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SOCIALLY RESPONSIBLE INVESTMENT AND SHARIAH-COMPLIANT INVESTMENT: AN ASSESSMENT OF CURRENT SCREENING NORMS

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Abstract

Socially responsible investment (SRI) and Islamic finance are religious-based investments that are committed to the concepts of 'do good' and 'avoid harm'. Although Islamic finance must abide by the Maqasid-Shariah (objectives of Islamic law), which also covers environmental, social, and governance (ESG) sectors, scholarly debate has emerged regarding less consideration of Islamic finance engagement in such sectors. Premise on this issue, this study analyzes critically the extent to which investment in SRI practices accords with Islamic tenets, including assessment of their screening investment strategies. This study further evaluates factors limiting engagement of Shariah compliance with broader ESG. By employing content analysis, these issues are analyzed based on secondary data, largely in the form of literature, guidelines, statutes, reports, and precedents that deal with SRI and Shariah investment. This study concludes that the screening strategy is relatively new to contemporary Islamic finance compared to conventional ones, and a narrow interpretation of the Shariah framework has resulted in limiting the engagement of Shariah compliance with broader ESG criteria. This study proposes that in order to effectively uphold the Maqasid-Shariah, Islamic banking and finance should ensure that all transactions adhere to Shariah principles, focusing not only on legal technicalities and formalities but, more importantly, on the economic substance rooted in Maqasid-Shariah.

Keywords: *SRI, Islamic Finance, Shariah, Compliant.*

INTRODUCTION

Over the past few years, the growth of ethical investments or faith-based investments (Bifulco, 2017) which are sometimes referred to as religious-based investments (Renneboog et al., 2008) has been remarkable. In particular, one may highlight social responsible investment (SRI) and Islamic finance. The globalization of socially responsible investment markets grew from US$18.3 trillion in 2014 to US$35.3 trillion in year 2021 (Global Sustainable Investment Alliance, 2020). Meanwhile the total Islamic finance assets grew by 7% and were valued at US$2.2 trillion in 2016 (United Nations, 2018a) and reached to almost US$4 trillion in 2020 (Statistica, 2023). In SRI, the investment process integrates investors' financial goals with their considerations of environmental, social, and governance issues (Eurosif, 2010; Sparkes, 2002). Given that the philosophy of Islamic law is grounded in the principles of social justice and fairness, coupled with the imperative to minimize excessive risk-taking and align transactions with tangible assets as advocated by

Islamic finance, one can infer that these objectives are inherently geared towards promoting social well-being (Kayed & Hassan, 2011).

Although the ultimate goals of SRI and Islamic finance investments may appear to be mutually exclusive, these ethical investment approaches have gained prominence as a significant and debated issue in the finance sector. Some scholars argue that there are similarities and ethical orientations shared between SRI and Islamic funds (Beekun & Badawi, 2005; Brammer et al., 2007; Dusuki, 2008; Dusuki & Abdullah, 2007; Mir et al., 2017). In this context, many argue that Islamic finance should be seen as a subset of SRI funds (Charfeddinea et al., 2016; Reddya et al., 2017). Nevertheless, this perspective is not universally accepted. Novethic (2009) contends that there is no inherent connection between the two, emphasizing the absence of a natural link due to differences in the expertise they employ and their distinct target clientele. Meanwhile Miglietta and Forte (2011) and Mahfooz and Ahmed (2014) posit that Islamic investments are inherently faith-based, thereby advocating their exclusion from the broader classification of SRI due to substantial differences in their investment practices. The conflicting views that have emerged through theoretical debates represent an issue for this study to examine the extent to which SRI practices differ from Islamic tenets.

On the notion of 'do good; avoid harm', SRI and Islamic finance trigger similar expectations among their proponents in that they differ from conventional or Western finance in terms of ethical expectations (Hayat, 2013). The discourse on ethical conduct raises questions, particularly regarding the extent to which ethics in business should rely on universally applicable ethical codes for any social institution, a point not definitively addressed (Hellsten & Mallin, 2006). Although primary objective of ethical investment is to adhere to specific criteria, avoiding investment in companies with ethical concerns while employing positive criteria to support companies that contribute to the public good (Hellsten & Mallin, 2006), various ethical investments employ distinct screening processes, influenced by the type of fund and its country of origin (Gillet & Salaber-Ayton, 2017). In light of recent scholarly discussions, this article critically examines the concept of 'ethical' within these two investment strategies, specifically exploring what constitutes ethical investing from the perspectives of SRI and Islamic finance. This study thus adds to the expanding literature on ethical considerations in Islamic and socially responsible performance funds (Abdelsalam et al., 2014; Rennebooga et al., 2008), contributing valuable insights to this field.

