

## **Advocating ESG through Islamic Market/Finance System**

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ESG (Environment, Society and Governance)<sup>1</sup> has gained the spot light both the investment and corporate world since many years now. What initially started as a “trend”, has now evolved into a major performance driver and one may fairly call this a “paradigm shift”. The importance of ESG has gained momentum in the corporate world as shareholders are eager to discuss ESG, its impact and relevance on the company’s performance especially the Board’s efforts towards ESG initiatives.

One of the reasons behind the growing importance of ESG globally is the risk associated with it. Changing business landscape in the light of social media, technology and climate change, ESG factors need special attention to de-risk the business operations and benefit the shareholders. Research on ESG framework by McKinsey has demonstrated that companies with well thought-out ESG propositions benefit from superior performance and value creation<sup>2</sup>.

Pakistan, like other countries, have shown some pace in recognizing the importance of ESG and commence the adoption of ESG Global Standards in the local market. Over time, the apex regulator, Securities and Exchange Commission of Pakistan (SECP) has been issuing relevant guidelines and directives such as Code of Corporate Governance Guidelines (2017), Corporate Social Responsibility (Voluntary) Guidelines 2013 and any other regulatory framework as applicable to create a sense of responsibility for companies to report, disclose and implement sound ESG values. Several listed companies have started voluntary disclosures on ESG including ENGRO, HBL, FFC and few others. ICAP, ACCA and CFA bodies in Pakistan have been actively advocating for ESG reporting and adoption for the corporate sector and capital market. Despite this, the progress remains slow. Several countries have already issued ESG disclosure and reporting guidelines particularly for listed companies.

The aim of this article is to highlight how ESG principles can be promoted in Pakistan when aligned with Islamic (Shariah) market and business principle. As per the latest reports, MoF (Ministry of Finance), SECP and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have agreed to make joint efforts to mainstream Islamic Finance in Pakistan. Therefore, an integrated effort for these two distinct objectives can lead to greater success and impact.

A closer look at the 3 main ESG principles highlights that ESG and Islamic Market/Business System are two concepts that share an inherent overlap.<sup>3</sup>

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<sup>1</sup> <https://www.cfainstitute.org/en/rpc-overview/esg-investing>

<sup>2</sup> <https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value>

<sup>3</sup> <https://www.mdpi.com/2076-0760/11/6/228>

### **Environmental Aspects:**

As most of the people are aware, the Environmental component of ESG emphasizes on how businesses have to focus on environmental and sustainability factors while managing and planning their activities. Some of the common action points include: carbon emissions, supply chain sustainability, waste management, water conservation, energy efficiency among many others.

It can be seen that this is very much in line with Islamic principles of operating and managing businesses. According to the Islamic guidelines, all environmental resources including water, earth, fire, forest and light belong to all creatures in the ecosystem and not just humans. It has been enjoined on humans to protect and preserve the natural resources for all elements of ecosystem and future generations. Moreover, several teachings have stressed on people to observe moderation in consumption at all times and not waste anything. Extravagance which leads to unequal distribution of resources has been forbidden. Water conservation is the central part of Islamic teachings for the entire community even if water is available in abundance. Several examples in Islamic history from the Islamic State have indicated establishing protected areas where the wildlife were given protection, hunting was limited to few seasons only and trees were not cut. Protection of trees and laying down seeds is considered to a lifelong charity according to Islamic principles. Even during war times, it was strictly prohibited to harm trees, birds or animals in eco-system.

Similar ideas and factors are being propagated under the ESG initiatives as corporates strive to become more environmentally conscious and adopt sustainable business practices such as resource conservation, animal and wildlife protection, clean energy and efficiency.

### **Governance and Social Aspects:**

The Governance and Social Aspect of ESG lays emphasis on businesses understanding their obligation and duty towards society, employees, customers and general public. Governance, on the other hand, is focused towards fair business practices which do not malign the shareholders (owners) or the community at large.

While looking at it from the Islamic system perspective, here also we find a natural overlap. Firstly, for the social aspect, there are clear instructions about the concept of social welfare in Islamic system. Any business/corporate is bound to not engage in any practice which is detrimental to employees, customers and public. Any concept of economic development in Islamic system comes from equitable growth, public welfare and social development. The underlying concept comes from “community” thinking and sharing resources for uplifting entire community at large as opposed to concentrated development. Zakat, Waqf, Sadqa (charity) and Bait-ul – Maal are some examples of how upholding social factors is paramount. Islamic Finance or non-interest based finance, which is now a major part of global financial system, is based on similar guidelines that limit any kind of exploitation and undue benefit to any one party or group in transactions.

Furthermore, specific guidelines exist for businesses about customer protection and rights, trade practices, upholding contracts, paying salaries and wagers to workers on time, supportive human resource policies,

work-life balance all that are in line with social factors in ESG framework. Moreover, Islamic system promotes meritocracy at all levels and fair opportunities irrespective of caste, color or creed.

