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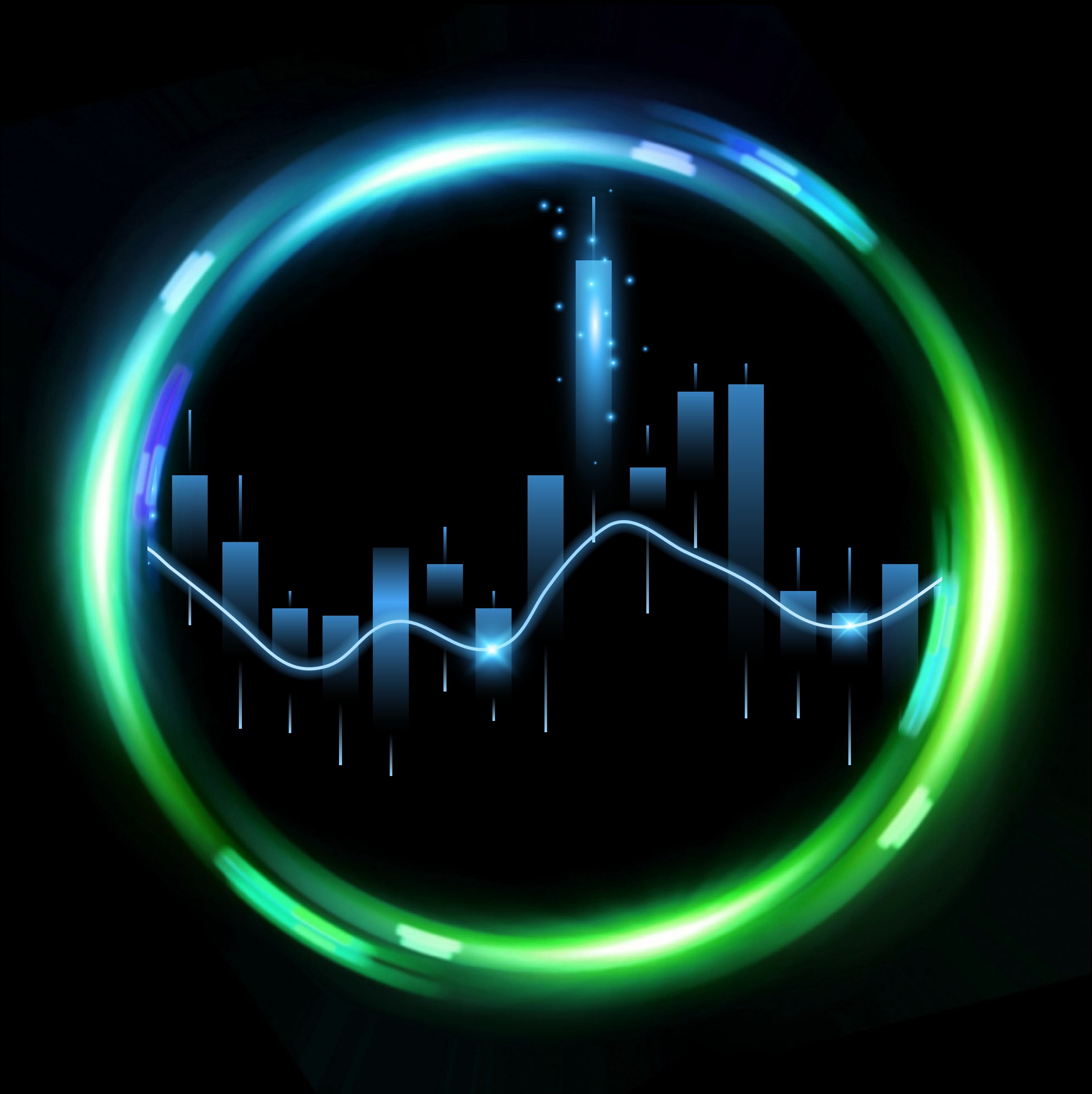

Islamic Finance as a catalyst for financing the Sustainable Development Goals (SDGs)

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Overview: The shift to sustainable practices

The United Nation (UN) estimates the damages caused by extreme weather climate change in 2021 at over US$170 billion and that an increase of at least 590% in annual climate finance is required to meet all internationally agreed climate objectives by 2030, as well as to avoid the most dangerous impacts of climate change. Addressing the transitional challenges encountered by workers, communities, and countries as the shift to a resilient, low-carbon economy takes place, is crucial. If we only focus on reducing emissions, we risk leaving communities out of the transition and creating more poverty and inequality. Replacing fossil fuels with clean energy, for example, could also disrupt labor markets, shifting jobs from one community to another and requiring some skills over others. Climate action should therefore be a part of the race to meet the Sustainable Development Goals (SDGs) in the context of just transition.