In Islamic finance, *Maqasid-Shariah* goes beyond the ban of *riba* (usury) (Lewis 2010). It encompasses the broader circulation of wealth in society (Hurayra, 2015), addressing legal considerations for both the natural and built environment, demonstrating empathy for laborers and distressed debtors, and emphasizing transparent and participatory governance. In each instance, these principles embody the fundamental values of compassion (Moghul, 2017; Moghul & Safar-Aly, 2014). Within this framework, Islamic financial institutions are expected to meet the normative aspirations of the Islamic moral economy as articulated by *Maqasid-Shariah* (Asutay, 2012), defined as the promotion of human and social well-being (Chapra 2000). While similarities do exist between the principles of *Maqasid-Shariah* and ESG factors (Damak et al., 2018), many studies argue the opposite. The work by Sairally (2004), Kamla and Rammal (2013), and Mohamad et al., (2016) asserted that social responsibility was not an integral part of Islamic business policy. In practice, Standard & Poor's reported that Islamic investment in the environment and governance sectors is still minimal compared to SRI or the global 'green bond' market which saw $168 billion worth of issuances in 2018 (Damak et al., 2018). Further, a recent estimate by Bloomberg, the ESG asset market is projected to reach $53 trillion by the end of 2025, potentially constituting approximately one-third of the anticipated global total. In contrast, Islamic investment products are expected to amount to less than $3 trillion by 2025, assuming a continued growth rate of around 10% (PwC, 2022). Therefore, this study argues the factors which limit the engagement of *Shariah* compliance with broader ESG issues must be examined. Such an examination is crucial for

providing complementary investment classes for both types of investors. Those investors who emphasize ESG in their investment strategies may not deem Islamic investment to be a form of SRI (Binmahfouz 2012).

In capturing the investment strategies of Socially Responsible Investment (SRI) and Islamic finance, a research methodology utilizing content analysis was employed. This approach was based on secondary data, primarily consisting of literature, guidelines, statutes, reports, and precedents related to SRI and *Shariah*-compliant investment. A time frame that encompasses recent developments in the field while also allowing for a comprehensive analysis of historical trends, including the evolution of SRI and Islamic finance practices, was considered.

The remainder of the paper is structured as follows. The first part will critically examine the extent to which SRI investment practices differ from Islamic finance. This investigation will cover the origins, investment practices and ethical criteria in investment strategies for SRI and Islamic finance. Following this, the second part will analyse factors limiting the engagement of Islamic finance in ESG sectors.

THE ORIGINS OF SOCIALLY RESPONSIBLE INVESTMENT AND ISLAMIC FINANCE

The origins of SRI in the Western world can be traced back to the 17th century when the Quakers in the United States refused to profit from the trade in arms and slaves. John Wesley (1703–1791), the founder of Methodism, advocated in his sermon 'The Use of Money' that individuals should refrain from engaging in sinful trade or profiting from the exploitation of others (Renneboog et al., 2008). However, the first investment fund applying ethical screening criteria, the Pioneer Fund, was established in 1928, initiated by the Methodist church. This fund was exclusively reserved for a limited religious community and prohibited investments in so-called 'sinful' (in the biblical sense) companies, specifically those involved in activities such as brewing, tobacco, weapons, and gambling (Paranque & Erragragui, 2016).

In 1971, the Pax World Fund was introduced by the Methodists, marking a significant milestone in the development of socially responsible investing (SRI). Concurrently, the Interfaith Center on Corporate Responsibility (ICCR) was established, playing a pivotal role as an activist shareholder and a catalyst for SRI. ICCR, formed by various religious organizations, including the Methodists, seeks to positively influence companies' actions in social and environmental matters, managing approximately US$100 billion in assets (Bifulco, 2017). The environmental crises of the 1980s and the financial scandals of the 2000s (such as Worldcom, Enron, Parmalat, etc.) spurred the emergence of a new generation of SRI funds. This generation is characterized by a heightened focus on environmental conservation and the advocacy for more ethical governance practices, contributing to a comprehensive socially responsible portfolio (Paranque & Erragragui, 2016). This backdrop demonstrates that SRI is a fully-fledged strategy, stemming from a desire to turn religious beliefs of investors into good financial practices that recognize environmental, social and governance concerns.

Ethical investing also has roots in the Islamic tradition (Renneboog et al., 2008). Islamic finance, with principles derived primarily from the Quran (the holy scriptures of Islam), dates back to the inception of the religion around 1400 years ago. While pinpointing the exact date of the first formal Islamic financial institution is somewhat challenging, references often cite the Mitghamr Egypt Savings Association in 1963 (Archer & Ahmed 2003). This savings bank, based on profit-sharing, operated discreetly in the Egyptian town without projecting an explicitly Islamic image, as it sought to avoid being associated with Islamic fundamentalism – an ideology opposed by the Nasser regime. Simultaneously, in Malaysia, the government addressed the welfare of Muslims in relation to their pilgrimage to the Holy Land. This led to the establishment of the first Muslim fund called Tabung Haji (pilgrimage fund). Its foundation aimed to enable Muslims to save for pilgrimage without the concern of funds being tainted by *riba*, i.e., usury (Anwar, 1991). The year 1975 witnessed a significant development with the establishment of the Islamic

Development Bank (IDB), marking a modern institutionalization of Islamic banking. This followed closely after the inception of the first major Islamic commercial bank—the Dubai Islamic Bank—in the United Arab Emirates (Hussain et al., 2015). As Islamic financing experienced rapid growth, the financial infrastructure, including standards setting and regulatory institutions, has been catching up with these developments.

