INTEGRATING ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) INTO SHARIAH COMPLIANT FUND INVESTMENT PORTFOLIOS: LEGAL AND REGULATORY INITIATIVES IN MALAYSIA

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ABSTRACT

The Environmental, Social and Governance (ESG) investing and Shariah compliant investing generally share common objectives in that they promote social values. The ESG intiatives include a range of issues related to company activities in environmental, social relations and corporate governance aspects to promote sustainable business practices. Shariah compliant investing, which is based on the prohibition of riba, maisir and gharar, also applies negative sreening process when dealing with industries such as tobacco, alcohol, weapon as well as other non-halal products. Thus, integrating ESG elements into Shariah investing is consistent with the fundamental Shariah principles that promote equality, social justice and financial inclusion. However, there are few funds that combine the elements of ESG and Shariah compliance that are available for Malaysian retail investors in the market currently. Of more than 600 unit trust funds managed in Malaysia, only five are ESG Shariah compliant funds. On this point, the government and the regulators in Malaysia are becoming more ESG-focused and have developed the Socially Responsible Investment (SRI) Roadmap by having policies and framework that promotes ESG initiative in order to attract fund managers and investors. Thus, this paper will examine the legal and regulatory initiatives taken by the policy maker and regulator in promoting ESG initiatives. The methodology adopted in this article is a document analysis of the relevant legislations and policies.

Keywords: ESG, SRI, Shariah Compliant Investment, Legal and Regulatory, Shariah Screening

1. Introduction

Environmental, Social and Governance (ESG) components are central factors within the context of sustainability. There are numerous classifications of ESG based on categories such as climate change, environment, ethical, governance, social impact, responsible and sustainable investments, including the use of different acronyms (World Bank, 2018). ESG investing and Shariah compliant investing generally share common objectives in that they promote social values. The ESG initiatives include a range of issues related to company activities in environmental, social relations and corporate governance aspects to promote sustainable business practices. Shariah compliant investing, which is based on the prohibition of *riba, maisir and gharar*, also applies negative screening process when dealing with industries such as tobacco, alcohol, weapon as well as other non-halal products. Thus, integrating ESG elements into Shariah investing is consistent with the fundamental Shariah principles that promote equality, social justice and financial inclusion. Global trends show greater synergies between Islamic fund's investment strategies and ESG with increasing recognition of ESG principles and sustainable development goals (SDGs) by asset managers, investors and regulators. While different labels are applied and diverse issues are addressed, the different approaches undertaken by the governments and the industry players to achieve similar objectives of creating financial systems that are more equitable, sustainable and impactful on society, the environment and the economy (COMCEC, 2018). In recent years, many financial institutions and policymakers around the world have taken steps towards integrating (ESG) consideration into financial frameworks. The United Nations estimated that approximately 300 policy and regulatory measures with the objective of promoting sustainability were in place across 60 countries in 2017 compared to only around 140 in 2013 (Securities Commission & World Bank, 2018). Thus, the objective of this paper will examine the legal and regulatory initiatives taken by the policy maker and regulator in promoting ESG initiatives in Malaysia. Being a legal research, the methodology adopted in this article is a document analysis of the relevant legislations and policies.

2. Literature Review

The term ESG was first coined in 2005 in a landmark study entitled "Who cares Wins" by the UN Global Compact. ESG investing is a type of 'sustainable investing' which is an umbrella term for investment portfolios that, while seeking positive returns, also take into account and evaluate the long-term impact of business practices on society, the environment and the performance of the business itself (Al Ansari & Alanzarouti, 2020). Schroders' Environmental, Social and Governance Policy defines ESG investing to cover the range of investment activities which recognise the relationship between companies, the societies and environments in which they operate, and between companies and the shareholders which have control over them. ESG integration looks at investment decisions in a wider context than traditional financial analysis and explicitly includes analysis of a range of risks and opportunities related to ESG consideration (Schroders, 2019).

Shariah compliant investment has been considered as an integral part as of the Socially Responsible Investment SRI market (Chowdhury & Masih, 2015) . SRI applies a series of screens to select or exclude companies on the basis of their ESG performance alongside other positivist practices such as shareholder activism. Shariah compliant investment also exclude companies on the basis of ethical principles inspired by Shariah principles (Paranque & Erragragul, 2016). The integration of sustainability within a Shariah portfolio would make these improvements more purposeful and resilient. It would also formally recognise that sustainability principles are at the core of Islamic beliefs, a fact which has failed to receive the prominence it deserves among traditional Shariah investment strategies (Schroder, 2019). Integrating SRI filters into an Islamic portfolio, or vice versa, might provide complementary investment classes for retails and institutional investors. On the same note, it also could produce diversification benefits for fund managers, by reducing the non-systematic risk that stems from differences in Islamic and SRI portfolio profiles (Erragraguy & Revelli, 2015).

