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## **The Role of Islamic Financial Institutions in Sustainable Development**

**Abul Hassan and Abdelkader Chachi**

Sustainable development is an economic issue, but there is an ethical standpoint that lies behind it. In the light of the demand of sustainable development and the call of agenda 21, the United Nations Environment Programme (UNEP) recognised the importance of financial institutions. The Islamic financial institutions may interact with the environmental issues: as investors, innovators, valuers and as powerful stakeholders. In this chapter, a transactional model of Islamic financial markets is used to indicate how it is possible to influence economic and financial transactions.

### **Introduction**

In its 1987 report entitled ‘Our Common Future’, the World Commission of Environment and Development defined sustainable development as: ‘development, which meets the needs of the present without compromising the ability of future generations to meet their own needs.’<sup>2</sup> Although the idea is simple, the task is substantial. It means meeting four objectives simultaneously, throughout the whole world:

- (i) Social progress which recognizes the needs of everyone;
- (ii) Effective protection of the environment;
- (iii) Prudent use of natural resources; and
- (iv) Maintenance of high and stable levels of economic growth and employment.

Many governments and non-governmental organizations (NGOs) have long feared that sustainability and development might be incompatible. In particular, they fear that the existing economic trends and the fallout from international agreements could freeze global economic and political inequalities in the name of sustainability, and that this would stifle the hopes of progress and socio-economic parity in the developing countries. As a result, financing development has always been the main priority for the Southern countries in international negotiations. At the United Nations Conference on Environment and Development (UNCED), popularly known as the Rio Earth Summit,

held in 1992, financing and technology transfer were the two ‘cross-cutting issues’ passed by the South. A decade later, in 2002, these two issues continued to provide central themes at the Johannesburg World Summit on Sustainable Development (WSSD). The UN Conference on Financing for Development (FfD) held in 2002 in Monterrey, also repeatedly focused on development financing mechanisms at the behest of the developing countries.

Notwithstanding the persistence of the issue, the trend since 1992 has been disappointing. At the Rio Summit, the UNCED Secretariat estimated the financing needs of Agenda 21 to be close to US\$600 billion per year, including \$125 billion per year as grants or concessional financing. In practice, despite growing economic prosperity in the North and repeated commitments to ‘new and additional financing’, there was a net decline, even in existing official development assistance (Banuri and Spanger-Siegfried, 2001). In 2000, official development assistance (ODA) fell to its lowest level ever, declining to \$53 billion from \$56 billion per year (IIED, 2002).<sup>3</sup> The aid level in 2000 represents only 0.22 per cent of the GNP of the Developed and Advanced (DAC) countries, less than a third of the UN target of 0.7 per cent. Even this low volume of aid is not spent primarily in countries whose population is in absolute poverty nor on measures that directly benefit the most disadvantaged groups.

In the light of the demand of sustainable development and the call of Agenda 21, the United Nations Environment Program (UNEP) recognized the importance of financial institutions by stating that ‘financial institutions which assume the risk of companies and plants can exercise considerable influence - in some cases control - over investment and management decisions which could be brought into play for the benefit of the environment’. The Islamic financial markets can present an opportunity for environmental policy, which may be particularly useful in view of the need for a wider range of policy instruments. The aim of this chapter is to examine and explore, as to what extent the Islamic financial institutions (IFIs) can encourage the corporate sector and directly participate in sustainable development. The chapter is organized as follows:

Section 2 discusses Islamic perspectives on sustainable development. Section 3 gives an overview of different models for understanding corporate responsibility in sustainable development. Section 4 focuses on the role of the Islamic financial

institutions (Islamic banks, investment companies, insurance companies) in sustainable development. A transactional model of the Islamic financial markets is used, to indicate how it is possible to influence financial transactions. Section 5 discusses the relationship between the companies, investors and environment. Finally, section 6 offers some conclusions and recommendations.

### **Sustainable Development from an Islamic Perspective**

One does not find a formal Islamic theory of sustainable development in the current literature. However, its absence from the current literature on Islamic economics does not mean that such a theory cannot be built. Asad (1987) argued<sup>4</sup>: ‘in an ideology like the Islamic one, there can be no dividing line between the ‘spiritual’ and the ‘worldly’ spheres - and therefore also no dividing line between man’s faith and his practical life...’ The Qur’ānic portrayal of nature, as found in numerous verses, is multifaceted. God creates nature, the Qur’ān emphatically declares<sup>5</sup>. Whereas God is characterized by Unity (*Tawhīd*), nature is characterized by duality<sup>6</sup>, in the sense of complementarity or diversity as denoted by the Arabic word *zawj*. Another characteristic of nature found in the Qur’ān is order or balance.<sup>7</sup> The idea of a divinely arranged order in nature found in the Qur’ān, could be said to refer to the idea that nature is the purposive creation of an omnipotent and omniscient God and is therefore perfectly ordered and structured.<sup>8</sup> Evil human forces should not be allowed to disrupt the order of nature. In this regard, the Qur’ān states: ‘...Do not spread corruption on earth after it has been so well ordered’<sup>9</sup> (Qur’ān 7:56).

According to Asad (1984), the Islamic doctrine asserts that: ‘Man is an animal in the sense of organically belonging to that group of living beings which are endowed with the faculties of sensation, perception and movement, as well as in the sense of being dependent on physiological needs and functions more or less resembling those of other animal beings’<sup>10</sup>. Man’s distinction lies in ‘trust of reasons and volition whereby man has been given the ability to exercise choice between good and evil. This rational consciousness gives man the ‘ability to form concepts and to bring them together in countless combinations by means of mental processes which can be guided and directed by his will.’<sup>11</sup> Consequently, whereas other animals adapt themselves to the environment (or else suffer the fatal consequences), man has become increasingly skilful in adapting his environment through the use of science and technology to suit his

own ends. . Islam endorses these activities and thus environmental transformation is, from the Islamic perspective, an inevitable component of life<sup>12</sup>. But according to Islam, man should not carry out these activities arbitrarily. The Qur'<sup>ān</sup>, sets up a vision of nature in relation to God and man. It also sets out an ethical code to guide man. Waste is abhorred,<sup>13</sup> as is haughtiness and all its expressions in boastful displays of wealth. Instead, Islam exhorts moderation and distributive justice.<sup>14</sup> There is also in existence a body of Islamic resource law, dating from the time of the Prophet (peace be upon him), which prohibits private ownership of common property resources such as pasture, woodland, wildlife and water, which must be managed for the common good. Wildlife and forests are safeguarded in *hima* or reserves, which are established solely for conservation purposes (Sardar (1988)). Islamic jurisdiction rules can be applied to the management of natural resources.<sup>15</sup>

Chapra (2000) argues that in all matters, including economic, a Muslim's faith is to be placed first because it provides the worldview, which influences the whole human personality, behaviour, life-style, tastes, preferences, and attitudes towards human beings, resources, and the environment. It tries to promote a balance between the material and the spiritual urges of the human self, foster peace of mind in the individual, enhance family and social solidarity and prevent the development of animosity. A Muslim's faith provides the moral filter, which aims at keeping self-interest within the bounds of social interest by changing individual preferences in accordance with social priorities and eliminating or minimizing the use of resources for purposes that frustrate the realization of the social vision.<sup>16</sup> These are the components, which fulfil the objectives of the *Shari'ah*.

There are two commandments of major importance in the *Shari'ah*, which have an immense bearing on the sustainable development issue. These two are the command to pay *zakāh* and the prohibition of usury (*ribā*). We shall briefly discuss each of these in the light of the definition of sustainable development to highlight the relationship between them.

*Zakāh*: *Zakāh*, or obligatory alms giving, is one of the 'Five Pillars of Islam'. It is a tax on personal wealth that is paid on, or more properly taken from, three forms of wealth, namely, crops, livestock and money. It is an obligation based on clear Qur'<sup>ān</sup>ic instructions, 'Establish the prayer and pay the *zakāh*'.<sup>17</sup> The seriousness of the

obligation to pay *zakāh* is indicated by the fact that it can, in certain circumstances, be collected by force, even if that implies waging a war against those who refuse to pay it.<sup>18</sup> The economic institution of *zakāh* thus presupposes the political institution of *Khilāfah* both for its execution and enforcement.

The acquisition and accumulation of wealth is permitted if it is pursued through lawful means, that is, if the individual meets all of the attendant obligations (including payment of *zakāh* and other voluntary taxes), and if it does not distract one from the remembrance of God. The principle of mutual interest is used in such cases to establish social optimality in the distribution of resource and wealth. So, *zakāh* and *sadaqah* (voluntary charity) are part of an effective social apparatus to ensure distributive equity and social justice. The act of giving is so important that generosity and charity have been declared ‘an occupation without a loss’. Islam views social justice a vital objective of social policy, which is evident from the fact that it repeatedly urges Muslims not to seek salvation through self-alienation or monastic life, as this could entail one’s withdrawal from the active promotion of society’s well being.<sup>19</sup> Thus the pursuit of social justice as a component of sustainable development has a well recognized place in Islamic theology.

