Development Goals realization to more than US$ 150 billion over the next 15 years .

Grant:

Grants are of two types:

Technical Assistance (TA) Grant: These grants are provided for technical assistance and capacity building activities in IDB's Member Countries, with priority given to Least Developed Member Countries (LDMCs).

Special Assistance (SA) Grant: These grants are provided for social projects (schools, hospitals etc.) for the exclusive benefit of Muslim communities in Non-Member countries. They are also provided for disaster relief in Member countries.

Subsequent to approval by IDB and its agreement with the recipient of grant, the recipient signs a contract with a supplier/contractor/consultant to procure the goods/services to whom IDB disburses directly. The supplier/contractor/supplier then delivers the goods/service to the recipient.

Loan:

Loan is a long-term concessional facility that IDB provides for financing development in its Member Countries. IDB charges a service fee to cover its administrative expenses. The different types of loans are as follows:

6. http://www.isdb.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IDB/CM/Projects/Financing%20Instruments/IDB-Modes_of_Finance_28Sep14.pdf

Ordinary Capital Resources (OCR) Loans - These loans are classified into 2 types depending on their scope of activities. The source of funds for these loans is the IDB's Ordinary Capital

Resources (as defined in Article 9 of IDB's Articles of Agreement)

- Ordinary Loans are long-term concessional loans provided for financing development and infrastructure projects.
- Technical Assistance (TA) Loans are loans with soft terms to assist Member Countries in obtaining consultancy services to conduct feasibility and other such studies for major projects.

Islamic Solidarity Fund for Development (ISFD) Loans – These are loans with soft terms mainly directed at projects and programmes that aim for poverty alleviation and micro-finance programmes in various sectors (education, health etc.) in the Member Countries, especially Least Developed Member Countries (LDMCs).

Subsequent to approval of loan by IDB and its agreement with the recipient of grant, the Borrower signs a contract with a supplier for procurement of goods/services to whom IDB disburses directly. The Borrower repays to IDB the principal loan amount plus service fee. IDB charges the service fee to cover its administrative costs. It ranges from a minimum of 0.75% to a maximum of 2.00% per annum of the principal amount. The loan product is modeled after the qard-al-hasan contract on which service charge based on actual cost is permissible and does not tantamount to riba.

Leasing

Under a basic lease contract the owner of an asset (lessor) sells a definite usufruct of the asset in exchange for a periodic definite reward (the rent). IDB operates the 'Lease-to-Own' structure on a medium to long-term basis. This product is used to provide

for fixed assets and capital equipment (movable assets in certain cases) such as machinery and equipment for projects. The Lessee acts as an agent on behalf of IDB, to procure the Asset and for the maintenance of the Asset.

Subsequent to approval of leasing arrangement, IDB appoints the Client as its Agent, to sign a contract with a Supplier to procure the Assets and supervise, monitor and take delivery of the Assets. The Client also maintains the Assets, takes care of insurance, and repairs in the name of IDB during the lease period. Then, IDB pays the price of the Assets directly to the Supplier. The Client (now the Lessee), as IDB Agent, takes delivery of the Assets from the Supplier. The Lessee pays fixed periodical rentals to IDB over the agreed lease period. At the end of the lease period, IDB transfers ownership of the Assets to the Lessee, as a gift. The calculation of the rental is based on the Capital Cost of IDB, plus a fixed or floating mark-up. In case of a floating mark-up, there is a floor and a cap and the rental of the first 6 months is known to the parties.

Istisna'a

In a basic form, istisna'a is a sale where an Asset is transacted before it comes into existence. A purchaser orders a manufacturer to manufacture a specific Asset according to the purchaser's specifications and deliver it at a pre-agreed delivery date for a pre-agreed price, which is payable either in lump sum or instalments at any time as agreed. IDB

operates Istisna'a on a medium to long-term basis, wherein IDB appoints the Purchaser (client) as its Agent who gets the Asset constructed/manufactured. When the Asset is constructed/manufactured and accepted by the Purchaser, IDB transfers the title of the Asset to the Purchaser. The Purchaser then pays the Sale price of the Asset in deferred payments. IDB uses this product to finance infrastructure projects and trade in capital goods within and among member countries. The Purchaser, as IDB's agent, ensures that until the final acceptance of the Asset, it is comprehensively insured with an acceptable Islamic insurance company and that IDB is named as a loss payee under the insurance policies.