A number of research have been carried out to illustrate the relationship between ESG and Shariah compliant investments. An analysis of the 6,554 companies in Refinitiv's EIKON global database shows an average 5.9% higher ESG score for Shariah-compliant companies than for those that are not compliant (RFI Foundation, 2019). Research also show that Shariah portfolios score better on sustainability criteria than the broad market. For instance, DJ Islamic World scores much better than the broad market on a number of sustainability criteria (Schroder, 2019). There is a also numerous academic research supporting the view that there is a positive relationship between companies with strong ESG criteria and corporate financial performance. The most exhaustive academic study in this area, which combined the findings of around 2,200 individual studies, found that the large majority of studies demonstrated a positive relationship between ESG criteria and corporate financial performance (Friede et al, 2015).

The Islamic fund industry has, so far, not been able to capitalise on the growing global interest in sustainable investing. While interest in Shariah investing has been slow to take-off, interest in ESG investing has been accelerating with over $133 billion invested in funds in this sector. (Schroder, 2019).

3. Analysis and Discussion: Legal and Regulatory Initiatives in Malaysia

The initial development of the Islamic funds industry also marked the start of the Malaysian capital market's involvement in SRI as the Shariah principles underlying Islamic investing have significant commonalities with the principles underlying SRI. Islamic funds are also recognised as sustainable investments as Shariah principles promote the pursuit of positive social outcomes alongside commercial returns. In addition, Islamic investing is often associated with ethical practices and require the application of screening (Securities Commission, 2017).

As far as the Islamic fund industry in Malaysia is concerned, there are few funds that combine the elements of ESG and Shariah compliance that are available for Malaysian retail investors in the market currently. As at November 2020, of more than 600 unit trust funds managed in Malaysia, only five are ESG Shariah compliant funds. The funds are BIMB ESG Sukuk Fund managed by BIMB Investment Management Berhad, Public e-Islamic Sustainable Millennial Fund managed by Public Mutual Berhad, Maybank Global Sustainable Equity-I Fund managed by Maybank Asset Management Sdn Bhd, United-i Asia ESG Income Fund by UOB Asset Management (Malaysia) Berhad and RHB i-Global Sustainable Disruptors Fund by RHB Islamic International Asset Management Berhad (Securities Commission, 2021).

3.1 Legal and Regulatory Initiatives

The following section examines the legal and regulatory initiatives taken by the policy maker and regulator in promoting ESG initiatives in Malaysia:

3.1.1 Malaysian Capital Market Master plan 2 (CMP2) 2011

The development of sustainable investment for the Malaysian capital market can be traced back to the introduction of the Malaysian Capital Market Master plan 2 (CMP2) by the Securities Commissions in 2011. The CMP2 has placed greater emphasis on socially responsible financing and investments in order to encourage intermediaries and public-listed companies to give greater consideration to social and environmental issues. The CMP2 strategy is supported by the introduction of the SC's 5i strategy to facilitate sustainable investment ecosystems. The 5i was later embedded in the Sustainable and Responsible Investment Roadmap, which chart the role of the capital market in driving Malaysia's sustainable development plans from 2019 to 2023.

3.1.2 Social Responsible Investment Framework 2014

One of the earlier outcomes of the CMP2 strategies was the introduction of the SRI Sukuk framework in 2014, which is widely acknowledged as a pioneering regulatory development that formally integrates the principles of Shariah with those of SRI. The launch of the world's first green sukuk in Malaysia signified a significant milestone in product innovation under this initiative, and added another feather to Malaysia's cap, strengthening its value proposition as a centre for sustainable finance and investment. In November 2019, the Framework was revised to further harmonise the SC's requirements with internationally accepted principles and best practices. The SC has also put in place supporting measures to further attract issuers to this segment.

3.1.3 Sustainable and Responsible Investment (SRI) Sukuk Framework 2014

The SC introduced the Sustainable and Responsible Investment (SRI) Sukuk Framework (the Framework) in 2014 to facilitate the creation of an ecosystem that promotes sustainable and responsible investing for SRI investors and issuers. The introduction of the Framework is part of the SC's developmental agenda to facilitate the creation of an eco-system conducive for SRI investors and issuers and is also in line with the rising trend of green bonds and social impact bonds that have been introduced globally to facilitate and promote sustainable and responsible investing. Combined with Malaysia's leading position in the global Sukuk market, this framework is expected to further enhance Malaysia's value proposition as a centre for Islamic finance and sustainable investments in the region (Securities Commission, 2014).