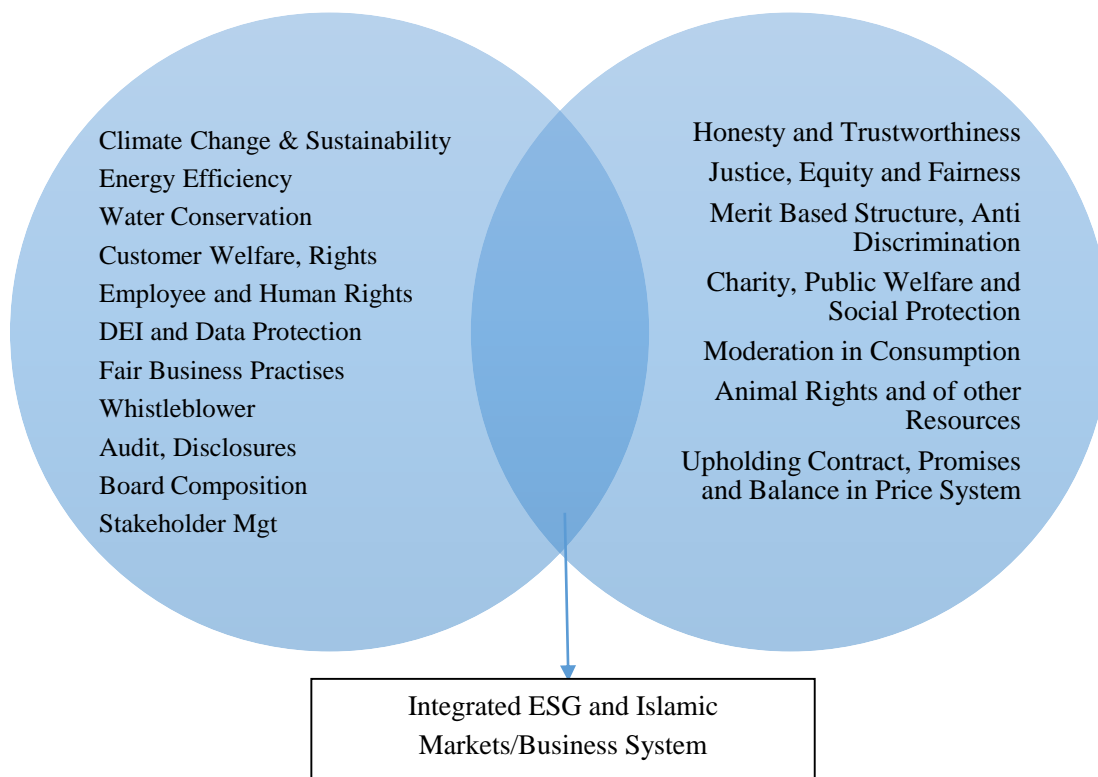
In the modern ESG framework, a socially responsible business is expected to cater to general public welfare and exhibit similar characteristics as explained above.

In Governance, fair business practices form the crux of the Islamic system. The underlying principles of Governance that apply on businesses as well as individuals include: Accountability, Transparency, Justice, Equity, Fairness, Right and Wrong Distinction. It is required from businesses in Islamic system to be honest, care about customer dealings and with suppliers, not engage in price fixes, hoarding and such practices that can harm public.

A closer look at these values reveals that an ideal modern corporate governance structure encompasses exactly the same values towards its shareholders. An ethical business that has a sound corporate governance system will ensure that the Board is accountable and Transparent in its composition, duties, disclosures towards the shareholders and community at large. Plus, an effective CG system will ensure to avoid any malpractice (bribery, corruption), have a whistle blowing mechanism, maintain equity and justice in its dealings, strategic plans, minimize conflicts of interest and implement sound audit and reporting systems.

**Proposition:**

**Framework of Integration:**



According to a data base of 6500 listed companies by Refinitiv's EIKON, Shariah compliance screening has a link with better ESG performance. Companies that are Shariah compliant in financial sector tend to score higher on ESG particularly for environmental and social factors whereas in non-financial sector, the outperformance of Shariah compliant firms is even better on ESG scores<sup>4</sup>.

This is only a succinct account of how Islamic principles of business ethics and finance align with modern ESG practices. Further research on this can lead to much deeper insights on the topic.

However, the proposition can be made that one of the ways to encourage corporates in Pakistan to embrace the spirit of ESG is to make it a part of Islamic (Shariah) Finance/Market screening. This can help to achieve two major objectives of SECP as well as of Government i.e. to promote Islamic Market and Finance in Pakistan in addition to ESG compliance; both in line with Global Standards and Trends. A strategic convergence of the ESG principles and Islamic system can unlock opportunities for corporate sector in the field of green finance, inclusive and equitable growth, community welfare and sustainable businesses. Through this approach, an increased awareness for ESG and its positive impact on the bottom-line can contribute towards improving the performance of corporate sector overall.

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<sup>4</sup> <https://www.sc.com/en/feature/shared-values-share-values-overlaps-between-islamic-esg-investing/>