Usury (*ribā*): *Ribā* is traditionally defined as ‘any unjustified increment between the value of the goods given and the counter value of the goods received’.<sup>20</sup> The seriousness of the prohibition against usury is indicated by many verses.<sup>21</sup> In simple terms, *ribā* can be understood as lending money at interest, including any transaction in which money, or what acts as money, is effectively bought for time. It is not out of place to mention here that real money, such as gold and silver, are commodities with their own market value, which can be, and are, bought and sold in their own right. But the excessive circulation of paper monies brings two main dangers to any economy: inflation and stagnation. The direct causal link between usury and inflation is very clear from the credit creation of the Central banks. It proves that the more ‘money’ there is in circulation to pay for the same amount of goods - as is inevitable under the present system - the more the prices go up. So abolishing usury - which is what the Muslims are called upon to do - would mean reducing inflation.

Most of the day-to-day transactions now taking place involve usury in some form or the other. Since usury is forbidden in Islam, it brings with it trouble. This is so because

from the Muslim point of view, every permitted act brings with it a blessing from Allah, while every prohibited act brings with it the opposite. With usury so prevalent, it is not surprising that there is such an extent of degradation and despoliation associated with it today.

The basic ethical standpoint of the Muslims is belief in God and acceptance of His laws, which include economic laws. The primary obligation in Islam is to pay *zakāh*, while the primary economic prohibition is to avoid any kind of *ribā*. However, neither of these is possible, without *Khalīfah*, that is, the political authority of a *Khalīfah* or an *Amīr* within a group who accepts his leadership and who, together, can put these commandments into practice. Sustainable development is thus not so much a question of managing land, water, etc., as managing the people who could take care of economic development. The Qur'an supports this argument: 'God does not change what is with a people until they change what is in themselves' (13:11).

Islam also does not offer an elaborate formal model for the enhancement of well being in the ecological sense. Instead, it presents principles that can be used for the development of appropriate models. Therefore, sustainable development in the sense of maintaining ecological balance, also needs to be understood within this implicit but potentially formal framework. Islam is a monotheistic religion that has a holistic view of the world.<sup>22</sup> According to Islam, the true ownership of all resources resides with God. In sharing this ownership, humanity is God's supreme creation and its role is to serve as God's vicegerent (*Khalīfah*) on the earth. While superior human intelligence means power and control over all other things on earth, this is not absolute. Nobody can violate the basic premise of trusteeship while using it to his advantage.<sup>23</sup> Since the environment and ecology are part of God's creation, their misuse may be interpreted in two ways: as transgression of the absolute authority of God and as harming both the violator and the person who is injured. Thus, any misuse of the environment that involves waste and destruction is a sinful act in both senses.

Ahmad (1976) argues that the development process may be directed through *tazkiyah* (purification and growth) in order to improve the quality of life and welfare of human beings in this world and hereafter. The quality of life and welfare of human beings are determined by many elements. Development is concerned not only with economic development but also with human development. The foundation blocks of the Islamic

approach to development include: *Tawhīd*, *Rabūbiyyah*, *Khilāfah* and *Tazkiyah*. The Islamic concept of development is to be derived from its concept of *tazkiyah*, as it addresses the problem of human development in all its dimensions and is concerned with growth and expansion towards perfection through purification of attitudes and relationships. Sustainable development is thus clearly a familiar term to many people and is on the political agendas of governments of the Islamic countries as well as countries throughout the world. 'Sustainable development' can be covered under the definition of 'Balanced Development', a term used by Ahmad, (1976).<sup>24</sup>

### **Understanding Corporate Responsibility in Sustainable Development**

The struggle to define the boundaries of corporate responsibility for social and environmental matters has deep roots in the history of business. From the beginning of the Industrial Revolution, those within and outside the business world have battled over the very notion and extent of corporate responsibility. Different models have emerged, all of which exist in the Islamic world today. We only give a brief description of the following models:

#### **Ethical model**

We find many informal models in Islamic history. With inspiration from the Qur'an and the sayings of the Prophet Muhammad (peace be upon him), many Muslim businessmen played an active role in promoting socio-economic development in Islamic countries. The history of Muslim philanthropy has encompassed cash or kind donations, community investment, and provisions of essential services such as *madāras* (schools for religious education), schools, infirmaries etc. Many Muslim firms, particularly 'family run businesses', continue to support such Islamic philanthropic initiatives. But the first formal ethical model of corporate responsibility lies in the pioneering efforts of 19<sup>th</sup> century corporate philanthropists such as the Cadbury brothers in England.<sup>25</sup>

#### **Static model**

A second model of corporate responsibility emerged during the time of *Khalīfah* Umar Ibn al-Khattab (d.644CE). The office of consumer protection and market supervision, the *muh̄tasib*, was instituted. The cartels, monopolies, hoarding and any other methods of artificially interfering with market prices were banned in Islamic law. The means of making profit was made generally beneficial to the community.<sup>26</sup> The boundaries between the state and society were clearly defined for the state enterprises.

Elements of corporate responsibility, especially those relating to community and worker relationships, were enshrined in Islamic law and management principles.

### **Liberal model**

Indeed, a third model of corporate responsibility underpins the worldwide trend towards privatization and deregulation, by which companies are solely responsible to their owners. This approach was encapsulated by the American economist Milton Friedman<sup>27</sup> (1958) who challenged the very notion of corporate responsibility for anything other than the economic bottom line.

‘If anything is certain to destroy our free society, to undermine its very foundation, it would be a widespread acceptance by management of social responsibilities in some sense other than to make as much money as possible. This is a fundamentally subversive doctrine’ (Friedman, 1958; p.23). Many in the corporate world and elsewhere would agree with this concept, arguing that it is sufficient for business to obey the law and generate wealth which, through taxation and private charitable choices, can be directed to social ends.

### **Stakeholder model**

The rise of globalization has brought with it, a growing realization that, with increasing economic rights, business also has a growing range of social obligations. Citizen campaigns against irresponsible corporate behaviour along with consumer action and increasing shareholders’ pressure on corporate policies have given rise to the ‘stakeholder model’ of corporate responsibility. This view is often associated with R Edward Freeman,<sup>28</sup> whose seminal analysis of the stakeholder approach to strategic management in 1984 brought the concept of stakeholding into the mainstream of management literature (Freeman, 1984). According to Freeman, ‘a stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the organization’s objectives’.

The experience of the past decade has served to reinforce this viewpoint. With companies facing increasing scrutiny in the global economy, the corporate responsibility agenda now encompasses a wide range of issues including provision of quality, safe products at fair prices, ethical business practices, fair employment policies, and environmental protection. Companies are increasingly expected to perform according to a ‘triple bottom line’<sup>29</sup> of economic, social, and environmental

performance. In addition, increasing focus is being placed on the growth of corporate power and the need for greater accountability and transparency to society, for example, through reportage and stakeholder dialogue. Indeed, there is an emerging consensus throughout the world, that companies need to go beyond their traditional ‘economic’ roles; the following analysis from the Centre for Development and Enterprise in South Africa demonstrates this:

Each of the four models of corporate responsibility described above are prevalent to some extent in Islamic countries. What is noticeable today is the dynamic nature of corporate responsibility in the Agenda 21 of the United Nations<sup>30</sup> Action Program for Sustainable Development, and the need to clarify the implication for corporate practice. One of the weaknesses of the current situation is the tendency for the agenda to be set-up at a global level, largely by institutions located in the industrialized world, with little understanding of the diversity of approaches and its track record in other parts of the world. For example, a 20-country public opinion survey on corporate social responsibility carried out by the Toronto-based ‘Environics International’ in July 2001 concluded that some of the ‘third world countries’ (including Bangladesh, Indonesia and Pakistan) rank last in terms of the level of social responsibility demanded from companies.<sup>31</sup>

To clarify the implication of corporate responsibility within the entire corporate sector is beyond the scope of this study. The present study will examine and explore the extent to which, the IFIs can motivate, encourage, and finance the corporate sector to participate in sustainable development in accordance with the approach of the stakeholders’ model.

### **Role of the Islamic Financial Institutions**

The World Commission on Environment and Development (WCED), also known as the Brundtland Commission, recognizes the importance of financial institutions. It emphasized that financial institutions, which assume the risk of companies and plants, can exercise considerable influence, and in some cases, control, over investment and management decisions, which could be brought into play for the benefit of the environment. So far, the role of the Islamic financial institutions has not yet been explored in detail at the Islamic world level. The IFIs may interact with the environment in a number of ways including :

- As investors - supplying the investment needed to achieve sustainable development,
- As innovators - developing new financial products to encourage sustainable development, e.g., in energy efficiency,
- As valuers - pricing risks and estimating returns, for companies, projects and others,
- As powerful stakeholders - as shareholders and lenders they can exercise considerable influence over the management of companies,
- As polluters - while not dirty industries, financial institutions do consume considerable resources.

In view of the indirect nature of many of the interactions above, policies are likely to be most effective if they aim to complement and work with existing financial activity.

The stakeholders in the corporate sector of the Islamic countries have tended to play down their potential role in moving towards sustainable development, believing that such matters are primarily the role of governments. However, their view has often tended towards dismissing environmental concerns as being of marginal importance to their business, and at first sight, the short term expediencies of the financial markets and the altruistic, long term concerns behind sustainable development might appear to have little in common.