The Framework which was revised in November 2019, remains a key element in riding the way forward. The Framework is drafted in accordance with international standards and best practices which emphasise the importance of transparency in respect of disclosure requirements. This Framework is intended to serve as a reference to the relevant stakeholders, which must be read together with other requirements in the Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework and Guidelines on Issuance of Corporate Bonds and Sukuk to Retail Investors, as the case may be (Securities Commission, 2019). The Framework is widely acknowledged as a pioneering regulatory development that integrates the principles of Shariah and SRI. The Islamic concept of *waqf* (endowment) is one of the eligible SRI projects under the Framework, besides green and social (Securities Commission, 2020).

3.1.4 Islamic Fund and Wealth Management Blueprint 2017

With the introduction of the Islamic Fund and Wealth Management Blueprint (IFWM Blueprint) in 2017, the SC has identified three strategic thrusts, namely, strengthening Malaysia's position as a global hub for Islamic funds, establishing the country as a regional centre for Shariah-compliant sustainable and responsible investment and developing Malaysia into an international provider of Islamic IFWM wealth management services. On this note, the third strategic thrust which aims towards establishing Malaysia as a regional centre for Shariah-compliant sustainable and responsible investment is relevant to this discussion. This strategic thrust will focus on enhancing and strengthening the SRI ecosystem which will mutually reinforce other strategies to promote Malaysia as a regional centre for sustainable investments. Many initiatives are already in place such as the establishment of dedicated SRI products, indices and funds while Malaysian institutional funds have been encouraged to further increase their participation and incorporate these philosophies in managing their assets. To this end, the IFWM Blueprint has also outlined 11 recommendations for Malaysia to achieve this desired status by 2021, which focuses on addressing impediments to growth and innovation, while identifying potential opportunities for collaboration and partnerships, as well as accelerating the process of building scale (Securities Commission, 2017).

3.1.5 Social Responsible Investment Roadmap 2019

The implementation of the SC's Sustainable and Responsible Investment Roadmap for the Malaysian Capital Market (SRI Roadmap) focused on creating a facilitative ecosystem for SRI products and investments. This included the establishment of the Malaysian Sustainable Finance Initiative (MSFI), the Centre for Sustainable Corporations and a dedicated SRI Centre within the Bond Sukuk Information Exchange (BIX).

The Grant Scheme that was set up to offset external review costs for issuers was expanded to cover all Sukuk under the SRI Sukuk Framework, as well as all bonds under the three ASEAN Bond Standards. It was accordingly renamed, the SRI Sukuk and Bond Grant Scheme. The income tax exemption for grant recipients was also extended.

In pursuant of the abovementioned initiatives, the SC has also issued the Guidelines on Sustainable and Responsible Investment Funds 2017 to facilitate the implementation of SRI in general and ESG in particular. The Guidelines is issued by the SC by virtue of section 377 of the Capital Markets and Services Act 2007 (CMSA) with the objective to set out the additional requirements to be complied with by any new or existing funds seeking to qualify as an SRI fund. Section 377 of the CMSA empowers the SC to issue such guidelines and practice notes as the it considers desirable to govern the industry. Para 3.01 of GSRIF 2017 provides that an SRI fund must be a fund that is structured as a unit trust fund, closed-end fund, wholesale fund, exchange-traded fund, real estate investment trust, venture capital or private equity fund, or any other fund structure permitted by SC and incorporates sustainability considerations. Para 3.04 further states that an SRI fund‘s policy and investment strategies, including the selection, retention and realisation of its investments, must adopt one or more sustainability considerations such as the United Nations Global Compact (UNGC) Principles, one or more of the Sustainable Development Goals (SDG) or any other environmental, social or governance factors.

In determining whether or not a fund fulfils the requirements of the Guidelines, reference must be made to SRI strategies provided under the Guidelines as shown in Table 1.1.

Table 1: SRI Strategies

Strategy	Description
Negative screening	Exclusion of companies undertaking certain business activities or practices from a portfolio based on specific environmental. Social or governance criteria including Shariah screening methodology.
Positive screening	Prioritising investment in companies or projects that demonstrate positive environmental, social or governance performance relative to industry peers.
ESG integration	Systematic assessment of quantitative and qualitative data on environmental, social and governance factors in investment analysis.
Thematic integration	Selection on investments that align with specific themes related to sustainability.
Impact or social investing	Targeted investments with intent to solve social or environmental issues, or investments towards business and projects with a clear social or environmental purpose.