Instalment Sale

In a basic form, instalment sale is a credit sale of an Asset, delivered on spot, in which the purchaser can pay the price of the Asset at a future date, either in lump sum or in instalments. IDB operates Instalment Sale on a medium to long-term basis. Under this arrangement, IDB purchases an Asset for its client against a promise by the latter to purchase the Asset once it is delivered. IDB appoints the Client as its Agent, to procure the Assets from the Supplier and supervise, monitor and take delivery of the Assets. The client insures the Assets in the name of IDB during the transit period. IDB pays the purchase price of the Assets directly to the supplier. The Purchaser, as IDB Agent, takes delivery of the Assets from the Supplier. Then, upon delivery, IDB sells the Assets to the Purchaser at Sale Price on deferred basis. The Purchaser pays the Sale Price to IDB in instalments. IDB uses this product to provide for assets such as equipment and machinery for developmental projects. The Instalment Sale Agreement provides for the procurement function of the client (as an Agent of IDB), the terms and conditions as well as the Sale Price, tenor of financing, etc.

Restricted Mudarabah

In its basic form a mudarabah is a profit-sharing loss-bearing contract in which one party (Rab al-maal) provides capital and the other party (Mudarib) provides expertise to manage a business enterprise. Any profit earned is shared in a pre-agreed ratio and any loss is borne solely by the capital provider (Rab al-Maal), except in case of negligence and misconduct from the Mudarib. Restricted Mudarabah is a variant of Mudarabah that is used by IDB, wherein the Mudarib (the entity) is bound by certain restrictions on the sectors/areas/projects into which it can invest the Mudarabah capital. These restrictions are agreed upon upfront in the Restricted Mudarabah Agreement (RMA), which lists the terms and conditions of the operation, the investment plan, profit-sharing ratio, duration etc. IDB uses this arrangement for investment in specific sector projects such as sustainable agriculture, renewable energy, youth employment programs etc.

Upon the maturity of the Mudarabah arrangement, the Mudarib will liquidate the assets of the Mudarabah operation. Following the liquidation by the Mudarib, IDB will receive the Mudarabah Capital plus IDB's share of Profits. If the profit is greater than what was agreed upon, the Mudarib, as an incentive, will retain the excess. The Authority and Responsibilities of Mudarib include the following:

- Conduct the relevant feasibility studies to determine the financial viability of the projects that will be invested in;

- Ensure that the financing will be used only for *Shariah*-compliant ventures;
- Invest only in those projects which will return not less than the anticipated profit as mentioned in the Agreement; and
- Submit progress reports to IDB, as and when requested.

Musharakah (Equity Participation)

In its classical form, a Musharaka is an arrangement where two or more parties agree to contribute to the capital of the partnership in equal or varying amounts to establish a new project or share in an existing one. IDB uses a variant of this under which it makes strategic long-term investments with the objective to maximize its developmental objectives. These investments are usually in the equity of *Shariah*-compliant industrial, agro-industrial projects, Islamic banks and financial institutions of its Member Countries. IDB does not acquire majority or controlling interest in the share capital of a company. Its investments do not exceed one-third of the company's capital and do not provide IDB with control or the ability to exercise any significant influence over the financial and operating policies of such companies. Investments are sold at a time when IDB considers it appropriate.

3.2 SRI and Green Islamic Funds

Socially Responsible Investment (SRI) refers to the practice of integrating environmental, social and governance criteria into financial investment decisions. Characteristics for SRI investments include longer-term investment returns and investor's attention to the wider contextual factors, including the stability and health of economic and environmental systems and societies. The social investment forum defines SRI as an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis. SRI may refer to portfolios resulting from a deliberate exclusion of

specific investments. For example 'green investing' usually refers to the exclusion of firms with environment damaging operations (like strip mining) or products (for example, hazardous chemicals) that lead to environmental pollution, or the inclusion of firms with business strategies that help the environment (for example, alternative energy). Investment choices can also be grounded on moral beliefs such as excluding companies that produce weapons, tobacco, and alcohol. The SRI approach is to 'screen' (positive screen) companies with strong environmental and management records (i.e. looking for sustainable business), instead of screening out (negative screen) investments connected to alcohol, tobacco and weapons.