In order to achieve sustainable development, it will require substantial investment in environmental technology, in new energy systems, in an environmentally sensitive infrastructure and in information technology (Zeinelabdin, 1993).<sup>32</sup> This may require financial innovation to develop mechanisms for new Islamic markets that sustainable development will create. It may also involve working with the policy makers of Islamic countries to ensure that the most appropriate structures are established to enable ready financing. IFIs can respond quickly to new opportunities, particularly when the potential is presented to them in a clear and consistent manner, and although large, the financing needs of sustainable development in Islamic countries are well within the scope of the financial markets of Islamic countries. However, inconsistent or ineffective policy development may send a negative signal to the market, and can result in adverse market sentiments against environmental projects.

The financial institutions of Islamic countries exercise considerable influence over most areas of economic activity, from the individuals struggling to make mortgage repayments, to the directors of multinational companies facing investors and analysts at the company Annual General Meeting. Of all the stakeholders of a company, financial institutions are usually the most powerful, yet have frequently been ignored from the perspective of achieving environmental change. Thus, it is not surprising that to date, the financial institutions have rarely used their influence for environmental matters. From the perspective of environmental policy makers, this situation represents a potential opportunity, particularly useful in view of the fact that the OIC/United Nations Cooperation Committee has recognised the need for a wider range of policy instruments, especially the use of market based tools (Zeinelabdin, 1993). Ideally, environmental policy makers in Islamic countries would like to see the IFIs complementing and reinforcing the signals that policy makers are trying to establish, including financially 'rewarding' environmentally superior behaviour (for example, with a lower cost of capital or a higher share price) and penalizing the bad.

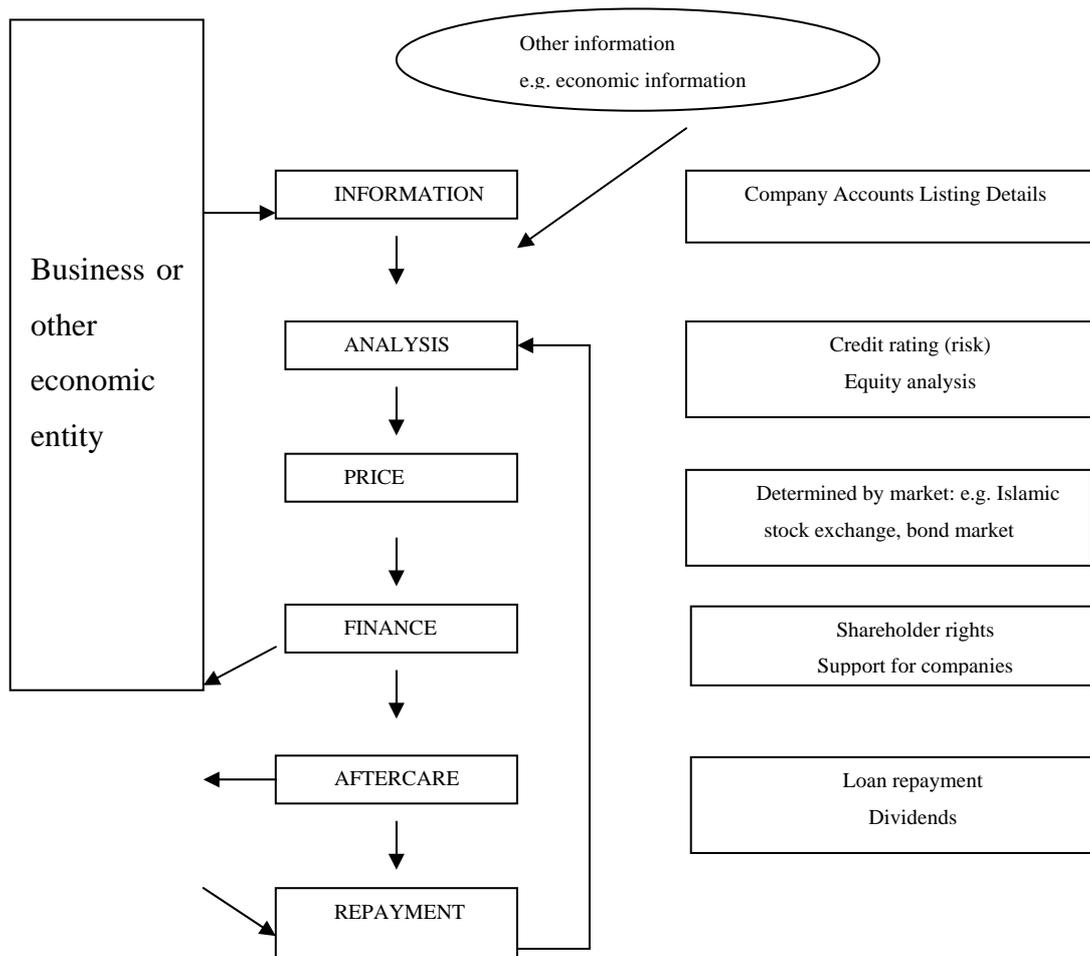
Like conventional financial institutions, the IFIs also have some direct environmental impacts from their own operations - such as power usage, paper use, and business travel. While not thought of as major polluters, there is scope to reduce this impact, and often to do so without incurring financial costs. The service sector is becoming increasingly important within the economies of Islamic countries, and as a whole its environmental impact is significant. Given their influence, the IFIs are well placed to play a leadership role within the sector in demonstrating environmental responsibility.

In order to achieve this change, the policy makers may have a number of options. Existing environmental legislation may be modified or interpreted in ways to make it more relevant to the Islamic financial markets. New environmental legislation may be evolved to encourage or coerce the financial markets to consider environmental issues. Financial instruments can be used to persuade the financial sector to get involved. Finally, the Islamic financial markets themselves are highly regulated and subject to legislation and there may be scope here to adapt legislation to incorporate environmental aspects.

### **Transaction model of the Islamic financial markets**

Islamic markets will only use their influence for the benefit of the environment if they see that it is in their interest, which means that it will help them to generate profits either directly or indirectly (by improving the quality of their business or their reputation). The indirect considerations are particularly important in the investment performance through better advice or management.

Figure 4.1 Transaction model of Islamic financial markets



While this is straightforward, to apply it is rather more difficult. It can be very difficult to know beforehand whether a particular activity will be profitable or will enhance investment returns. Before considering any new activity, Islamic financial institutions will want to consider what they are letting themselves in very carefully. As a result, it is useful to understand how the Islamic financial markets work in supplying

capital. The diagram above provides a model of the Islamic financial markets operations in this matter.

Analysis is the key part of the process and will be largely driven by the objective of making profitable investment decisions. A key factor in analysis will be the estimation of the actual and perceived risks involved. One important aspect of analysis is that it involves costs, which can be quite substantial. Thus, an initial estimation is often made of the likely outcome of the analysis, with many propositions being rejected at an early stage (Gazni and Tamer, 1997). The price is primarily determined by the market, and is largely dependent on the type of finance and the risk once it is known. Aftercare refers to the fact that most financing lasts for a period of time and the Islamic financial institutions have a valid interest in supporting their investments once finance has been provided, which can be done through shareholder actions, through covenants on loans or through general provision of services which enhances the business.

This model applies both to individual financial transactions and to the development of new business lines - although the latter can be far less quantitative, and will be expected to offer the potential to recoup the initial costs several times over. This model highlights that for a financial activity or modification to an activity for making sense to an Islamic financial institution, not only does it have to make sense in simple financial terms (to offer a fair return/ be correctly priced), but also it has to be broadly viable and relevant to business, including covering the various costs involved in going through the steps above.

Like conventional financial systems, if the Islamic financial institutions are to integrate environmental considerations into their decision making, they need to be convinced that not only are they profitable in the narrow sense, but also the arguments are sufficiently strong to make the environment a key issue for the IFIs, facing challenges and competition both internally and externally. Practically, the model suggests that information and analysis present key obstacles for the environment, as historically, obtaining good environmental data is a challenge. This will increase the costs and reduce the reliability of analysis and makes it more difficult for Islamic financial intuitions to justify many environmental actions. That said, there is often considerable latitude in decision making in Islamic financial institutions - rarely are decisions in black and white. Thus, in terms of individual transactions, environmental

factors may play a significant role in marginal financing decisions, even if information is incomplete.<sup>33</sup> At the company level, while it may be difficult to justify new environmentally related activities in narrow business terms, they may offer benefits to an Islamic financial institution such as good publicity, and appear a good proposition in overall terms. Following are the possible strategies:

### **‘Niche’ strategies**

The IFIs could see the environment as offering the potential for profitable lines of business. Some of them are:

- i. Building expertise in providing finance for key environmental sectors such as environmental technology, renewal energy, water and waste.
- ii. Developing financial products to assist in the use of environmental services such as energy efficiency.
- iii. Developing ‘green’ products in compliance with *Shari’ah* for clients and customers

In the above-mentioned businesses, to offer attractive opportunities to the IFIs will require the existence of growing, profitable market segments. The extent to which such opportunities exist is clearly open to debate, but there is some evidence to suggest that substantial unexploited opportunities exist.<sup>34</sup> These opportunities represent a ‘niche’ approach in terms of an Islamic bank’s business - although some of the niches could be quite substantial. The present impact of financing on the environment will depend on the extent to which finance is mobilized towards key sectors.

### **General strategies**

Apart from the above, the IFIs could see the environment as an opportunity to improve the overall quality of their business, for instance by:

- i. Improving the quality of their loan book by managing risks such as environmental liability.
- ii. Improving the quality of their investment decisions by including environmental factors.
- iii. Improving the quality of advice offered to clients, for example, in investment research.

