COMMENT

Sukuk SRI at a crossroads

INVESTMENT ETHICS: It can enhance country's position as an Islamic financial and sustainable investment hub

FOR many top executives, night-time worries and sleepless nights are about innovation. Leaders are plagued by the fear of inspiring people to think creatively — to challenge the status quo and stay relevant in a rapidly changing environment.

Tackling global challenges, such as climate change, sustainable development and infrastructure gaps, calls for new thinking and ways of doing things. Quite clearly, the world's challenges are beyond the capacity of any single institution. The message is clear — governments and civil society cannot do it alone.

In charting a sustainable future, access to capital markets and global investors is a critical success factor. This means departing from traditional approaches in mobilising resources to financing socially-responsible investments (SRI).

Globally, countries are seeking creative solutions in implementing innovative financing mechanisms, which may be best suited to their national development needs.

Over the last two decades, Islamic finance and SRI have become commonplace in the development discourse. These two have seen the most rapidly growing areas of finance, of which Islamic financial assets have grown by 15 to 20 per cent a year and its volume in 2014 exceeded US$2 trillion (RM8 trillion), while the SRI assets globally in the same year soared from US$13 trillion to US$20 trillion in two years.

While investments traditionally have been driven only to maximise risk adjusted returns, the growth of both Islamic finance and SRI mirrors the rising demand of investors in activities that conform to their ethics, beliefs and emphasise the social returns that society receives.

In Malaysia, the performance of Islamic finance is praiseworthy. Positive trends had emerged in the development of the sukuk market as Malaysia led the marketplace for sukuk issuance with 53 per cent of global market share, amounting to US$35 million last year.

To a large extent, sukuk, as a debt security, differs from conventional bonds with respect to the allowance of asset ownership as opposed to debt obligations. Evidently, the global financial markets are converging to make SRI sukuk potentially the "bridge" product that links the Islamic and conventional financial markets.

The principles of Islamic finance that prescribe risk-sharing, social responsibility and prohibit unfair and speculative activities share common threads with SRI. These commonalities provide opportunities for Islamic finance to broaden its investment portfolio by tapping into the large amount of SRI funds available in global market. If implemented strategically, this will further enhance the country's leading position as an Islamic financial and sustainable investment hub.

Malaysia is indeed ahead of the curve. In August 2014, the Securities Commission launched its Sustainable Responsible Investment Sukuk Framework to facilitate the financing of SRI initiatives.

Following that, Khazanah Nasional Bhd issued the nation's first SRI sukuk with a RM1 billion nominal value and a tenure of 25 years from its first issuance. The proceeds of the sukuk are targeted to improve accessibility to quality education in Malaysia through a public-private partnership model.

Despite the SRI sukuk phenomena gaining traction, the market development are at a crossroads.

FIRST, the complexity in setting up a SRI sukuk increases the transaction costs. The design of the highly-structured instrument is aimed to reconfigure sukuk's fixed return so that it is not reflected as an interest in fulfilling the requirements of Islamic laws.

This consequently poses a challenge in meeting investors' liquidity expectations. Typically, conventional investors shy away from unfamiliar set of terms and contract types.

On the other hand, scholars argue that the novelty of sukuk is lost in the attempt of issuers to make special efforts to render sukuk identical to conventional securities in easing potential investors to assess risk. Such efforts undermine the notion of product innovation in Islamic finance industry.

SECOND, while sukuk comprises a process that relies heavily on a set of guidelines and an endorsement of their legitimacy, there is a lack of commonly-accepted standards and verification system for performance measurement.

Arguably, standards could reinforce credibility or, on the contrary, inhibit growth and innovation.

In addition, the cost on reporting and monitoring adds on to the burden of the issuers.

THIRD, potential investors often face a dilemma in weighing between financial return and social/environmental return. The central tenet of Islamic economic systems requires a balance between financial and social objectives that necessitates a disciplined approach towards long-term sustainability.

Ultimately, the SRI sukuk can act as a compass and an important yardstick, against which issuers and investors can align their own key sustainability strategies in the creation of shared value within society.

Encouraging greater participation and uptake, a robust legal, regulatory and governance framework, coupled with financial technological revolution (FinTech), will act as catalysts in supporting the growth of the Islamic financial sector.

Whether or not these instruments are new wine in old bottles, the architecture for innovative finance is likely to evolve in a messy manner. As an old saying goes: "innovation is anything, but business-as-usual".

> *Ultimately, the SRI sukuk can act as a compass and an important yardstick,* ***against which issuers and investors can align their own key sustainability strategies in the creation of shared value within society.***

michelle@isis.org.my

The writer is an analyst at the Institute of Strategic and International Studies (ISIS) Malaysia