The relationship between faith and economic behaviors is one where ethical investment originated from a monotheistic faith, whether Christianity or Islam. These monotheistic religions articulate distinct sets of divine values and norms concerning human behavior, particularly in the economic realm (Anas & Mounira, 2009). In Christianity, the foundational scriptures are the Bible, encompassing the Old Testament and the New Testament. Judaism draws its principles from the Torah or the Tanakh, closely aligned with the Old Testament used by Christians. Meanwhile, Islam derives its rules from the *Quran* and the *Sunnah* (traditions) of the last Messenger, Prophet Muhammad (PBUH). In the contemporary application of SRI, its basis is rooted in Protestant and Catholic religious convictions, while Islamic finance models are practiced by Muslims under the framework of *Shariah* law. Notably, commonalities emerge as both investment types generate similar expectations among their advocates of being ethically distinct from traditional finance. Traditional finance has traditionally been guided solely by the pursuit of maximizing risk-adjusted returns. In contrast, Islamic finance and SRI investments introduce an additional objective for financial market activities—commitments to social improvement and religious justification.

THE BASIC PILLARS OF ISLAMIC FINANCE IN *SHARIAH* STANDARDS OF AAOIFI VERSUS SRI INVESTMENT PRACTICES

In examining the extent to which SRI practices differ from Islamic tenets, this study accentuate the basic pillars of Islamic faith as highlighted in the *Shariah* Standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Drawing from the *Shariah* standards, at least five main pillars can be recognized to oversee the religious validity (*Shariah* compliance) of any financial activity. Firstly, there is the prohibition of *riba* (usury) in all its forms, underscoring that charging interest on money loaned is considered unlawful. Secondly, the concept of *gharar* (uncertainty) is prohibited, necessitating the full disclosure of information and the elimination of any asymmetrical information in a contract. Thirdly, there is a prohibition on gambling or any form of monetary gain that comes too easily, condemned as unlawful. Fourthly, the illegal appropriation of people's wealth is prohibited, encompassing prohibitions on certain goods and behaviors considered harmful or, in simpler terms, activities classified as haram or sinful. Fifthly, there is an emphasis on encouraging risk and return sharing, as "profit" rather than "interest," align with ethical considerations and notions of fairness. Grounded in these norms and values, the Islamic finance industry was established and has achieved its current paramount status, evident in its growth surpassing that of all other financial sectors (AAOIFI, 2015).

As a minimal requirement, investments are categorized as *Shariah*-compliant if they conform with these pillars, regardless of any type of Islamic financial product (Yusof et al., 2010). However, from the Islamic perspective, these pillars should be harmoniously combined to preserve balance, distributive justice, and equality of opportunities. They must be honored in every transaction aligned with Islamic practices, ensuring that no financial elements contradict the ethical principles of the religion. Therefore, if an investment is in line with *Shariah* principles, it should inherently be considered ethical (Damak; In: QInvest, 2017). The mission of human beings extends beyond merely abiding by Islamic values; it involves a commitment to striving for the reform of societies in accordance with the Islamic worldview. This notion represents righteous living, believed to promote a balance between individual and social interests, and contribute to the realization of *Maqasid-Shariah*, also known as the vision of Islam. Two vital constituents of this vision are socio-economic justice and the well-being of all of God's creatures (Chapra

2014), which encompass aspects related to Environmental, Social, and Governance (ESG) considerations (Damak et al., 2018).

The Quran provides explicit rules governing personal status, contracts, property, civil and criminal law, and the economic system. However, many aspects of Islamic finance are not covered in *Shariah* but in *fiqh*, or jurisprudence (also translated as understanding of *Shariah*) – specifically, in Islamic commercial jurisprudence (*fiqh al-mu'amalat*) (Hayat, 2013). Muslim jurists depend on the *Maqasid-Shariah* approach in all types of *ijthad* [1] in Islamic law whether the subject matter is Islamic finance or even something else that has a connection to the Muslim way of life. Therefore, *Maqasid-Shariah* is one the very important aspects in Islamic jurisprudence as it helps to validate the different resolutions and rulings derived from the *Quran* and *Sunnah* (Laldin & Furqani, 2013). As Islamic banking and finance have evolved, *Maqasid-Shariah* has become a primary reference for *Shariah* advisory boards in issuing *fatwas* and resolutions, including those of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). On this matter, AAOIFI has developed over twenty *Shariah* standards, encompassing topics such as *Shariah* Supervisory Boards: Appointment, Composition, and Report, *Shariah* Review, Internal *Sharia*h Review, and Audit and Governance Committee for Islamic Financial Institutions (AAOIFI, 2015).