All these opportunities represent a ‘broad’ approach, cutting across sectors, which could in theory have far reaching consequences for many industrial sectors. However,

the immediate impact on the environment is harder to quantify as it will depend on the extent to which such actions change the behaviour of the businesses and other economic entities involved. Initially, the effect is to remove an obstacle to environmentally responsible behaviour by companies, who appear to find the financial markets ignoring and possibly unsympathetic to the actions-many progressive companies are taking. In the long run, as companies see that the financial markets are prepared to recognize and reward environmentally superior behaviour, the effects could be substantial.<sup>35</sup> A key factor in this approach is whether environmentally responsible behaviour does contribute to superior financial performance (such as corporate profitability, investment returns, etc.), and is thus a matter worthy of the attention of Islamic financial institutions.

### **Sectors and clients**

The Islamic financial markets cover a wide range of different functions and products and serve a wide range of different clients. The Islamic financial sector may be divided into Islamic banks, Islamic asset management companies and Islamic insurance companies (*takaful*). Islamic banks and asset management companies will trade off risk against potential return and may be interested in upside potential; insurers actively aim to adopt risk and offset it internally.<sup>36</sup> These different attitudes to risk can clearly result in differing attitudes of each sector towards environmental issues. Similarly, different IFIs have differing customer groups such as small and large industries, individuals, the public sector, and non-governmental organizations (NGOs), and have different levels of influence over them. This will also affect where and how Islamic financial institutions can have an environmental impact and where they can best develop environmental practice. The main customer groups are reviewed below:

### **Large companies**

Islamic banks are substantial lenders to large companies in the Muslim countries, and also providing a variety of other financial services, such as transaction processing and treasury management. Their ability to influence larger corporations is relatively limited, as competition is strong and these services are rarely central to large corporations. The greater influence on larger corporations will come from the investment sector and is discussed later. Some companies may be more subject to Islamic bank influence such as private companies (unlisted) or those with tightly held shares, smaller listed companies

more dependent on banks, and companies in financial difficulties. However, in certain sectors Islamic banks can have a greater influence, particularly where high levels of lending are normal. These include property (real estate), lending and project finance (*mushārakah*), and lending for stand alone infrastructure projects – this can be relevant for the environmental sector. In this field, the Islamic banks can impose a variety of conditions relating to the construction and operation of the facility, through conditions and covenants on lending. These can include environmental considerations. While many Islamic banks will conduct an environmental risk review as part of the credit assessment; this tends to be retrospective, and few can appear to actively impose and enforce environmental conditions. Environmental impact assessments can be a useful tool with such projects for identifying environmental project risks and suggesting risk management procedures. Liability regimes will also have an impact on the risk assessment of such financing.

### **Small and medium enterprises (SMEs)**

Islamic banks are the most significant source of external finance to small and medium enterprises (SMEs) and can exert considerable influence on them since most of the SMEs have a banking relationship. The Islamic banks can send the following powerful signals to the SMEs:

*Influence Management through Lending Arrangements:* When lending to SMEs, the Islamic banks may consider the quality of management and other risks, which can include environmental factors. The Islamic banks, when deciding whether to extend funds, can explicitly include environmental considerations in conditions they impose on lending and in the terms of business they offer.

*Supporting Companies with Infirmities:* The IFIs are a major source of information for companies, particularly SMEs in the Islamic countries, and there is potential for Islamic financial institutions to act as a conduit of information in the environmental area.

*Specialist Environmental Financial Services:* There is some scope for Islamic banks to develop Islamic financial products, which contribute to the environment, such as energy efficiency loans or leasing of environmental technology.

*Specialist Support for Environmental Companies:* Most emerging sectors can face difficulty getting recognition from the financial markets, because they are new, the risks

are unknown, the technology unfamiliar and the markets uncertain. The environmental business sector certainly faces these difficulties. By actively trying to understand the sector and the issues it faces, the IFIs at least may try to reduce some of the obstacles the emerging businesses face, although one cannot expect them to forgo normal financial judgment. Interestingly, while several Islamic banks are actively involved in areas such as renewal energy financing, often neither their environment nor their publicity departments seem to be aware of such activities.

*Households and Individuals:* Individuals have a major impact on the environment through their activities and consumption of goods and services, and in some cases, their impact proves more intractable than commercial impacts. The IFIs can have a major impact on the activities of individuals by the provision of suitable financial arrangements - for instance, access to interest-free mortgage finance is a prerequisite to widespread home ownership, and car ownership may be increased by the availability of car loans and hire purchase. In the absence of suitable financing arrangements, products or goods may struggle to achieve sales, particularly if they have high capital costs and long life spans (in economic language, most consumers have a marginal discount rate far higher than the financial market norms).<sup>37</sup> This may often apply to environmental goods and services, which involve an up-front capital cost. The obvious example is energy efficiency, which in theory offers very attractive financial returns, but is impeded by the fact that individuals are unwilling to fund such investments and the Islamic financial markets have largely failed to provide suitable financing vehicles.

*The Public Sector:* The public sector comprises a major part of the economy of most Islamic countries, and thus will contribute directly to a large part of the environmental impact of the country, particularly if sectors such as water, waste, energy and transport are in state hands. Islamic financial institutions are also suppliers of capital to governments and public sector organizations and thus theoretically could have some influence over how that capital is provided and used. However, in most cases, public sector funding carries an explicit or implicit sovereign guarantee and thus there is little scope for individual public sector activities to be assessed on either their environmental or financial impacts by financing organizations. In extreme cases, it could be argued that if environmental mismanagement at a national level threatens the productive capacity of a country, then this should be reflected in the overall credit rating of the

country. If public sector financing is provided at a more local level, without recourse to the central authorities, then environmental impacts might be possibly significant to merit the attention of the Islamic financial markets.

*Non-Governmental Organizations (NGOs)*: Non-governmental organizations include organizations such as charities, cooperatives, academic institutions, micro-finance institutions etc. While having both modest needs for finance and low environmental impact, they can be important at the margin, as they can be working in critical areas or area actively seeking to apply financial innovation to the solution of key environmental problems – thus they can play a role in financing the environmental sector. Environmental economists and social activists have repeatedly emphasized that the financing in sustainable development should begin by investing in people, e.g., by investing in education, by refinancing the micro finance and by promoting social responsibility. As Harran al- (1999) argues,<sup>38</sup> the availability of even modest amounts of capital can encourage entrepreneurial activity and create employment. While it is true that many micro finance organizations do not have a direct environmental focus, the activities of the Islamic banks supporting the micro finance organizations certainly help to address the social aspects of sustainable development.

### **Islamic banks**

Unlike their conventional counterparts, Islamic bankers do not expect to advance money and receive a predetermined sum on a fixed date in the future. Under the *Shari'ah*, they are instead responsible for ensuring that money is invested in viable projects, with reliable borrowers. If the project succeeds the banker shares in the profit. If it fails banker suffers losses.

The *Shari'ah*, which dictates the activities of the Islamic banks as well as forming the basis of the daily lives of all Muslims, requires that reward comes from risk sharing. Profit must be justified through the creation of value that the banker brings to complement the value of the borrower's efforts and skills. Against a background of rapid growth in the economies of Islamic countries over the last 25 years or so, and a desire to increasingly compete internationally, Islamic banks have begun to change and develop to provide a range of alternative financial products firmly based on Islamic principles.<sup>39</sup> Islamic financial techniques have been employed successfully in a growing number of major projects in the West. Islamic Banks, such as Al Barkah Group, Al

Rajhi, National Commercial Bank, Faisal Islamic Banks Group, Bank Islam Berhad, Malaysia, Dubai Islamic Bank, Islamic Bank Bangladesh Ltd etc., have completed project deals using the *ijārah* (lease financing technique) and many industrial projects, including the building of power stations, refineries and schools, by using *istiṣnāʿ*. The Islamic Development Bank, has also financed many projects which are directly linked with sustainable development.

Spread across the Islamic world and beyond, there are more than 200 Islamic financial institutions: banks, mutual funds, mortgage companies, insurance companies - in short, an entire parallel economy in which Islamic *Shariʿah* has the final say. Industry growth has averaged 10 to 15 percent a year. Sniffing opportunity, conventional banks like Citibank and HSBC have opened Islamic 'windows' in the Gulf. The industry's market share is modest - about 10 percent (Useem, J; 2002). Islamic banks in Muslim and non-Muslim countries have total assets of over \$200 billion. Thus they have sufficient influence on the economy of the Islamic world and its environmental impact. Islamic banks' services cover a wide range, including: deposits and lending in the modes of *mudārahah*, *mushārahah*, and *murābahah*, providing cheques and other transaction processing, and selling financial products and services. In principle, investment on a long-term basis (*mushārahah*) is the most important activity in the Islamic banking system. A key factor in determining the influence of Islamic banks on the environment will be the nature of the clients. Thus, it is worth looking at the key client groups individually, including large companies, small and medium enterprise (SMEs) and individuals. There is, however, scope for Islamic banks to influence consumer behaviour through the financial products they offer. Now Islamic banks have focused on two areas: Firstly, some have made considerable progress in developing internal environmental management systems to reduce their own environmental impact. Secondly, some Islamic banks include environmental analysis into their credit assessment process.<sup>40</sup> One particularly encouraging area of activity is providing practical support to small business on how to manage their environmental impact, through information packs and other support.<sup>41</sup> Where Islamic banks have been less progressive is in developing new financial products with an environmental perspective for both business and individuals, such as energy efficiency loans, and encouraging the development of such products appears desirable. It has been observed

that there is growing popularity in developing environmental management systems (EMS) and the improvement of reporting within Islamic banks.<sup>42</sup>

### **The investment sector**

The potential of the investment sector lies primarily in the signals about the advantages of environmentally sound behaviour it can send to the investors.<sup>43</sup> The signals it can send will depend on who is seeking finance. It is observed that the influence of investors over the public sector is limited, and largely confined to monetary macroeconomics. The most significant influence of the Islamic investor community is therefore on industry, particularly on large companies. The investment community can send the following powerful signals to the industry:

*Pricing ratings of new capital for companies:* When a company first obtains a listing or seeks to raise new capital, the process of due diligence provides an opportunity to examine a company's overall strategy and management, including environmental issues. Full consideration of environmental factors could influence the amount and price of capital available to companies, rewarding good companies with cheaper debt (due to lower environmental risk) or access to equity at better ratings. Conversely, investors may avoid companies with too great an environmental risk.