Sustainable Finance and financing Green projects

The importance of carbon credits lies in their ability to provide a financial incentive for companies and organizations to reduce their carbon emissions, in other words, financing the renewable and green projects to improve the adverse social and environmental impact of these projects. It is also widely acknowledged that the carbon credit mechanism incentivizes companies to reduce their carbon footprint and invest in more sustainable practices. In addition, carbon credits provide economic benefits to communities by creating job opportunities in nature conservation projects and renewable energy and carbon offset markets. This can spur economic development while also reducing carbon emissions.[1]
Carbon markets are trading systems in which carbon credits are sold and bought. Companies or individuals can use carbon markets to compensate for their greenhouse gas emissions by purchasing carbon credits from entities that remove or reduce greenhouse gas emissions.[2]

The World Bank reported that the share of global emissions covered by carbon taxes and emissions trading systems (ETSs) has grown from 7% to around 23% in 2023.[3] Jurisdictions continue to introduce new carbon pricing instruments, such as Indonesia's ETS, and cover new emission sources, such as aviation.

The Sustainable financing agenda

The sustainability agenda, as articulated by the 17 United Nations (UN) Sustainable Development Goals (SDGs), recognizes that businesses are an essential partner for addressing the SDGs, from contributing finances to providing products and services that address sustainability.
In line with this, global financial institutions led several business initiatives to support and align what has become a blueprint strategy for sustainable finance i.e., incorporating and achieving the SDGs. Some of the main initiatives that have emerged lately include:

- The World's largest pension funds and insurance companies representing US$2.4 trillion in AUM commit to transition their portfolios to become carbon-neutral by 2050.
- Principles for Responsible Investment (PRI), an international network of responsible investors, hits 500th asset owner signatory milestone. PRI signatories, now representing over US$90 trillion in AUM, commit to mainstream sustainable finance.

The SDGs business strategy and Islamic finance business principles (jurisprudence) are interconnected through their shared values and business objectives of addressing social impact, ethical investing, responsible and sustainable financing, and climate change, advocating sound sustainable development in our societies and economies. The following analysis considers how Islamic finance resonates the good practices of the global leading practices of implementing the SDGs, green economy financing to achieve sustainable practices.

How can Islamic Finance achieve sustainability?

The primary objective of Islamic law - which drives the business and jurisprudence principles of Islamic finance - is the realization of its benefit to mankind by preserving and protecting five fundamental objectives i.e. the Maqasid Al Shariah or Shariah objectives. These are:
- Religion (Deen),
- Life (Nafs),
- Lineage (Nasl),
- Intellect (Aql) and
- Property/wealth (Mal).

However, it is suggested that achieving these 'Maqasid Al Shariah' begins with mapping the widely accepted concept of global development framework designed by the UN's SDGs with product development in Islamic finance to ensure that product innovation is aligned to the global financing and investment practices. Moreover, achieving both the SDGs and the 'five pillars' of Maqasid Al Shariah can be better addressed and aligned if Islamic financial institutions take a lead and adopt the approach of developing products and services that address the local economy's needs; more precisely, develop its Islamic green financing solutions for sectors that will make social impact and social returns rather than the quick return commercial and trade financing sectors. For example, developing products and services to the pressing and priority sectors such as the housing, education, health-care and other social infrastructure institutions.

Table 1 on the right maps the core five Shariah objectives with the UN's SDGs. Business enterprises and governments can work more closely with specialized advisory firms to help them set their priority sectors, better understand their local markets, map their strategic business objectives and design new business models to develop their plans.

Yet again, the link between the SDGs and carbon credits lies in the fact that many carbon credit projects contribute to achieving multiple SDGs.[4] Table 2 on the right charts some of the climate actions relating to green projects such as clean energy and water and life and land goals that are supported by carbon credit projects and activities.