The governance standard stipulates that the role of the *Shariah* board is to ensure compliance with *Shariah* principles by possessing the authority to direct, review, and supervise. Additionally, the governance standard emphasizes the binding authority of the *Shariah* board upon Islamic financial institutions (AAOIFI, 2015). From the standpoint of Islamic economics, effective governance is crucial to fortify Islamic financial institutions, allowing them to expand rapidly and fulfill their roles effectively. This necessity becomes more pronounced as institutions grow, facing increasingly complex challenges that could undermine their long-term capacity to meet these demands (Chapra & Ahmed 2002). In light of this requirement, religious supervision stands out as one of the most crucial features of Islamic banking. Every business operation conducted by Islamic financial institutions must strictly adhere to rigorous religious standards. The *Shariah* supervisory board plays the role of gatekeeper to safeguard the legitimacy and compliance of Islamic banking operations and products. In this way the unique feature of Islamic financial institutions' governance in the form of the *Shariah* board is demonstrated.

TO WHAT EXTENT SRI INVESTMENT PRACTICES SHARE IDEALS WITH ISLAMIC FINANCE?

Generally, the five pillars play a crucial role in Islamic finance, overseeing the regulations and religious validity of any Islamic financial activity. However, when considering the origins of Socially Responsible Investing (SRI) in the West, a parallel prohibition on interest emerges when the pursuit of economic justice is at the forefront. Judaism and Christianity, predating Islam, have teachings and ethical restrictions on the use of money, loans, and investments. The ban on interest is first mentioned in the holy scriptures of Judaism, with the Old Testament emphasizing the prohibition of interest-based transactions among Jews, considering them as "brothers." In Christianity, the Luka Bible strongly emphasizes an interest ban that the church adhered to for a considerable period (Ahmad, 1981). The Roman Catholic Church universally prohibited usury from 1139 until the 19th century. In Tudor and Stuart England, laws prohibiting excessive usury were in effect from 1571-1624 (Renneboog et al., 2008). In fact, some contemporary mutual funds or SRI options are grounded in religious principles regarding the prohibition of interest. For instance, the MMA Praxis mutual funds are sponsored by Mennonite Mutual Aid (MMA), serving as the stewardship agency for the Mennonite Church. Similarly, the Amana funds adhere to Islamic principles, including a prohibition on interest (*riba*) and other

[1] *Itihad* refers to the practice of making a verdict by independent understanding of the legal sources, the holy *Qu'ran* or rationalizes law on the basis of the *Qu'ran* and the *Sunnah*

interest-bearing securities (Statman, 2005). In the context of the present-day financial market, the *riba* prohibition is now a widely accepted strategy since many outstanding conventional financial institutions have implemented interest-free banking operations (Anas & Mounira, 2009).

The Roman Catholic Church deems games of chance sinful only when played excessively, leading to deprivation (Schwartz, 2006). These beliefs found explicit expression in SRI with the launch of the Pioneer Fund in 1928, the third oldest fund in the US. This fund refrained from investing in gambling and other 'sinful' activities such as tobacco and alcohol (Renneboog et al., 2008), highlighting Christianity's influence on condemning gambling within the underpinnings of SRI practices. The Ave Maria Catholic Values fund, established in 2001, goes further by excluding from its portfolio stocks of companies connected with abortion, pornography, or those offering non-marital partner benefits to employees (Statman, 2005). Meanwhile in Islam, any haram activities are strictly prohibited, aligning with the original SRI practice of excluding stocks from companies involved in harmful or controversial activities (known as sin stocks), a practice also evident in Judaism and Christian beliefs. This exclusionary strategy remains the most common SRI approach today (Abdelsalam et al., 2014).

The foundation of a profit and loss-sharing system on which Islamic finance should ideally be based, has also been applied in SRI investment. Some initiatives to transition from interest-based systems to profit-sharing have been initiated independently of Islamic finance. For example, JAK Members Bank, a small cooperative bank in Sweden committed to a just economy and advocating profit-sharing. Based on the concept that arose in Denmark in 1931, they expresses, *"We regard receiving money in exchange for labor and for risk-taking as legitimate; however, we do not consider it legitimate to earn money simply with money."* Similarly, mutual insurance companies like Royal London were established without any reference to Islam, predating the advent of modern Islamic finance (Hayat & Malik, 2014). In fact, equity-participation systems have been proposed during various economic crises in the United States and Latin America, with Henry Simons (1899 – 1946), an American economist in the 1930s, being a notable proponent. He argued that the traditional fractional reserve banking system was inherently unstable. Currently, within the capital market sphere, the SRI market has predominantly focused on equity rather than fixed-income investments. In the United States alone, there are hundreds of equity mutual funds with an SRI mandate, investing either partially or entirely according to socially responsible criteria (Bennett & Iqbal, 2013).