3.2 Other Initiatives

Other than the abovementioned initiatives undertaken by the SC, several other initiatives are relevant to this discussion:

3.2.1 ESG Index by Bursa Malaysia

In 2014, Bursa Malaysia and FTSE introduced the first exchange- driven ESG Index in Asia, i.e. the FTSE4Good Bursa Malaysia (F4GBM) Index in 2014. This was followed by the launch of the Malaysian ESG Opportunity Fund which is an equity growth fund benchmarked against the F4GBM Index. The fund is managed by a Malaysian fund manager and caters to qualified investors. In addition, Malaysia's large institutional funds have been encouraged to allocate 5% of their respective investment assets into SRI funds to attract potential investors.

3.2.2 Malaysian Social Enterprise Blueprint 2015–2018

The Malaysian Global Innovation and Creativity Centre (MaGIC) has launched the Malaysian Social Enterprise Blueprint 2015–2018, a strategic roadmap for developing a social enterprise ecosystem which includes supporting Islamic sustainable investments. This Blueprint is three-year blueprint that entails pivotal strategy to promote and accelerate development of the sector, of which by the year 2018, supposedly be self-sustaining, equitable, and people-centric in order to empower impact-driven entrepreneurs. The blueprint highlighted several challenges and issues that need to be resolved in order to fully unleash the potential of social entrepreneurship in Malaysia (Abdul Kadir et al, 2019).

3.2.3 Social Finance Roadmap for Malaysia 2016 – 2020

The Social Finance Roadmap is introduced to provide a guideline of how best to leverage the potential of this space by building the ecosystem in an effective, inclusive and collaborative way. In relation to SRI, Section 6 of the Roadmap is focused on the concept of social finance and Islamic finance. While Islamic finance is based on the principles of fairness, equality and ethics that lead to social well-being and sustainable economic activity, social Finance has a similar rationale, broadly seeking sustainability, mission- orientation and green or ethical investment opportunities. In both instances, investors seek to achieve a strong return on their investments, besides accounting for social returns to the society and not just pure economic return. The use of Islamic finance instruments to achieve social outcomes is a mechanism that is directly applicable to the Malaysian Social Finance landscape. Malaysia has long been a global innovator in the Islamic financial industry. The domestic sector is driven by a conducive environment and is characterized by continuous product innovation, a diversity of financial institutions from across the world, a broad range of innovative Islamic investment instruments, a comprehensive financial infrastructure and adopting global regulatory and legal best practices (Social Finance Roadmap, 2016).

3.2.4 Strategy Paper on Value-Based Intermediation 2018

The Bank Negara Malaysia had published the Strategy Paper on Value-Based Intermediation (VBI) on 12 March 2018 with the objective of promoting VBI as a vision of how the Islamic finance industry should operate. The initial focus has been on Islamic banking but the planned scope is universal, including asset management. The strategies focus on adoption of relevant practices, offerings and conduct that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests. According to the strategy paper, VBI is described as an intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests. This is not a new concept in the sense that VBI shares similarities with several well-established concepts such as Environmental, Social and Corporate Governance, Ethical Finance and Sustainable, Responsible, Impact Investing, specifically on the intended outcomes (BNM, 2018).

One of the proposed underpinning thrust of VBI is good governance which, in practice has been driven primarily by regulations such compliance to relevant global standards e.g. ESG and Integrated Reporting formulated by relevant standard setting bodies (BNM, 2018). Pursuant to this strategy paper, the BNM has also issued three guidance documents to facilitate the practical adoption of VBI. First, the Implementation Guide for VBI which provides guidance on practical value-based banking practices, as reference to Islamic financial institutions that intend to embark on the Value-based Intermediation initiative. It also outlines the phases of implementation and deliberates on key implementation challenges alongside some pragmatic solutions. Second, the VBI Financing and Investment Impact Assessment Framework (VBIAF) to facilitate the implementation of an impact-based risk management system for assessing the financing and investment activities of Islamic banking institutions in line with their respective VBI commitment and third, the VBI Scorecard to provide an overview that covers purposes, key components of assessment and proposed measurement methodology (BNM, 2018).

4. Conclusion

It is submitted that encouraging legal and regulatory initiatives and the growing recognition of Islamic-ESG values by asset managers in the Islamic fund industry are giving a boost to responsible finance as a whole. The Shariah-compliant SRI fund sector is also expected to expand by virtue of the rising demand from value-based investors. This is illustrated by increasing evidence that ESG-integrated investment portfolios tend to outperform the market. In line with the government's continuous efforts to increase the number of green companies, public awareness on the similarities of Islamic finance and ESG/green finance should therefore be emphasised. This will encourage companies to be listed as both Shariah-compliant and ESG entities. Towards achieving these objectives, relevant parties would need to work together and establish relevant frameworks in line with the objective.

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