*Share ratings and company valuations by equity markets:* If investors were to reward companies with a superior environmental track record with higher share price, this would send a powerful signal about the merits of good environmental behaviour to the industry. For this to be effective, investors should anticipate the results of good environmental initiatives, rather than wait for the results to become evident. Financial markets need to be convinced that such behaviour leads to superior financial performance. At present, this has been a source of much contention and analysis, but evidence is emerging to support this hypothesis. Financial markets need to be convinced of the significance and validity of the findings.

*Ownership of companies via their share capital:* The IFIs control the majority of the share capital of most public companies, either directly or on behalf of their investors (fund managers) and are the most powerful of all stakeholders. In theory, they have the power to direct companies to take account of the environment in their management strategy. In practice, action has been limited; shareholdings are normally diffused, making majorities difficult to achieve and institutions are reluctant to become active if

financial benefits are uncertain. Other stakeholders thus enjoy more influence on the management of major companies. But if Islamic financial institutions are persuaded of the financial benefits of superior environmental performance, they can encourage such action.

As a whole, investors are probably less interested in the environment than bankers. However, a number of pressures are emerging on the investment sector (illustrated in Figure 4.2).

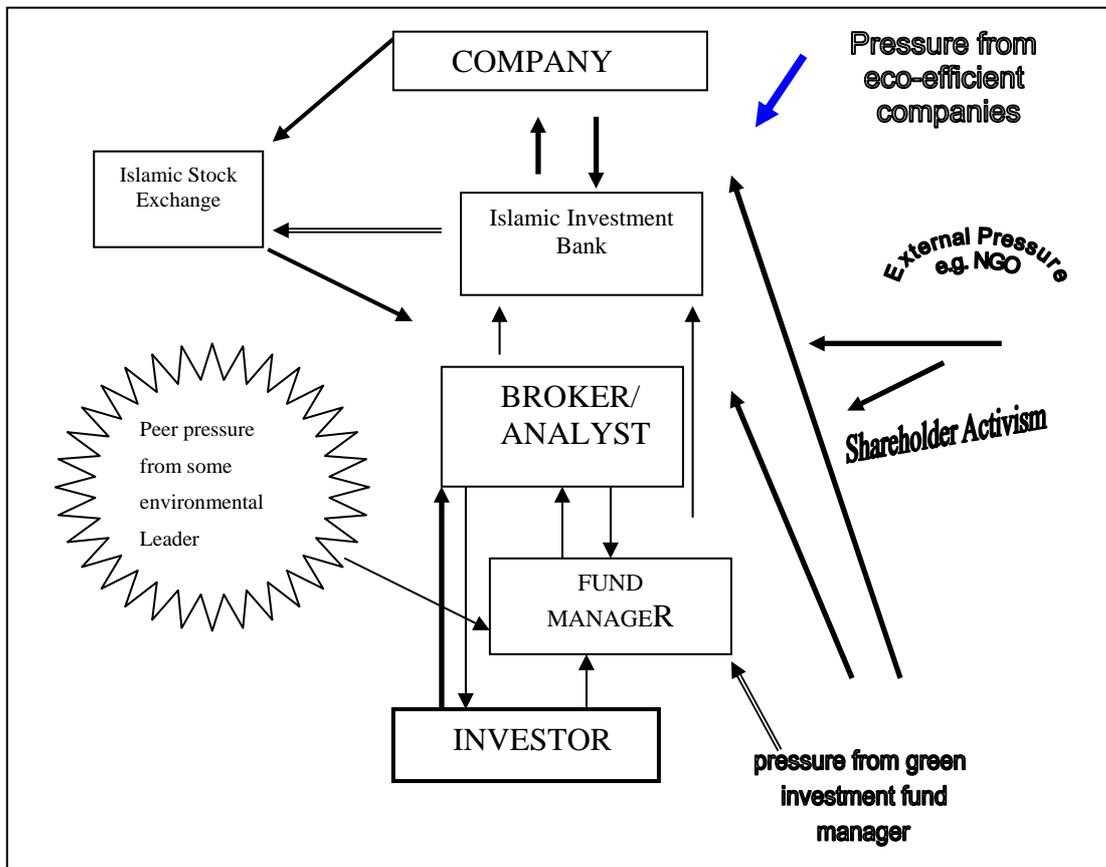
*Industry:* Leading companies have become increasingly frustrated with the failure of the investment community to recognize and reward the environmental progress they have made. In particular, the international business organization, World Business Council for Sustainable Development (WBCSD), has been active in this area, developing the concept of eco-efficiency and encouraging its use among investors.

*Investors:* There is growing interest from individual investors in environmentally responsible investment, and this has led to the development of some progressive environmental investment funds in conventional sector.<sup>44</sup> Institutional investors<sup>45</sup> have also started to explore this area, reassured by the good investment performance of such funds. As a 'green' product with no price or quality premium, the potential market for such products is likely to be substantial. Another avenue that some investors have pursued is shareholder activism. They have become frustrated with the indifference of investing institutions and are taking their concerns directly to large companies. This has proved effective in the US, but is more limited in the Islamic countries where shareholders' rights are less developed - there may be scope to develop it in Islamic countries.

*NGOs:* Environmental NGOs have also started to target fund managers and investment banks over their investments and involvement with environmentally damaging companies. To date, they have not had any major success, but have started to influence the sector.

*Within the investment industry:* A few organizations among the investment sector have started to take environmental issues more seriously and may be creating some peer pressure for change.

Figure 4.2 The environmental pressures on the investment sector



One of the major concerns for the investment sector is the relationship between environmental performance and investment performance.<sup>46</sup> The evidence from the conventional investment sector on balance suggests that environmental performance does contribute to good financial performance. However, many in the investment sector remain unconvinced, and action is needed both to persuade doubters and reinforce signals, such as through the development of environmental taxation. In order to encourage the investment sector to incorporate environmental issues, a number of obstacles need to be overcome. Two key obstacles are market inertia in investment practices, and the balance between long-term and short-term analysis. However, the most important issue is probably difficulties in obtaining good quality information in ways that the sector can understand and use. Methods need to be found to provide relevant information to the sector.

### The insurance sector

The Islamic insurance sector in the Islamic world is still in its infancy. The potential of the Islamic insurance sector in achieving sustainable development lies in its ability to price various types of environmental risk and to help pay for environmental damage. Potentially environmental issues can affect risks in a number of areas, the conventional insurance industry has taken an issue-based approach<sup>47</sup>:

- Building on a greater understanding of the interaction between the environment and Islamic insurance companies, there is some potential for practical action and business opportunities.
- Using sustainable development as a risk management tool - companies that are acting unsustainably are likely to present greater risks than those that are not. The precautionary principle would appear to be fundamentally about risk reduction.
- Looking at the potential for industry wide actions to reduce environmental risk, such as by developing standards, lobbying etc.
- Looking at the opportunities for the development of new insurance products to address environmental challenges;
- Insurance of new risk categories, such as technology risk.
- Products for the environmental sector, such as insurance against weather viability for the renewable energy sector.