Currently, the main tendency of SRI investment is to resolve environmental, social and governance issues or the ESG, but it lacks a clear standard framework (Mohamad, 2014). In terms of governance, SRIs often lack formal arrangements and instead depend on external advice from professional SRI organizations. Boards overseeing SRIs typically consist of professionals, academics, NGO activists, and businesspeople (Lewis, 2010). These diverse stakeholders collaboratively determine SRI principles in accordance with the fund's client base (Lewis, 2010). The ethical committee is present, in the form of an advisory body yet its decisions are not binding for managers; they have no power of veto (Miglietta & Forte, 2011). This is in contrast to Islamic finance in which *Shariah* boards' decisions are binding for Islamic financial institutions' activities.

Drawing from Islamic finance pillars and SRI practices, there are inclusive fields with shared ideals are present. Even if the religious ethics, mainly Islamic ethics tend to be idealistic for Islamic economics and society (Naqvi, 2013), these sorts of values are not unique to Islam or Islamic finance, nor is its practice confined to Muslims in terms of the SRI route. Mostly similar 'dos and don'ts' exist in the economic transactions concerning SRI or West and Islam with the ultimate aim to pursue ethical business activities. However, differences arise, particularly in the methods and consistency employed to guide and inform investment decisions, a concept referred to as 'governance.' In Islamic finance, the *Shariah* Board holds paramount importance as the key instrument for determining whether a product or investment decision aligns with the ethical framework of Islamic

banking and finance. The rulings issued by the *Shariah* Board are binding. While there are criticisms within Islamic finance regarding differing interpretations among Muslim scholars, the central tenet is that Shariah is always respected as the point of reference for Islamic investments within the relevant jurisdictions.

In socially responsible investing, investment activities are primarily guided by societal or group perceptions of what is ethical, sustainable, and promotes good governance. It relies on societal norms and values to determine ethical guidelines for investments. From a religious perspective, attempts have been made to articulate a Christian view of the economy, although it's acknowledged that the Bible does not propose any specific economic system (see Dion, 2009). In Christianity, for instance, the emphasis tends to be on general and unspecified life guidelines, often centered around spiritual issues (Ali & Gibbs, 1998; In: Agaoglu, 2014). While ethical committees exist in practice, their role in providing clear guidelines for ethical investment is sometimes limited. The challenge arises as companies expand globally and diversify, making it unclear to draw the line from an SRI perspective (Naqvi 2003). SRI organizations, including those with social ends, often grapple with a conflicting relationship between financial and social goals. In the Swedish mutual fund industry, for example, investment professionals steeped in financial logic resisted the emergence of SRI funds (Jonsson & Regnér, 2009) perceiving them as inconsistent with the norm of maximizing financial returns (Yan et al., 2019). As such, some scholars argue that SRI, in its current form, is distinct from earlier modes of ethical investment, evolving from being restricted to ethical funds to becoming a mainstream investment strategy that considers both economic and financial performance (McCann et al., 2003: 19). Despite the historical link between ethics and Christianity driving the growth of SRI, this form of investment has gradually detached from its religious foundation.

Guided by different values and norms, at times, an SRI investment denotes economic morality from their perspective, and so for the Islamic finance system. Therefore, the next section will examine closely in detail the criteria that are deemed ethical in both types of investment decisions. The extent of overlapping that exists in screening processes is investigated.

WHAT ARE DEEMED TO BE ETHICAL CRITERIA IN ISLAMIC AND SRI INVESTMENT STRATEGIES?