The green Sukuk was first introduced to the global financial market and aligned with global principles of the International Capital Market Association (ICMA)'s green bond. Evidently, this development of green Sukuk created demand for untapped Islamic financial capital to design innovative green finance instruments which represents an alternative climate financing option and reduces the financing gap for climate action.

A recent industry report highlights four core areas of alignment between SDGs and Islamic Finance.[5]
These are:
- Reducing poverty and hunger.
- Injustice and equality.
- Environment and climate change.
- Sustainable and economic development.

Table 1: Priority sectors: Maqasid al Shariah alignment to SDGs Development Goals (SDGs)

Maqasid al Shariah	**Property (Mal)**	**Intellect (Aql)**	**Life (Nafs)**	**Religion (Deen)**	**Family/ Lineage (Nasl)**
Priority sectors	**Infrastructure**	**Education**	**Housing and food security**	**Sustainable environment and energy resources**	**Healthcare**
Sustainable Development Goals (SDGs)	8 Decent Work and Economic Growth; 9 Industry, Innovation and Infrastructure; 17 Partnerships for the Goals; 11 Sustainable Cities and Communities	4 Quality Education	1 No Poverty; 2 Zero Hunger; 3 Good Health and Well-Being; 6 Clean Water and Sanitation; 10 Reduced Inequalities	7 Affordable and Clean Energy; 12 Responsible Consumption and Production; 13 Climate Action; 14 Life Below Water; 15 Life on Land; 16 Peace and Justice Strong Institutions	3 Good Health and Well-Being

Source: Deloitte Research and Analysis

Table 2: Examples of green projects and actions aligned with the SDGs

13 Climate Action	**Climate Action (SDG 13)**	• Carbon credits directly support SDG 13 by reducing GHG emissions. By investing in carbon credit projects, organizations or individuals can offset their own emissions and contribute to global efforts to combat climate change.
7 Affordable and Clean Energy	**Affordable and Clean Energy (SDG 7)**	• Many carbon credit projects focus on renewable energy generation, such as wind, solar, or hydroelectric power. These projects help increase access to clean and affordable energy, thereby contributing to SDG 7.
11 Sustainable Cities and Communities	**Sustainable Cities and Communities (SDG 11)**	• Carbon credits can support SDG 11 by promoting sustainable urban development. Projects that improve energy efficiency in buildings, develop public transportation systems, or encourage waste management and recycling initiatives in cities can generate carbon credits.
15 Life on Land	**Life on Land (SDG 15)**	• Carbon credit projects related to afforestation, reforestation, or sustainable forest management contribute to SDG 15. These projects help protect and restore forests, conserve biodiversity, and enhance ecosystem services.
6 Clean Water and Sanitation	**Clean Water and Sanitation (SDG 6)**	• Some carbon credit projects focus on improving water and wastewater management, leading to reduced water pollution and improved access to clean water. These initiatives align with SDG 6.

Source: Deloitte Insights and other public research

Carbon Credit Market and Islamic Financial Markets (The Organization of Islamic Cooperation Countries)

Generally, there is limited or no mainstream Islamic financial services industry (IFSI) product that has been developed for carbon emissions trading, and the purchasing of carbon credits from other nations (under Article 6 of the Paris Agreement) or other IFSI institutions is likely to be challenging.

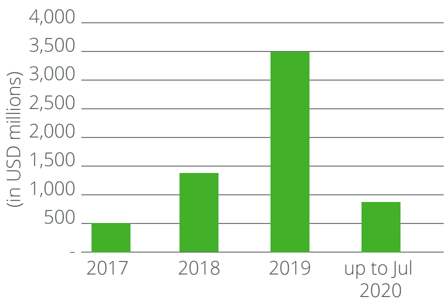
However, the Regional Voluntary Carbon Market Company (RVCM) and The International Islamic Trade Finance Corporation (ITFC), member of the Islamic Development Bank (IsDB) Group, announced a partnership which will utilize Islamic finance to combat climate change. This partnership will open doors for promoting the Voluntary Carbon Market in the Organization of Islamic Cooperation (OIC) member states and providing advisory and financing services to businesses aiming to offset their carbon footprint or seeking to generate Carbon Credits from their activities.