### **Companies, Investors and the Environment**

Companies increasingly see environmental issues relevant to their business development, yet financial markets in general, particularly investors, are not interested. Companies are increasingly aware of the environmental pressures they are under and have developed a range of practical tools to address them.<sup>48</sup> Understanding the financial implications of the environment on companies involves:

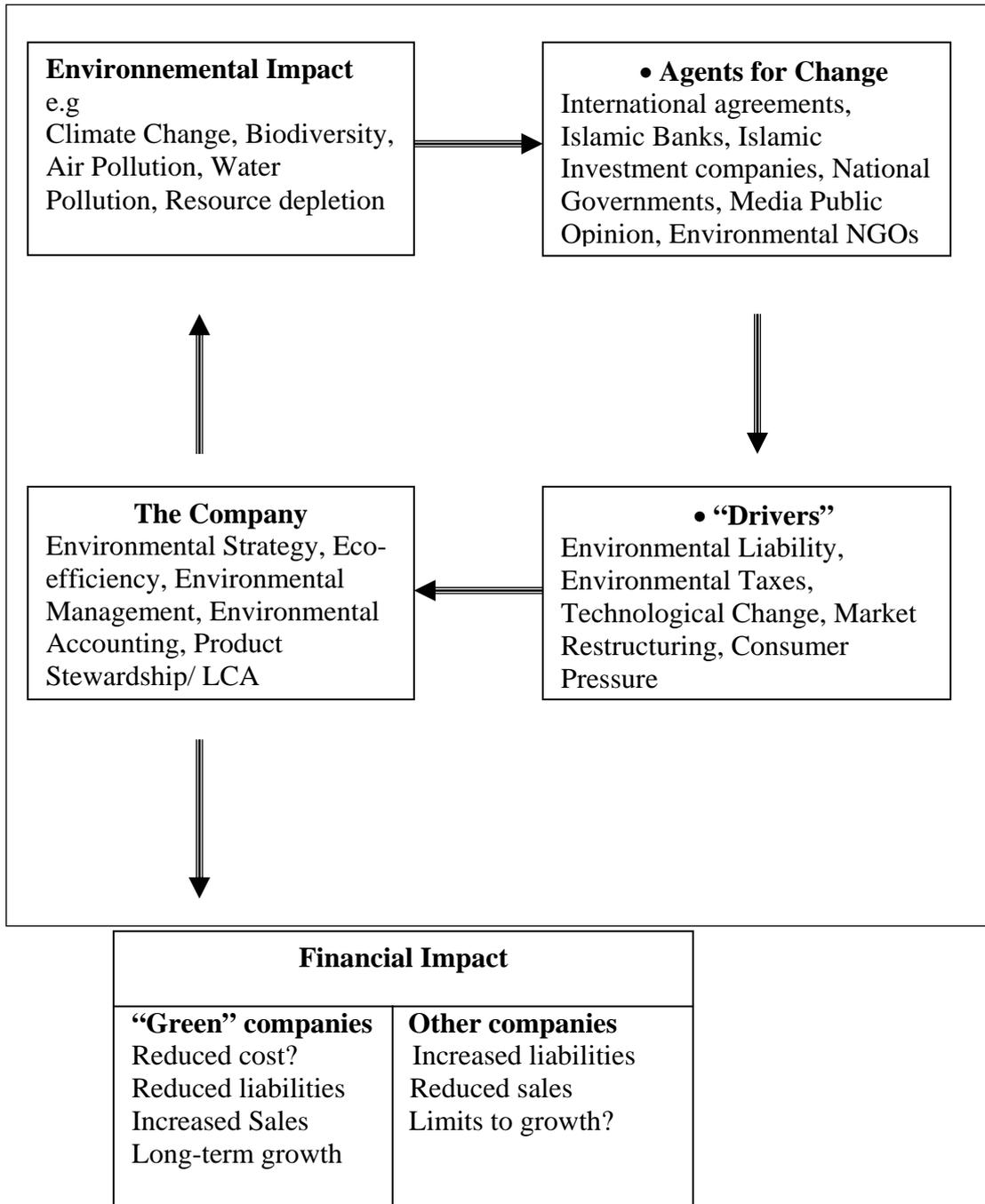
Identifying how environment affects companies - this rarely happens directly but instead involves companies:

Knowing how company management can respond, using tools such as: environmental management systems, eco-efficiency and risk management,

Communicating relevant information,

Understanding the financial implications of their environmental impact and the management response. The following diagram illustrates this relationship.

Figure 4.3 The relationship of companies, investors and the environment



The diagram also helps to identify where information is likely to be useful to the financial markets.

Information on the company's approach to environmental issues is desirable, including strategy, management systems etc. Such information is often qualitative but financial analysts are used to assessing management quality from such information. Environmentally relevant financial information on costs and liabilities is likely to be useful. However, such information will only cover certain areas and may not provide a guide to future financial performance and risk.

Company environmental information will be useful, as an indicator of the pressures it experiences, and the risks it runs. While the feedback process in the model is imperfect, companies having a larger environmental impact will come under pressure to change. The WBCSD and others have argued, environmental performance may also be an indicator of the effectiveness of the management of the company. Responsible analysts should also keep track of the pressures or 'environmental drivers' that companies face directly. Companies cannot report on this sort of information themselves, as it is outside their control.

### **Environmental reporting and rating agency**

Information is the key to financial evaluation, but there is limited useful information on environmental performance and management. The main existing sources of information are not geared to financial audiences.<sup>49</sup>

- i. The environmental reporting is targeting multiple audiences and many companies do not report,
- ii. The potential with annual reports is erratically exploited and lacks standardization,
- iii. Publicly available information faces substantial practical obstacles.

In order to address this, there is potential to develop standardized and financially useful environmental reports, potentially as part of the annual reports, encompassing Islamic financial information, environmental performance data and qualitative information on environmental policy and management. An alternative approach is through the development of environmental rating agencies that can provide a summary analysis geared to the needs of the financial markets.<sup>50</sup> At present, such services have limited appeal, but they offer long-term potential. An effective way of encouraging the

development of these services would improve the quality of information made available through the public regulators.

### **Environmental business sector**

The environmental business sector consists of businesses ranging from traditional environmental businesses, such as waste management, to emerging 'green' pioneers, such as renewable energy and eco-tourism. They have a critical role to play in achieving sustainable development and thus ensuring they have access to private sector finance is crucial. Despite apparently good prospects, with rapidly growing markets, the financial performance of the sector has been disappointing. Indeed, the poor performance of many high profile companies has been a major factor in creating a negative impression about the environment amongst Islamic financial institutions.

In response to the challenges faced by environmental sector companies, a number of innovative approaches and specialist organizations have developed in the conventional sector, such as project finance, venture capital, leasing, environmental and ethical banks, specialist environmental financiers, and environmental funds. These products can easily be replicated Islamically, and Islamic financial institutions should come forward with a positive approach. To encourage the Islamic financial markets and in order to support the sector, there is a need for measures at both, macro level, such as clear policy and dissemination, and at a micro level, such as training on Islamic financial markets for environmental entrepreneurs. There is scope to support innovation in Islamic finance to the sector.

### **Conclusions and Recommendations**

This study has found a wide range of activities which leading IFIs may undertake to encourage sustainable development and environmentally responsible behaviour. Bringing Islamic financial markets into the role of environmental sustainability is an activity, which needs to be undertaken carefully and with sympathy to the dynamics of the Islamic financial markets. The Islamic financial markets' function is to carry out the services their clients require. Innovation is only worthwhile when it is seen to pay. Thus, there is limited demand from industrial clients for environmental financial services, other than a few specific areas of concern. Environmental companies are too small and diffused to offer a major financing opportunity for the market as a whole. Yet there is scope to work within these limitations. The potential for environment factors to

be relevant to Islamic financing and investment decisions is greatly limited by the lack of useable information on these issues. The demand for environmentally oriented funds should be really increased if obstacles to their sales are overcome. Supporting niche activities more directly, such as the development of innovative Islamic financing approaches, should help encourage their development.

The following policy options are recommended for consideration by the Islamic Development Bank, the IFIs and the OIC. The options have been chosen on the basis of the potential to have a major long-term environmental benefit. In addition, many of the policy options chosen do not involve spending huge public funds or impose major burdens on industries. Indeed, one of their key aspects is that they are likely to improve the functioning of existing policy measures.

The Islamic Development Bank should establish an institute, namely 'the Islamic Institute for Sustainable Developmental Research', within the structure of the Islamic Development Bank in order to conduct research, disseminate information and to encourage Islamic financial institutions to undertake the environment seriously.

IDB/OIC may take a lead role in improving the flow of environmental information relevant to the financial markets. This could be done through the standardization and improvement of information collection and through the development of environmental reporting standards targeted at the Islamic financial markets.

IDB/IFIs should also consider taking action to increase the demand for environmentally responsible investment. Such action would create substantial demand based incentives for Islamic financial institutions to develop environmental expertise and products. Actions include: as part of its involvement in consumer investment protection: requiring Islamic financial institutions to ask investors if they are concerned about how their money is invested in the environment and in development, and as part of its eco-labelling scheme: a label for environmentally responsible investments.

IDB/IFIs should consider ways to encourage the development of environmental Islamic financial products for business and consumers. One cost effective mechanism for IDB/IFIs would be to support rewards for innovation in environmental finance. This would provide an incentive for companies and would enable publicity and dissemination.

IDB/IFIs are also advised to consider ways to improve their existing support of the environmental business sector by investing in the potential role for public sector, investment banks to take the lead in encouraging private sector finance to support the sector, and by involving the Islamic financial markets more closely in the supportive activities. This ensures that the recipients are aware of broader financing issues and the Islamic financial sector is able to step in as public sector support ends.

The overall consequence of the suggested policy actions would be to make Islamic financial institutions a positive force to participate in the sustainable development programmes. Such a programme of action would provide a major complement to, and reinforcement of, other more conventional environmental policy actions and would help achieving the objectives of sustainable development.

## Comment

**Abulhasan M. Sadeq**

The very nature and principles of Islamic finance, used by Islamic Financial Institutions (IFIs), involve investment and partnership in economic activities rather than working merely as a financial intermediary, as is the case with Conventional Financial Institutions (CFIs). Thus the financial operations of IFIs tend naturally to have positive implications for sustainable development (SD), which may not be as true for their conventional counterparts.