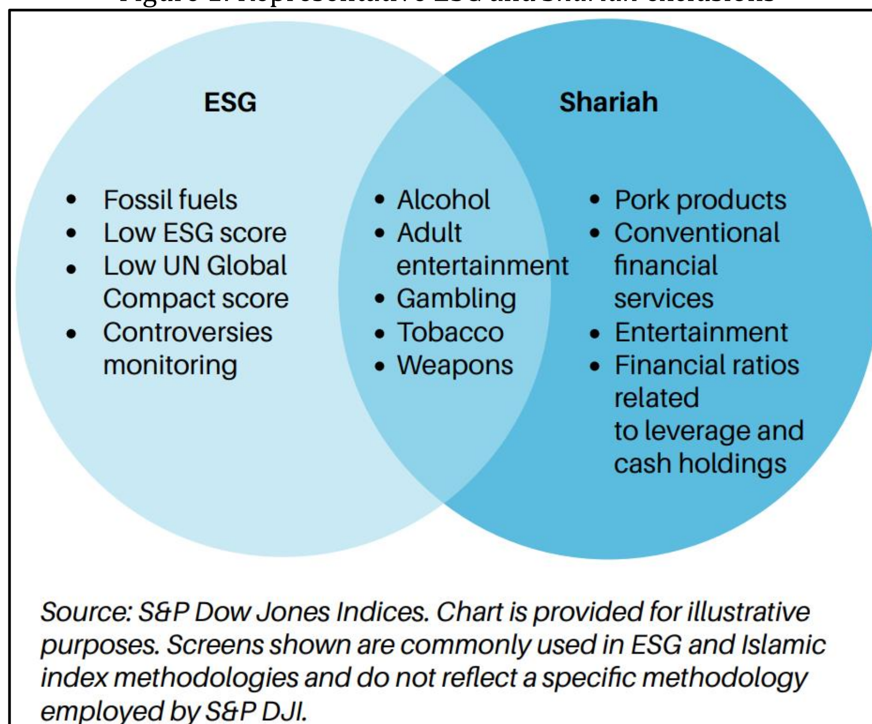
In evaluating the ethical criteria applied in SRI and Islamic investment decisions, this analysis focuses on the ESG and *Shariah* exclusions methodologies issued by S&P Global (2021) as depicted in Figure 1 below. By exploring the similarities and differences of broad-based ESG and Islamic indexing through a real-world example of an innovative index that combines both frameworks, S&P Global (2021) reported that overlapping themes exist in the typical screens relevant for ESG and Islamic indices. This demonstrates that there are some similarities between SRI and Islamic finance in the sense that both strive to exclude certain industries or companies that operate in a way that violates beliefs or is unethical. Since SRI and Islamic finance originate from a monotheistic religion, it is therefore not surprising that the list of forbidden sectors are similar to what Christianity has condemned, particularly tobacco, gambling and pornography because they are deemed harmful to people and society.

However, unlike SRI, Islamic investment tends to be more restricted in their investment selection which also includes alcohol, weapons, pork related products and conventional financial sectors. Although old forms of SRI prohibit interest or usury, it is the case that SRI has no objection to parties investing in interest-bearing securities and freedom to use any kind of derivative contracts. These practices stand in sharp contrast to Islamic investment principles that strongly oppose *riba* (usury) and *gharar* (excessive uncertainty or ambiguity). Islamic mutual funds, in particular, are not permitted to invest in fixed-income instruments such as government bills, government bonds, or corporate bonds. Additionally, the use of derivative contracts, including futures, forwards, options,

and swaps, is prohibited due to the perceived excessive *gharar* associated with these contracts. The more restrictive nature of Islamic investment reflects a commitment to aligning investment choices with *Shariah* principles (Mahfooz & Ahmed, 2014).

The Islamic Fiqh Academy of Organization of Islamic Cooperation (IFA-OIC, 2000, Resolution No.63/1/7) and Islamic Fiqh Council of Muslim World League (IFC-MWL, 2006, Session No. 14, Resolution No. 4) has underlined that Muslim investors are allowed to participate in companies that are completely *Shariah*-compliant businesses and operations (Hashim et al., 2017). However, finding such companies can be challenging in an imperfect world where most financial markets do not fully align with *Shariah* law, dominated as they are by conventional institutions. Most companies are involved in activities that are either completely *Sharīah* non-compliant or a mix of compliance and non-compliance. In Islamic finance, beyond exclusion screening, there are additional financial screening criteria to exclude companies with unacceptable levels of conventional debts, liquidity, and impure income. This goes beyond the concerns of SRI. A company is deemed acceptable for *Shariah*-compliant investments if it meets specific criteria regarding the level of debt, receivables, or impure interest income. While these criteria may vary based on the discretion of a specific *Shariah* board, commonly used standards developed by the Accounting and Auditing Organization for Islamic Financial Institutions are employed to determine whether a company is financially *Shariah*-compliant (AAOIFI, 2015).

Figure 1: Representative ESG and *Shariah* exclusions



Source: S&P Global (2021).

In contrast to other ethical investments, the Islamic investment process incorporates a unique aspect known as "purification," which involves donating impure (*haram*) profits to the poor (Wilson, 1997). Purification principles dictate that any investment income possibly generated from activities deemed unlawful according to Islamic investing principles should be given to charity. This requirement applies to all types of investors and investments. As investment income is forbidden, and *zakat* (alms-giving) is a fundamental tenet of Islamic investing, most contemporary Islamic investment managers offer mechanisms for purification for Muslim clients (United Nations, 2018b). Concerning the purification fee, the collective opinion of Islamic scholars is to permit investments in stocks with a tolerable proportion of revenues from prohibited activities,

typically set at 5% to 10% of total revenue (Ayub, 2007). Notably, the purification process appears to be unique to Islamic investment, as conventional Socially Responsible Investing (SRI) does not necessitate such screening.

