



Islamic Finance and ESG in the UK: An Opportunity For The Taking

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Islamic finance remains a relatively niche area of finance in the UK market. Its growth has been reasonably temperate since the 2000s. However, the pressing need to move towards a more sustainable world has seen ESG initiatives come to the forefront of the corporate agenda. We can scarcely get through a week without some new legislative change, government guidance, or environmental catastrophe. This sobering landscape may be the catalyst for Islamic finance to address these challenges.

Islamic finance has key principles that align with current ESG trends and may facilitate the implementation of ESG in the UK finance market. These principles are based on Sharia law and dictate what type of investments financiers can fund and how they can generate income. We have set out three key ESG-related trends (concerns of greenwashing, sustainable assets, and sustainable projects) that are prevalent in the UK, as well as how three principles of Islamic finance (ethical investments, sharing, and managing risk and surety) can help complement them.



Greenwashing and Ethical Investments

Greenwashing is an increasing global concern and the UK is no exception. Corporate bodies are understandably trying to build goodwill with customers by demonstrating their contributions towards a greener future. However, in an area combining technical complexity with high levels of public concern, it is easy for businesses to mislead the public, whether by exaggerating their environmental performance or by outright false claims.

Regulation and guidance emphasise that environmental claims must not just be true, clear and supported by evidence, but must take into account the full life cycle of a product or service – so advertisers must not overemphasise small green improvements if a product as a whole is environmentally damaging. The Advertising Standards Authority (ASA) has become increasingly strict on what were previously common statements in recent months, upholding a number of complaints in relation to claims that were, in themselves, true and accurate, because the advertisers were major polluters, and the claims exaggerated the advertisers' environmental commitments. The ASA's view is that major polluters must disclose the environmental harm they do whenever they make a green claim, for example with words such as "we know we have a long way to go..."

One of the difficulties for businesses in implementing ESG is that they do not “live their values”, meaning that their day-to-day activities do not live up to their high-level green ambitions. Regulators such as the ASA and the Competition and Markets Authority expect advertisers to demonstrate a serious, ongoing, funded commitment to environmental improvements before they make forward-looking claims such as “working towards net zero”. If principles are fed into the business from the top down, this can result in a mis-matched and sometimes contradictory approach. Boardroom statements and environmental publicity campaigns must be matched with a robust, detailed process making sure that all claims can be properly substantiated.

Practical steps are required to ensure compliance. Under Sharia law, all finance must be ethical. This means it must be for the benefit of society and have an ethical purpose. One of the ways Islamic finance deals with this requirement is by having various regulatory bodies, such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Finance Services Board (IFSB), which provide standards on ethical investments. Each transaction must be approved by a Sharia committee to ensure that the transaction is compliant. If it is compliant, the committee will issue a pronouncement or opinion. Transactions that do not have this sign-off cannot go ahead.

Whilst these committees are not currently reviewing ESG compliance, the structure of these boards gives them advantages. By having values built in at a transactional level, Islamic finance already has significant experience factoring in complex and potentially contradictory aims. In the context of greenwashing, this makes contradictions within the business far less likely. The ethical standards within Islamic finance are not only limited to Islamic projects. The Church of England’s faith-aligned impact investment capital has set aside funds to be used for restitution through community projects for the church’s role in slavery rather than to maximise financial returns. The majority of the capital in this fund is held by sovereign-backed Islamic finance funds and another large portion represents private funds devoted to Islamic capital.



Sustainable Assets and Managing Risk

The UK real estate sector is undergoing major transformation, notably the increasing responsibility of portfolio owners for matters of building safety, which could be extended to ESG considerations in the medium term. The Building Safety Act was introduced in 2022 as a response to the tragic Grenfell disaster. The sad incident highlighted major shortfalls in the way fire safety has been implemented, during both the building’s development stage and its maintenance post-development, and who bears ultimate responsibility for rectifying it.

While the BSA 2022 is currently limited to fire safety, it changed existing legislation, and its structure allows the Government to introduce new types of risk into the requirements, meaning that ESG-related risks (such as pollution and sustainability) could be introduced. The BSA 2022 has sweeping requirements for the construction and ongoing monitoring of buildings. This shift is changing the role of developers and property owners to actively rectify and monitor issues. It is also changing the way in which property companies choose their investments, as the risk is spread further into the medium to long term.

The UK commercial real estate market is facing a period of downturn, in part due to high interest rates. Under Sharia law, charging interest (making money from money) is considered exploitation of the customer which is strictly forbidden. Neither party should be unfairly exploited by the other. Islamic banks instead make profit from the returns of a successful investment. As returns are not assured, financiers invest in ventures they

believe will be successful. This exposes them to higher commercial risk than under conventional finance and desire for a successful outcome is shared between the parties.

Over the years, key Islamic banks have closed deals providing structured financing for various UK real estate projects, despite the downturn in the UK economy. Given the potential of Islamic finance, it will be interesting to see if this form of financing is better equipped to deal with the legislative changes to the real estate sector, such as those brought in by the BSA 2022.

Sharia principles can also impact what assets an Islamic bank can take security over. This can lead to a smaller set of assets over which to take security when compared to conventional finance. In these circumstances, Islamic banks have to assess financings more carefully to ensure their long-term viability. In today's world, this increasingly means complying with ESG.



Sustainable Projects and Surety

In March this year, the UK Government published its 2023 Green Finance Strategy, setting out plans for the UK to become the first net zero-aligned financial centre, putting in place a framework to assess the implication of adopting the International Sustainability Standards Board standards in the UK (the first two standards being published by the ISSB in June). Measures were proposed to, amongst others, enable the market to align with UK climate and environmental goals, and pushing investment focus into sustainable projects.

One analysis of Islamic finance is that it is overly reliant on real estate investment. This could be due to the surety this type of investment provides. It is forbidden under Sharia law to engage in speculation or gambling, as the onus is on commercial efforts to produce a return. There is room for commercial risk-taking, however, the prohibition of speculation still renders many transactions unsuitable for Sharia-compliant investors.

On this basis, Islamic finance has seemingly struggled to expand out from real estate investment. However, there are signs it is now starting to do so. In 2022, the International Islamic Trade Finance Corporation participated in Saudi Arabia's Public Investment Fund's largest carbon credit sale, which resulted in the sale of £1.4 million tons of carbon credits and has plans to launch carbon offsetting offerings before the end of 2023. Whilst this is not in the UK, it highlights the growing focus on other types of investment opportunities, particularly in the ESG sector. This year saw, in the UK, the redemption of a \$750 million AT1 perpetual sukuk, a Sharia compliant bond-like instrument, issued and listed on the London Stock Exchange in 2018, and another \$750 million AT1 perpetual sukuk was issued and listed a few months ago.

The planned UK Green Taxonomy could help facilitate Islamic finance's diversification out of real estate. The Taxonomy will provide a common framework for investments that can be defined as environmentally sustainable. Furthermore, the UK Sustainability Disclosure Requirements regime promotes consistent disclosures throughout a business' value chain. These schemes, amongst others, may offer levels of surety that could help address any speculation concerns.



The Way Forward

With the drive towards sustainability and Net Zero becoming increasingly urgent, Islamic finance's attitude to ethics, sharing risk, and long-term focus on project viability can offer examples of what a sustainable model for the entire finance industry could look like. However, to do so, it will need to demonstrate how it can adopt a wider range of investments in the UK. Hopefully, upcoming regulations on investments will encourage Islamic banks to broaden their portfolios.

Lest we forget, COP 28 will take place in the UAE later this year. This is an amazing opportunity for Islamic finance to showcase itself as a leader in the ESG space.



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