The chapter deals with the role of IFIs in SD. It is rightly mentioned that a formal Islamic theory of SD is not available which does not, however, imply that such a theory cannot be developed. A number of ideas and concepts like *tawhīd*, duality (*zawj*), balance, rational consciousness, *zakāh*, *ribā*, environment, etc., are discussed. However, the entire chapter seems to be more or less centred around environment and its role in SD. Even the role IFIs in SD has been confined mainly to policy suggestions as to how to make IFIs environment friendly financial institutions, rather than how IFIs can contribute to SD due to their methods of financing which are different from those of their conventional counterparts, although the title of the chapter tends to make one to expect the later instead of the former. While a reference to environment is important in the context of SD, but it would be useful to consider other variables including education, poverty, production and consumption patterns, health, science, agriculture, industry, business, and energy<sup>51</sup> that are important for SD as well.

The issue of corporate responsibility in the context of SD is discussed with respect to different models. No doubt corporate responsibility in SD is an important area that needs emphasis but its relevance to the present discussion seems to be less than appropriate, unless a linkage is established between corporate responsibility and SD through IFIs. The authors have discussed several models of corporate responsibility such as ethical model, static model and liberal model. According to the authors, ‘the origin of the first ethical model of corporate responsibility lies in the pioneering efforts of 19<sup>th</sup> century philanthropists such as the Cadbury brothers in England’. In the absence of elaboration<sup>52</sup>, a reader may be puzzled with questions in his mind, such as the following:

What are the ‘pioneering efforts’ that provide ‘the first’ ethical models of corporate responsibility in the 19<sup>th</sup> century such as that of the Cadbury brothers? If it is the philanthropic effort of the Cadbury brothers,<sup>53</sup> such efforts must exist in the Islamic history long before 19<sup>th</sup> century, for example, in the form of *waqf*, both at the individual and corporate levels. So, in what sense such efforts of 19<sup>th</sup> century provide ‘the first’ ethical models of corporate responsibility? Even the authors have indicated many Muslim firms doing this, some of whom should be before 19<sup>th</sup> century. Furthermore, what is the meaning of the first ethical ‘formal’ model of corporate responsibility? It seems to be an action on the part of some philanthropists rather than a ‘formal’ model, theoretical or otherwise. How to link such ethical responsibility to IFIs or SD? Some elaboration from the authors would have clarified such queries in the minds of some readers.

In the ‘Static Model’, the authors have referred to the office of the consumer protection, the *muhtasib* (the institution of *hisbah*). In this context, it would be useful to provide the linkage between the institution of *hisbah* and SD, and to elaborate why it has been termed as a static model. In the liberal model, the authors refer to the Friedmanian free economy model in which the corporate sector does not assume any social responsibility other than pure economic motives. It is not very clear in what sense it is a liberal model of corporate responsibility, and in what sense it is related to IFIs or SD?

In the section on the role of the Islamic financial institutions, the authors have dealt with three matters: (a) a transaction model of Islamic financial markets, (b) strategies to motivate the Islamic financial sector, and (c) role of Islamic banks, the investment sector, and the insurance sector. The transaction model of Islamic financial markets is based on the assumption that the Islamic markets will be motivated solely by their economic interest, namely, profits; and environmental considerations will be made only if these are in the interest of the IFIs and/or firms. This presents a model of Islamic economy that is a true replica of capitalism, which is absolutely based on self-interest, at least in a theoretical sense of pure capitalism. This notion is not in conformity with the Islamic norms of business and economic activities. The Islamic concepts of *la darara wa la diraar* (do not hurt others and do not get hurt) and that of social interest along with individual interest, including the matters of externalities, coupled with the

social imperatives built in the concept of *infāq* (spending for the sake of Allah) for public welfare, require Islamic markets to go beyond the considerations of self-interest.

The above assumption of self-interest has been reflected in the model itself. It is not clear how it is a transaction model of an Islamic financial market, or how is it different from a conventional model. Decision making in any conventional financing also depends on relevant business information, the analysis with respect to perceived risks and profitability, involving different factors such as market price, finance, aftercare, repayments and so on.

The chapter deals with both ‘niche’ and ‘general’ strategies that will motivate or facilitate environment friendly undertakings. The factors leading to SD have again been limited to environment, which seems to be a partial view of the phenomenon. The suggested strategies favourable for SD are not the ones that are built in the Islamic system and thus normally adopted by IFIs, but rather those which, according to the authors, should be adopted by the IFIs. Thus, these are not the usual advantages of the IFIs to indicate that the IFIs are superior over CFIs with respect to SD, but rather these are mere suggestions.

These suggestions are in no way specific to IFIs, but rather all of them may equally be applicable to the CFIs. Only one strategy ‘developing green products in compliance with *Shari‘ah* for clients and customers’ may be specific to Islamic finance. But even this may be adopted by the CFIs as well, since many CFIs in Muslim countries presently possess Islamic windows. In any case, this is an appreciable suggestion to develop appropriate *Shari‘ah* approved products.

It has been observed in the chapter that ‘some Islamic banks have made considerable progress in developing internal environmental management systems to reduce their own environmental impact’. Also, ‘some Islamic banks include some environmental analysis into their credit assessment process’. Further, ‘it has been observed that there is growing popularity in developing environmental management systems (EMS) and the improvement of reporting within Islamic banks’. These are encouraging information. It would be useful, however, to elaborate these matters and to relate how would these contribute to SD.

An important observation on the discussion of the role of IFIs in the context of Islamic banks is that the Islamic banks, due to the nature of their operation which are

built in the Islamic system, have not been found or shown to be superior to conventional banks with respect to SD, but rather policy suggestions have been made to make environmental consideration during their financing. Similar suggestions can be made for conventional banks as well, and hence IFIs do not have any comparative advantage over CFIs in SD due to their being Islamic banks.

In investment, IFIs have been advised to send signals to the companies to adopt environment friendly strategies for getting financial capital, share ratings and company valuations by equity markets, and so on. These are again policy suggestions for making IFIs environment conducive financiers, which may equally be valid for CFIs, and hence IFIs do not seem to have any advantage over CFIs with respect to SD.

With respect to the role of Islamic insurance in SD, the approach taken seems to discuss strategies to face the challenges of environmental risks on the part of the Islamic insurance institutions in providing insurance coverage, rather than how Islamic insurance can contribute to SD due to its nature of finance, which is different from that of conventional insurance companies, or how Islamic insurance can be made as an environment friendly financial institution.

As we know, some modes of financing in case of IFIs, especially Islamic banks, are distinctively different from those of CFIs, which are favourable for sustainable development. Agreeably, the most important and desirable modes are *mudārabah* and *mushārahah*, which provide a relationship of industrial partnership between IFIs and the clients, instead of IFIs being mere financial intermediaries. This partnership on the part of IFIs will contribute to industrial and economic progress. Excess liquidity often emerges as a serious problem in financial institutions, which breaks the continuity in the pace of fund use and development and, in turn, in SD. The application of *mudārabah* and *mushārahah* modes in financing can help solve this problem by facilitating full utilization of fund, *ceteris paribus*.

An example may clarify this matter, which can be demonstrated by a hypothetical case<sup>54</sup>. In order to do this, let us make some assumptions. First the pre-decided profit ratio between a *mudārabah* entrepreneur and the contributor of capital is 60:40; and that if the money is borrowed from a conventional bank, the interest rate is \$10 for \$1,000 per project period. Second, the project life is three months (meant for trading). The example is presented in Table 4.1. In this example, an entrepreneur can invest up to

\$9000, since marginal efficiency of capital equals interest payment at this level of investment. That is, when the entrepreneur adds \$1000 to previous investment of \$8000, he earns \$10 as profits, which he has to pay entirely to the financier leaving nothing for himself. His total profit after interest payment is \$505 (=\$595-\$90) when \$9000 is invested. If he invests \$8000 instead, he still earns \$505 (\$585-\$80). Therefore, it will be less risky for the entrepreneur to invest \$8000 instead of \$9000.

*Table 4.1* Full utilization of funds by Islamic banks

Total Investment	Total Profits	Marginal Efficiency of Capital	Distribution of profits under Islamic Financial system ( <i>muḍārabah</i> )	
			Share of the entrepreneur	Share of the contributor of Capital
5,000	520		312.0	208.0
6,000	550	30	330.0	220.0
7,000	570	20	342.0	228.0
8,000	585	15	351.0	234.0
9,000	595	10	357.0	238.0
10,000	603	8	361.8	241.2
11,000	608	5	364.8	243.2
12,000	611	3	366.6	244.4
13,000	613	2	367.8	245.2
14,000	613	0	367.8	245.2

An entrepreneur under an Islamic financial system can continue investment profitably beyond \$9000, since he keeps on receiving positive profits up to the investment of \$13000. He may even increase investment up to \$14000 without risk, since risk is borne by the contributors of capital, although net gain from the additional investment will be zero.

It is obvious from the above hypothetical example that investment and, accordingly employment and output, is expected to be higher in an Islamic financial system, and that there is, at least theoretically, a potential of full utilization of bank funds with an obvious positive effect on economic growth, which is an essential ingredient of sustainable development.

Savings are not expected to be adversely affected by the elimination of interest in case of IFIs. Instead, savings potentiality of an Islamic economy is higher<sup>55</sup>. If this potential is fully tapped by IFIs and utilized due to its investment friendly modes of financing, the growth rate of the economy concerned is expected to be higher than that of a CFIs based economy. This will contribute to SD.