Drawing from product-based exclusions, Islamic investment seems to heavily emphasize negative screening. The evaluation of a company's involvement in impermissible activities considers two main aspects: (i) the company's general business activities, and (ii) its financial operations. While both SRI and Islamic finance aim to contribute to the betterment of society, which is not the primary goal of traditional investment, the latter does not explicitly exclude issuers who are guilty of the worst social and environmental practices – lacking a positive screening approach. In contrast, SRI places significant importance on various issues such as environmental risk, social aspects, corporate governance, and ethical practices towards stakeholders like employees, investors, and customers (BinMahfouz & Hassan, 2013). Through "best-of-breed" or 'best-of-class' investing, SRI seeks to identify and select companies that excel in their respective industries. Quantitative and qualitative measures are employed to assess organizations' Environmental, Social, and Governance (ESG) or ethical performance, considering criteria such as adherence to good corporate governance principles, responsible resource use, fair treatment of staff, ethical interactions with customers and suppliers, and community engagement (Lewis, 2010). Notably, SRI has evolved beyond traditional exclusionary screening, adopting a proactive shareholder approach.

In conclusion, similarities can be identified between Islamic portfolios and socially responsible investing funds or ethically-screened funds. Both forms represent constrained portfolios, sharing the common goal of avoiding or excluding specific industries/companies perceived as unethical in their investment business decisions. However, the 'exclusion criteria' or ethical investment from the SRI perspective, to some extent is different with Islamic finance and apparently reflects their screening elements such as excessive *gharar* in the financial tools *riba* and ESG. There is no consensus on how SRI should be approached nor the extent to how uniform it should be in its application; it rather depends on individuals' values and beliefs which can vary greatly from one person to another. Without the governance and clear direction as practiced in Islamic finance through the decisions of a *Shariah* board and purification screening, the question may arise regarding consistency of SRI in placing an equal emphasis on the impact of their invesments on the social and environmental surroundings. Meanwhile for the Islamic finance industry, the predetermined prohibitions or negative screening must remain in place, but positive dimensions such as ESG practice in SRI should be emphasized in the investment selection so that it reflects Islamic values and norms.

WHAT LIMITS THE ENGAGEMENT OF *SHARIAH*-COMPLIANCE WITH BROADER ESG?

This study argue that the limited engagement *Shariah* compliance with broader ESG can be attributed from two main factors. First, the screening strategy is relatively new to contemporary Islamic finance and investment practices (Binmahfouz 2012). Only in 1987, prominent *Shariah* scholars Salih Tug (Turkey), Sheikh Mohammad Al Tayyeb Al Najar (Egypt) and Muhammad Taqi Usmani (Pakistan) teamed up with the objective of finding a solution in the *Shariah* screening criteria on how Muslim investors could become involved in buying shares (Mian, 2008). Following this, the ruling or *fatwa* regarding Islamic equity investment based on *Shariah*-compliant stock was legislated by the Islamic *Fiqh* Academy, Jeddah, in its resolution No.63/1/7 in May 1992 (Kahf & Al-Hajjaji, 2019). Then, the government of Malaysia, as part of its overall initiative to develop an Islamic banking and finance industry, established a *Shariah* Advisory Council (SAC) in 1996. Soon after its establishment, the SAC issued a *Shariah*–compliant securities selection methodology.

In contrast to Islamic finance, the history and development of ESG in SRI investment is not a new phenomenon. In the Western world, as early as 1758, the Religious Society of Friends (Quakers) prohibited its members from investing in the slave trade. The Pioneer Fund, established in 1928 on the initiative of the Methodist church,

marked the inception of ethical screening criteria in investment funds, which continues to be a crucial SRI strategy today. The formalization of the SRI movement occurred in the 1970s and 1980s, incorporating both negative and positive screening processes. During the late 1990s and early 2000s, SRI transitioned from ethics-based investing to sustainability investment, integrating ESG factors into investment decision-making (Lewis, 2010). Notably, at this time, Islamic finance was still in the formative stages of developing a screening methodology. Some scholars argued that the absence of positive criteria in the screening process of Islamic investment is linked to the relative "newness" of contemporary Islamic finance and investment practices (Binmahfouz 2012).

In the conventional SRI *per se*, ESG is not a new concept for Real Estate Investment Trusts (REITs). The REIT approach to real estate investing emerged in the United States, and the key legislation regarding this was passed in 1960. Then six REITs formed immediately, three of which – Pennsylvania REIT, Washington REIT and First Union Real Estate (now known as Winthrop Realty Trust) (Paz et al., 2018). Meanwhile in Islamic finance, the world's first REIT was the Malaysia-based Al-Aqar KPJ REIT, launched in June 2006. Although Islamic REITs now operate in various countries, such as Malaysia, Pakistan, Kuwait, Bahrain, and the UAE, Malaysia is the only country that has issued guidelines on Islamic REITs (COMCEC, 2018). Furthermore, it is essential to emphasize that a regulator's authority is limited to its own jurisdiction. For instance, the Securities Commission Malaysia's authority extends only to companies listed on Bursa Malaysia (Malaysian Stock Exchange). In contrast, private sector organizations or SRI screen companies based on their own data without such restrictions (Hashim et al., 2017). This situation underscores the ongoing challenges faced by the global development, principles, and operations of Islamic REITs due to the lack of a clear-cut regulatory framework and standards.