A Green Islamic Fund is a mutual fund or other investment vehicle that will only invest in socially conscious companies/assets that promote environmental responsibility and at the same time are *Shariah*-compliant. Such a Fund can target socially responsible investors. Companies that address environmental and other ethical concerns are associated with higher market valuation and superior returns.

It may be noted however, that the number and volume of green investment opportunities with appropriate risk-return-profiles remain limited. Large financial intermediaries and institutional investors have already stressed that it is currently nearly impossible to avoid some allocation of their capital to brown investments due to a lack of green investment opportunities.

3.3 Green Awqaf

Green awqaf are essentially Funds that can donate the return on their investments but need to keep their capital stock intact. Consequently, on the one hand they are a source of grant financing while on the other hand, they invest their capital to generate returns for their charitable activities and are consequently a source of investment financing. Green awqaf can ensure that their assets are invested in a sustainable way.

Climate change is already happening; it can be observed in many regions of the world which impact on the economies of the countries. The consequence of extreme climatic events such as droughts and floods in developing countries pose an increasing threat to the rural and peri-urban communities and their farming activities. Green awqaf can certainly play a role in coping with humanitarian crises resulting from climate change.

Awqaf may directly engage in provision of goods and services related to mitigation and adaptation aspects of climate change. Green awqaf may be established as dedicated entities for conservation of soil, water, plants, disposal of waste etc.

Awqaf may be dedicated to research and development that induce a movement along the learning curve and a fall in clean technology prices. With an increasing deployment of clean technologies and the resulting scale and learning curve effects, many clean technologies became cost-competitive with traditional electricity sources. This increases the market potential for clean energy technologies.

Awqaf may be dedicated to increasing consumer awareness and stronger support of action to mitigate climate change. A change in consumer behavior can bring in desired changes without regulatory intervention. This will change the market for the companies, create new opportunities for green businesses but will also pose a risk on companies, which have not prepared themselves for the green transformation.

Box 1: The Green Sukuk Working Group

In an effort to facilitate the Green Bond concept, a Green Sukuk Working Group had been established in 2012 by the Climate Bonds Initiative, the Clean Energy Business Council (CEBC) of the Middle East and North Africa, and the Gulf Bond and Sukuk Association. This working group had been mandated to:

- Identify green energy projects that fall under Shariah-compliant categories for potential investors
- Design Green Sukuk architecture, so that product issuers can offer and investors can access products with confidence about their compliance with Shari'ah law and ethical standards
- Promote the concept of Green Sukuk and other green Islamic finance products to governments, investors, product originators and other interested parties
- Engage with Governments and development banks about supporting appropriate project development and the growth of a Green Sukuk market
- Inform the market by promoting best practice, convening industry forums and developing template models

3.4 Green Sukuk

'Sakk› (sukuk is the plural) signifies an instrument evidencing financial obligations. A sakk represents a proportionate beneficial ownership in an underlying pool of assets, or ‹usufruct'. Sukuk are Shari'ah compliant securities backed by a specific pool of assets. Typically, sukuk returns are linked to returns and cash flows generated by the assets purchased or created through the proceeds of the sukuk. Most sukuk to date have been asset-backed (e.g. infrastructure projects), where credit of the originator has been the decisive factor for ratings and investor analysis, in accordance with

Shari›ah principles. A ‘green sukuk’ is the *Shariah*-compliant version of a green bond and represents *Shariah*-compliant investments in renewable energy and other environmental assets. Green sukuk notably addresses the *Shariah* concerns for protecting the environment.