To facilitate these joint efforts, a Shariah resolution was obtained from the IsDB Group Shariah Board on trading Carbon Credit, which marks a significant moment in the global drive to address climate change by allowing carbon credits as a traded "Rights to Intangible Assets" enabling Islamic Financing. This in turn will spur faster action by paying project developers for their climate-positive action today rather than in the future.[7] Nevertheless, a juristic complexity remains unresolved yet, which is the issue of how carbon emissions - which are considered to be harmful to the planet - can be accepted and qualify for valuation for commercial transaction and be licitly traded in the Shariah.[8]

The Growth of Green Islamic Financing and link to SDGs

Industry reports acknowledge how Islamic finance resonates the principles of SDGs, and global good governance practices such as ESG, Socially Responsible Investment (SRI), Principles of Responsible Investment (PRIs) and other industry good investment standards.

In this respect, the recent growth and success of green Sukuk issuances which was estimated at US$6.1 in 2020 stands out as an inspiration factor for developing 'green Sukuk' to bridge financing gaps for Small and Medium Enterprises (SMEs).



Source: World Bank (2020) "Pioneering the Green Sukuk: Three Years On" (October), World Bank, Washington, DC.017

Figure 1: Green Sukuk Issuance (2017 – July 2020)

Building the ecosystem and infrastructure of green Islamic financial markets is vital to boost the financing of product innovation and harness a vibrant sustainable and green economy in the OIC markets. Clearly, there are a number of considerations and challenges that need to be addressed and prioritized.

More precisely, there are a number of factors and market demand changes in economies which have all supported the growth of clean energy in many countries around the world. Some of these considerations include:

- Global investors are very keen to invest ethically and any effort to develop the green Islamic finance asset classes should begin with combining a social value objective with a commercial and responsibly sustainable approach when developing its products and services.
- Business enterprises, especially smaller and medium enterprises in the OIC markets are constantly in need of capital to expand their business and operational investment and adapt new technologies. This creates a market demand for creates a market demand for DEVELOPING BESPOKE SME GREEN FINANCING SOLUTIONS SUCH AS GREEN SUKUK.
- The green and sustainable economy business procedures and processes could trigger the use of more advanced technology and thus increase operational expenses and costs. Institutions offering Islamic Financial Services (IIFSs) will have a great opportunity to finance the emerging greener and sustainable economy business requirements.
- Classic finance and bank loans nowadays are strict and scarce and international regulators such as Basel III-IV have more restrictive regulations which impacted financing which impacted financing important sectors such as SMEs. such as the SMEs' business.

Building the ecosystem and infrastructure of green Islamic financial markets is vital to boost the financing of product innovation and harness a vibrant sustainable and green economy in the OIC markets.

Net Zero strategy using Sukuk

The main Sukuk markets in Asia and the Middle East will greatly benefit from the development of carbon credit Sukuk and contribute to Net Zero targets and climate change strategies in respective regions. Moreover, there is currently a financing shortfall for Islamic carbon credits financing solutions. To lift the market off the ground, the Islamic financial institutions and asset managers should develop the Islamic financial instruments necessary to structure the carbon market.[9]

Below is a proposed Sukuk structure, illustrating the main participants of carbon credit sukuk issuance, trading and investors. The structure is based on 'Commodity Murabaha' where the 'project developer' is a green project that supports the SDG 13: Climate Action.

Transaction highlights:

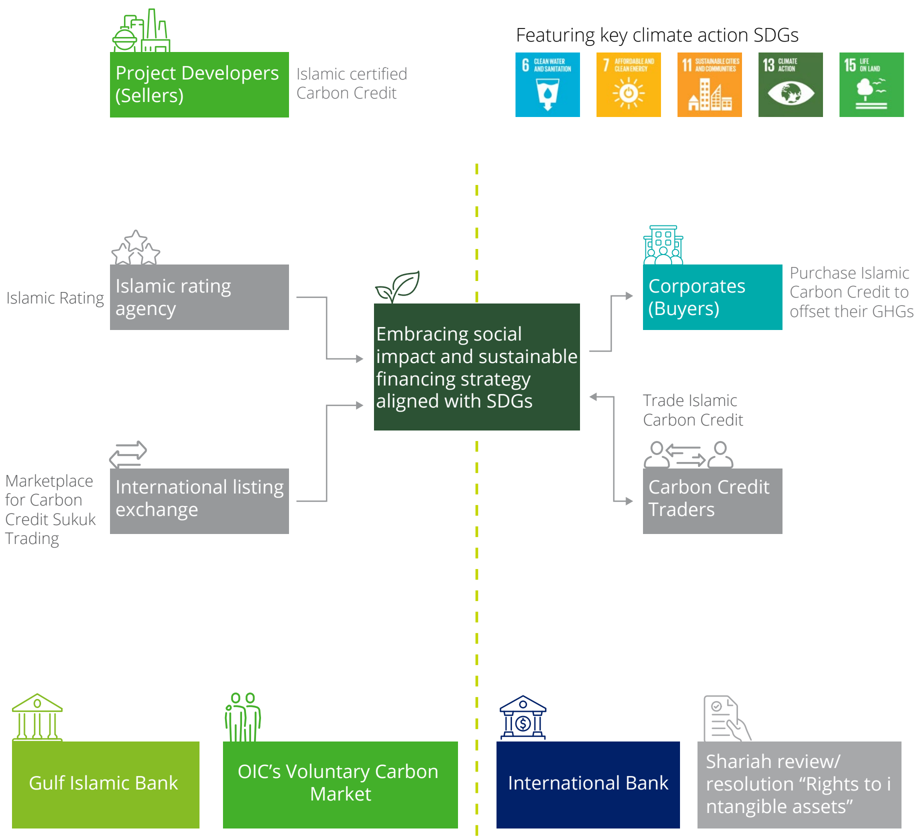
- Project assets: The project asset type should be supporting the green and climate change guidelines and be aligned to SDG 13 and contribute to global efforts to combat climate change.
- Some of the clean energy projects help increase access to clean and affordable energy, thereby contributing to SDG 7. Other urban development projects such as energy efficiency in buildings, developing public transportation systems, or encouraging waste management and recycling initiatives in cities can generate carbon credits and supports SDG 11, as well as water waste treatment contribute to SDG 6.
- Credit Carbon Sukuk Ltd: A Special Purpose Vehicle (SPV) will be set up to act as trustee of the Sukuk holders, also known as investors.
- The Carbon Credit Sukuk holders subscribe for the Sukuk and pay the proceeds to the SPV Issuer, generally a government or private sector (Project Developers). The SPV declares a trust over such proceeds and the 'project assets' acquired with such proceeds in favor of the Sukuk holders.
- The SPV Issuer uses the proceeds of the Sukuk to purchase commodities from the Commodity Supplier on a spot basis.
- The SPV Issuer immediately sells these commodities on a Murabaha basis to the Carbon Credit Purchaser (corporates or individuals, aimed to offset their GHGs).
- The deferred price/payment is made up of the cost of the commodity plus a profit amount.

Carbon Credit Sukuk details

Issuer(s)	• Government or private sector projects
Investor(s)	• Invest Carbon Limited
SPV name	• Credit Carbon Sukuk Ltd
Issue size	• US$ 100 million
Tenor	• 7 years
Structure	• Commodity Murabaha
Proceed	• Investing in carbon projects
Rating	• Islamic rating methodology that addresses Shariah as well as commercial elements
Listing	• Listing and tarding (subject to shariah) in key Carbon Exchange
Advisor	• Corporate Financing and Investment advisors

Proposed Murabaha Sukuk Structure

The key participants of a Carbon Credit Sukuk:



Key takeaways and conclusion

The previous analysis shows that there is growing emphasis among the OIC marketplace for green energy projects, and that legislative backing and policy support have been in placed in many member countries. This trend has been strengthened by the policy support from regulatory and industry standard setters and the Islamic Development Bank. Likewise, there is also significant Islamic carbon credit initiatives and policy support within the OIC marketplace, all of which emphasize developing a voluntary carbon market, Shariah consultations and trading guidelines for project developers and corporates to streamline processes and strategies to achieve their Net Zero Targets and maintain greener economies in many parts of the member countries. Governments in the OIC marketplace have also set clear climate change strategies and provided environmental policy support and climate change financing plans to achieve the UN's SDGs and its action plans (e.g. SDG 13).

However, to develop an efficient carbon credit sukuk market, the OIC's member countries and key Islamic finance industry players will need to align efforts and collaborative practice initiatives to ensure growth and sustainability of these green projects and tradability of carbon credit Sukuk.