Sustainable development involves many issues and factors. Such issues and factors include environment, education, poverty, production and consumption patterns, health, science, agriculture, industry, business, and energy<sup>56</sup>. Any discussion of SD without these issues appears to be incomplete.

## Comment

### Victor Murinde

The chapter discusses the role of Islamic financial institutions (IFIs) in sustainable development programmes. Some policy issues are considered and plausible recommendations are proposed. However, there is no attempt to present case studies of IFIs or particular economies and there is no econometric work on sustainable development (e.g. trends and projections/ simulations).

The chapter mentions models of corporate responsibility in sustainable development. In this context, it may be pointed out that the four main models mentioned in the chapter do not exist in absolute form; rather in the living corporate world, corporate structures are hybrid models. The implication of this observation is that IFI are likely to mimic a hybrid model of corporate responsibility rather than the absolute form of any one model.

Among the key roles of financial institutions all over the world, in the context of sustainable development in Islamic as well as non-Islamic environments, is that financial institutions should reduce transactions costs and engender lower financial risk for all economic agents. Importantly, financial institutions should reduce agency problems through monitoring mechanisms, which minimize information asymmetry. Lower agency problems reduce the possibility of moral hazard and adverse selection problems. However, it appears that the current operational practices of Islamic banks present a departure from the convention. For example, Al-Deehani, Karim and Murinde (1999) find that given the contractual obligation binding the Islamic banks' shareholders and investment account holders to share profits from investments, an increase in investment accounts financing enables the Islamic bank to increase both its market value and its shareholders' rates of return *at no extra financial risk to the bank*. Investment account holders are, therefore, fully exposed to financial risk. This finding has serious implications for sustainable development as well as corporate social responsibility. Central banks, with oversight of Islamic banks, have a duty to internalize this aspect into their regulatory policies for Islamic financial institutions.

The conclusions and policy recommendations are plausible. However, there are a number of important issues which are not addressed. First, the role of central banks

which oversee the operations of IFIs is important. Very relevant here is the nature of the regulatory regimes for IFIs at the national as well as international level. The existing regulatory machinery for banks is seriously constrained in the face of financial globalization. Second, it should be pointed out that sustainable development requires the maintenance of the very socio-economic institutions which generate development. How is this possible in the age of globalization, as for example under WTO and GATS? I believe that these two issues are very important to be taken up.

It is regrettable that there is no attempt to present case studies of IFIs or particular economies and no econometric work on sustainable development (e.g. trends or projections or simulations). Surely, there has been a number of good case studies on Islamic banks, as well as good econometric studies on sustainable development in economies with Islamic banks! Let us think of a number of questions in sequence. *Question 1:* Can we evaluate the financial, developmental and technological developmental role of IFIs in economic development of host economies? I suppose we can do this, albeit with some limitations, if we follow Murinde and Kariisa (1997). *Question 2:* Can we quantitatively measure the contribution of IFIs to economic development, in the sense of the incremental capital-output ratio (ICOR)? I suppose we can in the context of Lifumba and Murinde (2003).

*Question 3:* Can we quantitatively measure and then forecast the contribution of IFIs to *sustainable* economic development in the host economies? I suppose we can do this if we combine elements of questions 1 and 2, and if we devise surrogate measures of *sustainable* economic development. .

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<sup>2</sup> Our Common Future (1987).

<sup>3</sup> Financing for Sustainable Development (2002), 2-29

<sup>4</sup> Asad, (1987), 133.

<sup>5</sup> Qur'ān (3:191; 38:27; 46:3).

<sup>6</sup> Qur'ān (13:3; 31:10; 36:36; 53:45).

<sup>7</sup> Qur'ān (7:56; 14:33; 15:19; 16:10-15; 54:49; 55:3-13; 67-3).

<sup>8</sup> Baker (ed.) (1998), p.80.

<sup>9</sup> Qur'ān (7:56).

<sup>10</sup> Asad, 144.

<sup>11</sup> Asad 146. In order to avoid giving a truncated version of Asad's conception of man, the following passage should also be quoted: 'The Qur'ān makes it clear that our comprehension of reality can certainly be deepened and widened by what we describe as 'mystical experience', in other words, through an intuitive, spiritual contact with the Divine and, hence, with those truths which are neither open to our self-perception nor can be fully grasped by analytical thinking.'

<sup>12</sup> Baker, Ilyas (1998), 'Flight of Time, Ecology and Islam,' *Islam and Environment*, ed. Harfiah Abdel Haleem, London: Ta-Ha publishers, p. 83.

<sup>13</sup> Qur'ān (7:31).

<sup>14</sup> Qur'ān (9:60; 59:7).

<sup>15</sup> Sardar, (1988).

<sup>16</sup> Chapra, (2000), p.119

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- <sup>17</sup> Qur'ān (2.43).
- <sup>18</sup> Khan (Lahore: Kazi, 1979), IX:286-7
- <sup>19</sup> Ansari, (1994), 'Islamic Perspective on Sustainable Development', *American Journal of Islamic Social Sciences*, 11 (3), (1994) 394-401
- <sup>20</sup> Vadillo (1991) 15.
- <sup>21</sup> Such as Qur'ān (2:275-9).
- <sup>22</sup> Siddiqi (1995), 'Towards Regeneration: Shifting Priorities in Islamic Movements', *Encounters*, Leicester, UK: The Islamic Foundation, pp.3-29.
- <sup>23</sup> Ansari, op. cit. pp. 394-401.
- <sup>24</sup> Ahmad (1976), pp.171-90.
- <sup>25</sup> John and Benjamin, the Cadbury Brothers of Birmingham, pioneered the development of chocolate around 847. Detailed history available at [www.cadburyschewppes.com/company\\_information//company\\_history/200\\_year\\_history.html](http://www.cadburyschewppes.com/company_information//company_history/200_year_history.html)
- <sup>26</sup> Harfiyah (1998) p.8.
- <sup>27</sup> Recipient of the 1976 Nobel Prize for economic science, Milton Friedman is widely regarded as the leader of the Chicago school of monetary economics.
- <sup>28</sup> Pioneer of the stakeholder and 'business ethics' concept in the context of corporate responsibilities. Freeman developed a framework for identifying and managing the critical relationships of the modern corporation.
- <sup>29</sup> At its narrowest, the term 'triple bottom line' is used as a framework for measuring and reporting corporate performance against economic, social, and environmental parameters. At its broadest, it captures the whole set of values, issues, and processes that companies must address to minimize any harm resulting from their activities and to create economic, social and environmental value. It is signified as three lines representing society, economy, and environment.
- <sup>30</sup> See the UNCED (1992)
- <sup>31</sup> Environics International, (2001).
- <sup>32</sup> Zeinelabdin, (1993), pp.61-75.
- <sup>33</sup> Samulders (1998), pp.30-65.
- <sup>34</sup> J. Holland (1995).
- <sup>35</sup> B. Gentry, et. Al (1995), p. 18.
- <sup>36</sup> It should also be noted that as a result of these differences, the precise interpretation and use of the concept of risk varies between the financial sectors.
- <sup>37</sup> KPMG (1997).
- <sup>38</sup> Harran -al, (1999).
- <sup>39</sup> Iqbal (1997).
- <sup>40</sup> Sources of information: Annual Reports of some of the large Islamic banks.
- <sup>41</sup> For example, see Annual Report- 2000 of Islami Bank Bangladesh Ltd.

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- <sup>42</sup> Various reports from the Accounting and Auditing Organisation for the Islamic Financial Institutions, Bahrain. Please see in detail Serafy -el, (1996), pp.87-107.
- <sup>43</sup> While the investment sector does have some direct environmental impacts, these are relatively modest. Generally the same issues arise as for Islamic banks, although conventional investment companies are probably less active in this area (although not oblivious to its implications – the publishing of prospectus of the Halifax Building Society, for its flotation was one of the largest printing runs in the UK, and the society did promise to plant sufficient trees to replace the damage).
- <sup>44</sup> Most investors who seek to invest in ‘green’ companies do so through some form of collective investment fund, e.g., ethically managed funds, environmental sector funds, green managed funds etc.
- <sup>45</sup> For example, ihilal-an Islamic Mutual Fund Company.
- <sup>46</sup> For more details, please see ESD (1995).
- <sup>47</sup> For more details, ISO (1995).
- <sup>48</sup> Please see, European Commission (1995).
- <sup>49</sup> ACBE (1997).
- <sup>50</sup> UNEP (1994), pp.3-16.
- <sup>51</sup> For a list of SD issues, see United Nations, Sustainable Development, Agenda 21, World Summit on Sustainable Development, held in South Africa on 26 August - 4 September, 2002.
- <sup>52</sup> No further elaboration has been provided on the model beyond the quoted sentence, except for a website reference in the footnote.
- <sup>53</sup> Since it should not be the development of Cadbury chocolate by Cadbury brothers.
- <sup>54</sup> This example is taken from Sadeq, (1990), pp. 22-23.
- <sup>55</sup> For a reasonably detailed discussion on this, see the present Commentator’s ‘Development Finance in an Islamic Economy: Domestic Sources’ in Sadeq (ed.) (1992), pp. 11-24.
- <sup>56</sup> For a list of SD issues, see United Nations, Sustainable Development, Agenda 21, (2002).