Second, the limitation of broader engagement in ESG issues can be attributed to a narrow interpretation of the *Shariah* framework (Habib 2018). The narrow perspective of the *Maqasid-Shariah* in the Islamic finance industry is not a recent development and is rooted in the works of key scholars from various fields. Critiques underscore concerns raised by many scholars regarding the legalistic approach of Islamic finance practices. In study by Kamla and Rammal (2013) analyzed the social reporting of 19 Islamic banks and did not find any evidence of Islamic banks making any meaningful contribution to social causes or having any 'serious schemes targeting poverty elimination or enhancing equitable redistribution of wealth in society'. The industry continued to rely on debt-based products and further criticisms have continued to blame the Islamic banking industry for "merely replicating conventional banking products". Commercial activities and financial services or products created by financial institutions function simply to raise profits for corporations and the state, with little emphasis on improving the wider society (Abdelkafi & Bedoui, 2016; Mohammad & Shahwan, 2013). The literature highlights the growing frustration of scholars and proponents of Islamic economics regarding the failure of Islamic finance to address real economic and ethical issues beyond the legal domain of *Shariah* compliance. A legalistic approach results in a narrow understanding that overlooks certain dimensions of Islamic finance practices (Hasan, 2016).

The rationalistic legal interpretation of Shariah by Islamic law scholars has led to the oversight of the moral dimension and equally important substantial issues. Scholars justify this approach by asserting that the Islamic methodological focus should center solely on the 'intention,' and as long as the intention is correct, other ethical and social implications resulting from a Shariah-compliant contract need not be examined (Asutay & Harningtyas, 2015). A study by Ahmed (2018), further stipulated that anecdotal evidence from conversations with some Shariah scholars in the Islamic financial industry indicates a disregard for ESG factors, deeming them irrelevant to the *Maqasid-Shariah* as they do not exist in classical fiqh and are considered Western notions with no basis in Islamic jurisprudence. The perspective is that banks are obligated to maximize returns for shareholders and investors while conducting social activities, potentially conflicting with

contractual stipulations. Scholars argue that broader social objectives should be addressed at a higher level, such as by the government, policy-makers, or regulators. Consequently, Islamic finance is currently facing a "formalist deadlock," where the industry prioritizes formal adherence to Islamic law over the promotion of Islamic ethical values (Balz, 2010; Nienhaus, 2011).

CONCLUSION

In conclusion, the analysis of ethical investment in SRI and Islamic finance highlights the distinct foundations and approaches of these two investment strategies. Islamic finance relies on *Shariah* law as its authoritative ethical and legal reference, with a *Shariah* board ensuring proper governance. This firm grounding establishes stable parameters for contemporary Islamic finance operations. On the other hand, SRI does not adhere to a single reference, resulting in various interpretations of what is considered ethically and socially responsible. The divergence in perspectives between SRI and *Shariah* creates a unique feature, providing an opportunity for both forms of investment to learn from each other. SRI lacks a consensus on a unified approach, relying on individuals' values and beliefs, leading to potential inconsistency without formal governance. To address this, SRI should develop a clear framework that defines the ethical values guiding investment decisions. For Islamic finance, a negative screening process alone, focusing on prohibitions like *riba, gharar, maysir*, and certain goods, is deemed insufficient. There is a need to extend these prohibitions to include ESG aspects. The incorporation of positive screening, aligning with areas already covered by SRI but not yet employed by Islamic investors, represents a crucial step toward a more comprehensive ethical framework.

Further, the screening criteria for an ethical investment decision revealed that certain investments can be considered as ethical from the SRI perspective, but not according to *Shariah*, despite the fact that many overlap. The purification process, so far seems to be unique to Islamic investment, as conventional SRI does not necessitate such screening. Islamic investment might not be deemed as constituting a form of SRI for those investors who emphasize ESG in their investment selections, simply because the contemporary *Shariah* screening process does not capture such an issue. The real challenge will be to extend this research by embracing other “positives” in the Islamic agenda, particularly ESG and how to improve the well-being of Muslim communities. To effectively fulfill the *Maqasid-Shariah*, Islamic banking and finance must ensure that all transactions adhere to Shariah principles. This entails not only complying with legal technicalities and formalities but, more importantly, aligning with the economic substance of these transactions, grounded in the *Maqasid-Shariah.*

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