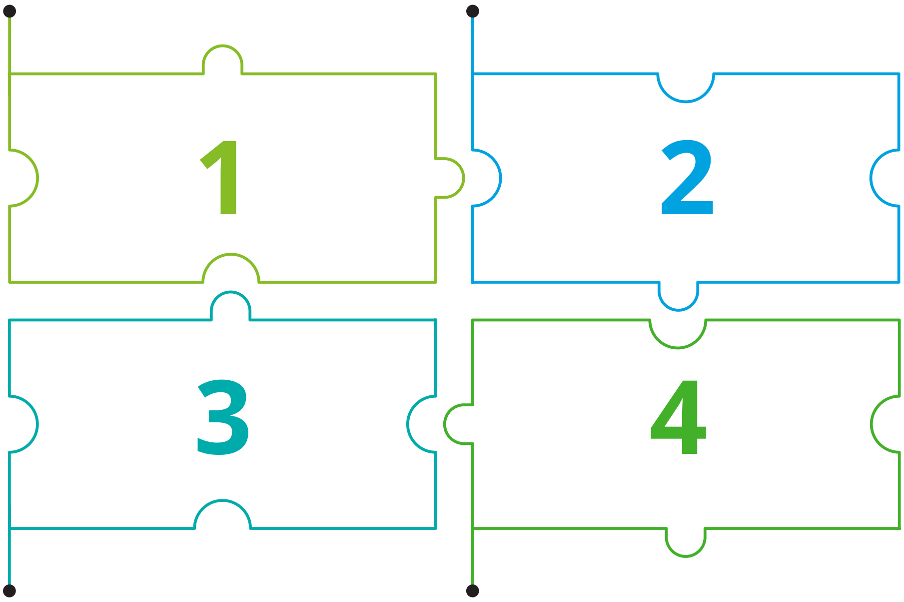
Four main areas of practice have been identified to stimulate practice and policy development including Shariah governance issues and consultations:

Shariah governance

- Shariah consultation and consensus over jurist issues need be resolved and agreed to provide confidence and acceptability relating to commercial valuation and carbon tradability acceptance.
- This includes tradability in Exchanges, transaction structures and Shariah Audit process. etc.

Regulatory and policy

- Government policy support will be required for building the carbon credit ecosystems to help facilitate the carbon capturing mechanism.
- Industry Standards Setting Bodies (ISSB's) such as the IIFM and AAOIFI need to provide transparency and reporting guidance.



Technology

- The use of technology driven processes will help improve efficiency and boost market growth of carbon credit business valuation and tradability.
- Carbon pricing mechanism and tax incentives strategies.

Corporate developers and investors

- Issuers: Governments/corporation's renewable energy projects
- The project asset type should be supporting the green and climate change and be aligned to SDG 13.
- Investors:
- Can be corporates or individuals who buy the Islamic carbon credit sukuk to offset their GHGs.

The OIC member countries need to establish an efficient Islamic carbon credit market and use Credit Carbon Sukuk. Several legislative backing, policy and practice support need to be developed, which include the following (non-exhaustive list):

- Firstly, there is a need to develop the newly established Regional Voluntary Carbon Market Company (RVCM) and design industry policies and standards to become a fully-fledged credit carbon market.
- OIC governments need to develop the ecosystem for the Islamic carbon market and provide industry support to industry participants and main players. Several initiatives are emerging and need be streamlined with global good practices and climate change regulatory developments.
- The need for policy alignment relating to SDGs strategy and climate change strategy including carbon credit regulations and market development. This is key for achieving targets set by the OIC member countries.
- Both governments and private sector corporations will need to build a professional approach to set their SDGs strategies and design the right plans to implement them. Key to this is working with a professional business and advisory partner to assess, design and implement their SDGs roadmap and implement this in their local community and markets.
- The need to create more awareness and education industry workshops among key industry players in finance, investment, energy, environment, and other relevant stakeholders to boost the market for Sukuk.

The growth of Carbon Credit Sukuk will boost green Islamic funding strategies to provide sustainable financing for green energy projects in many countries of the OIC marketplace, in particular the Middle East, and will similarly enhance climate change policies in the region and provide green and renewable energy power projects. Equally, this new asset class will attract a new pool of international investors who prefer to invest in sustainable and ethical investment assets.

Developing new innovative green Islamic financing products and services – levering the digital disruptions will harness a stronger integration of Islamic finance to the global financial markets and attract wider spectrum of international investors and widen its global reach to other societies and economies beyond the OIC markets.

The OIC member countries need to establish an efficient Islamic carbon credit market and use Credit Carbon Sukuk.

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Endnotes

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