Green projects funded by sukuk include clean energy, mass transit, water conservation, forestry, and low-carbon technologies. These green financing initiatives also include socially responsible investments designed to improve the lives of people and communities. They are also designed to encourage investors to move capital into companies that instill high governance standards for diversity, accountability, and transparency. Eligible assets for Green Sukuk as defined by Climate Bond Standards certification include: solar parks, biogas plants, wind energy, ambitious energy efficiency and renewable transmission and infrastructure, electric vehicles and infrastructure, and light rail.

4 Conclusion

Islamic finance has substantial synergies with the Green economy concept and fits in well with the ethical requirements of green projects. As such, environmental protection and sustainability align strongly with the Islamic finance agenda that seeks to enhance the general welfare of society. Protection of the planet and the environment are clearly in conformity with the goals of the *Shariah* as well as with the SDGs. In this context, Islamic finance offers promising instruments that can provide solutions to financing climate change.

The institution of waqf can play a major role in climate finance. It can certainly play a role in coping with humanitarian crises resulting from climate change. Awqaf like foundations may directly engage in provision of goods and services related to mitigation and adaptation. Such green awqaf may be established as dedicated entities for conservation of soil, water, plants, disposal of waste etc. Awqaf may also be dedicated to research and development that induce a movement along the learning curve and a fall in clean technology prices. Awqaf may be used to increase consumer awareness and stronger support of action to mitigate climate change.

Similar to SRI Funds, the Islamic Green Funds and the Islamic Green Sukuk can provide new financial resources to support financing climate change.

The Islamic Development Bank as a pioneer in the field has been successful in using a range of Islamic products for development finance in general and climate finance in particular. New players in climate finance can benefit from the rich experience of IDB in the field.

Corporate profile of the Islamic Development Bank

Establishment

The Islamic Development Bank (IDB) is an international financial institution established pursuant to Articles of Agreement done at the city of Jeddah, Kingdom of Saudi Arabia, on 21 Rajab 1394H corresponding to 12 August 1974. The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the IDB formally began operations on 15 Shawwal 1395H (20 October 1975).

Vision

By the year 1440H, the Islamic Development Bank will have become a world-class development bank, inspired by Islamic principles, that has helped significantly transform the landscape of comprehensive human development in the Muslim world and helped restore its dignity.

Mission

To promote comprehensive human development, with a focus on the priority areas of alleviating poverty, improving health, promoting education, improving governance and prospering the people.

Membership

The IDB has 57 member countries across various regions. The prime conditions for membership are that the prospective country should be a member of the Organization of the Islamic Cooperation (OIC), that it pays the first instalment of its minimum subscription to the Capital Stock of IDB, and that it accepts any terms and conditions that may be decided upon by the Board of Governors.

Capital

At its 38th Annual Meeting, the IDB's Board of Governors approved the 5th General Capital Increase whereby the Authorized Capital was increased to ID100 billion and the Subscribed Capital (available for subscription) was increased to ID50 billion. By the same Resolution, the Board of Governors agreed to the calling in of the callable (in cash) portion of the 4th General Capital Increase. As at the end of 1436H, the subscribed capital of the IDB stood at ID49.92 billion.

Islamic Development Bank Group

The IDB Group comprises five entities: the Islamic Development Bank (IDB), the Islamic Research and Training Institute (IRTI), the Islamic Corporation for the Development of the Private Sector (ICD), the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), and the International Islamic Trade Finance Corporation (ITFC).

Head Office, Regional and Country Offices

Headquartered in Jeddah, the Kingdom of Saudi Arabia, the IDB has four regional offices in Rabat, Morocco; Kuala Lumpur, Malaysia; Almaty, Kazakhstan; and in Dakar, Senegal and Country Gateway offices in Turkey (Ankara and Istanbul), Indonesia, and Nigeria.

Financial Year

The IDB's financial year used to be the lunar Hijra Year (H). However, starting from 1 January 2016, the financial year will be Solar Hijra year starting from 11 of Capricorn, (corresponding to 1 January) and ends on the 10 of Capricorn (corresponding to 31 December of every year).

Accounting Unit

The accounting unit of the IDB is the Islamic Dinar (ID), which is equivalent to one Special Drawing Right (SDR) of the International Monetary Fund.

Language

The official language of IDB is Arabic, but English and French are also used as working languages.

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