ESG FINANCE AND ISLAMIC FINANCE

Date: 13 September 2022

Finance Alert

By: Jonathan Lawrence

This note was originally published on Practical Law. It looks at how Islamic finance is adopting environmental, social, and governance (ESG) standards to produce hybrid Sharia-compliant ESG products. In particular it sets out the key features of green sukuk.

SCOPE OF THIS NOTE

Financial institutions have become increasingly interested in the environmental and social impact of their investment and business practices, and Islamic—or Sharia—compliant compliant investors, banks, and corporations are no exception. ESG and sustainability-linked finance has become one of the fastest-growing sectors. Similarly, we have also witnessed the huge growth of Islamic-compliant finance that has directed trillions of dollars toward investment projects and financings under the purview of Islamic principles.

This note looks at how Sharia-compliant finance transactions can be combined with ESG principles to create green, social, and sustainability-linked Islamic finance instruments and considers the particular issues that might arise when combining these two different, if overlapping, regimes. It explores the basic outline of each type of finance and looks for the similarities and disparities between them.

SHARIA-COMPLIANT ESG FINANCE

Islamic finance and ESG finance are based on the core principles of ethics and morality; therefore, one may expect that there is a significant overlap between the financial instruments provided through each form of financing. Certainly, there are similarities.

Islamic law does not have an exhaustive list for what finance is and is not Sharia compliant. However, there are a number of principles that will guide a prospective investor seeking to comply with Islamic principles.

These include:

Riba

Under Islamic law, interest-backed transactions are prohibited as the risk and the reward of any transaction must be shared between the parties, rather than there being a disparity.

Maisir

All forms of speculation or gambling are prohibited under the tenets of Sharia law. Therefore, financial institutions cannot be involved in transactions where the ownership of the good depends on an uncertain event in the future.

Gharar

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Islamic finance bans the participation in contracts that include excessive risks or uncertainty. Therefore, short selling and other derivative transactions are forbidden.

Profit or Loss Sharing

When parties enter into contracts, the profits, losses, and risks that are associated with the transaction are shared, meaning neither party can take all the upside or downside of a transaction.

Societal Benefit

Investment should also have a social and an ethical benefit to wider society beyond pure return. However, this principle has (in the view of some commentators) been diminished over recent years as the overall impact of, for example, a construction project on the workers or the environment has not been adequately considered in some otherwise Sharia-compliant deals.

Material Finality

This means that there must be an underlying tangibility in the transaction.

Many of these ethical and religious constraints, in particular the emphasis on risk sharing; the prohibition of speculation, gambling, and excessive risk; and the requirement that there should be societal benefit, make it easier for Sharia-compliant transactions to fit easily within the social and sustainability aspects of ESG.

The strict use-of-proceeds disclosures and their external regulation by boards of Islamic law scholars means the rules governing Sharia-compliant transactions are stringent enough to ensure that they do not claim to be something they are not. However, there are ways in which they differ due to their structure and requirements. For a potential investor that seeks ESG compliance combined with financing conforming to Islamic principles, the green sukuk are the only model of such financing that has so far gained traction.

Islamic finance has developed a practice of negative screening, ruling out certain sectors, industries, or financing structures. ESG finance has adopted a more positive screening framework, through which improvements in ESG performance are a key goal of the structures.

As practiced in an Islamic finance transaction, ESG transactions will employ the aid of external experts to judge the compliance of a proposed transaction, as maintaining oversight is a crucial element to the governance side of any ESG transaction. This element of governance is easily achieved through Islamic finance as good governance has been placed as a key element to any transaction to ensure that all principles are upheld. Islamic financial institutions have achieved this using Sharia advisers and scholars who will sit and advise with as much weight as the executive board when it comes to decision making. This can be used as an easy blueprint for adaption to ESG as the employment of ESG advisers and the creation of oversight committees that can scrutinize and oversee all transactions will ensure that the principles of ESG are followed. One may argue that Sharia boards have traditionally been involved at the instigation of a transaction rather than taking an ongoing role. In those cases, there would need to be a change of approach to involve the scholars in a continuing oversight role.

On the other hand, Islamic finance and ESG requirements, while similar, present two different sets of rules for a transaction to follow. Islamic finance will ensure that the Sharia principles are complied with, which certainly contribute to a good overall ESG standing. Nevertheless, ESG rules will push further in the societal benefit for a transaction because while Islamic finance says any transaction must come with societal benefit, ESG says where,

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by when, and how this benefit must be achieved. Some Islamic scholars will also require training on ESG finance standards in order to be able to sign off on their achievement.

The rules of ESG finance and Sharia principles lend themselves to the now stylized green sukuk financing. This is a combination of the traditional Islamic sukuk financing with the green requirements of green project finance. This form of finance allows the parties to pre-define all aspects of the transaction, ensuring certainty and allowing the avoidance of Riba, while also allowing the full scope of the project to be understood and therefore allowing itself to be properly analyzed in the style of ESG rules.

The Gulf States like Saudi Arabia and the United Arab Emirates (UAE) have announced ambitious plans to boost their clean energy production over the next decade. These projects will require vast sums of finance and the green sukuk may well provide the best avenue for these projects to be undertaken. As the world looks towards COP 27 in Egypt and COP 28 in the UAE for the next set of global solutions to the climate crisis, the spotlight will be on the Middle East and the wider Islamic world. The green sukuk and the intersection between Islamic finance and ESG may provide the very thing needed to move this region to the forefront of global sustainable investment.

To date, the green sukuk have been the dominant financing structures that have sought to combine Sharia and ESG principles.

GREEN SUKUK

Generally, green sukuk comply with the same green principles as green bonds. They are issued in a similar manner as a non-green sukuk but with the following additional elements:

Green Framework

Green frameworks typically align to recognized standards, such as the Green Bond Principles issued by the International Capital Market Association and include four components: use of proceeds, process for project evaluation and selection, management of proceeds, and reporting.

Second Opinion

An independent review of the green framework of the proposed green sukuk issuance is typically required. This is to confirm alignment with the components of the relevant standards. This can either be given by the Sharia board or another board comprised of ESG experts.

Impact report

Reporting on the progress of underlying projects and assets is seen as a key element.

The issuance of green sukuk that have taken place have been underpinned by existing global standards and aligned with a framework established or adopted by the issuer. These include the Sustainable Finance Framework introduced by the Islamic Development Bank (IsDB), the first AAA-rated institution to issue green sukuk. These additional requirements sit on top of those involved with issuing sukuk. While additional requirements do have cost implications, the market demand for green sukuk indicates there is a material market for such instruments.

The Sustainable Finance Framework contains a commitment to the United Nations Sustainable Development Goals (SDGs) and the IsDB states that it strives to incorporate ESG criteria in its investment process.

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With debut green sukuk and sustainability sukuk issuances in 2019 and 2020 respectively, the IsDB has been involved in the evolution of the Islamic capital markets, enhancing the profile of sukuk as financial instruments that can contribute to a sustainable recovery from the COVID-19 pandemic. This was exemplified by the IsDB Sustainability Sukuk. The proceeds were exclusively deployed towards IsDB projects under "SDG-3: Good Health and Well-Being" and "SDG-8: Decent Work and Economic Growth."

Further development of green sukuk may require dedicated Islamic-compliant ESG guidelines and risk management frameworks. An example in the conventional markets is the Equator Principles. These principles form a risk management framework adopted by financial institutions for determining, assessing, and managing environmental and social risk in projects.

The climate change challenge and the growth of the Islamic finance industry, together with the increase in socially responsible investing, could position green sukuk as a key instrument for financing clean energy and resilient infrastructure projects as well as shorter-term energy efficiency projects. Expansion of a green sukuk market could promote environment-friendly projects and help Islamic finance achieve its moral objectives.

SHARIA-COMPLIANT ESG PROJECT FINANCE MORE GENERALLY

Islamic-compliant structures, other than sukuk, can be used for project financing. There is not currently much evidence of these other techniques being used without a green sukuk wrapper in an explicitly ESG context (for example, to fund environmentally conscious energy projects, or social housing or development projects). However, they may well be happening without the ESG badge being explicitly applied to them. Islamic finance has a history of combining with conventional finance techniques to fund projects. There is no reason why such combinations with ESG principles and techniques should not evolve and succeed.

KEY CONTACTS



JONATHAN LAWRENCE
PARTNER & ASSISTANT GENERAL COUNSEL

LONDON
+44.20.7360.8242
JONATHAN.LAWRENCE@KLGATES.COM

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