GREEN BANKING AND ISLAMIC FINANCE: A SYNERGISTIC APPROACH TOWARDS ETHICAL AND ECO-FRIENDLY FINANCING

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Abstract. *Islamic principles provide a robust foundation for environmental preservation, emphasizing responsible stewardship and ethical conduct. The concept of "Amanah" entrusts humans with the duty to safeguard the environment, with khalifah (stewardship) outlining the divine mandate for Earth management. Designated as stewards in the Qur'an, humans are responsible for judiciously managing the Earth and utilizing resources responsibly to avoid harm. This interconnectedness of Islamic principles and environmental ethics forms the bedrock for a synergistic approach between Green Banking and Islamic Finance. At the core of Islamic Finance lies the essence of ethical financing, aligning seamlessly with the goals set by Green Banking. Green Sukuk, one of the main instruments in Islamic Finance for fundraising, emerges as a powerful tool akin to green bonds. It serves as a means to channel funds specifically into environmentally friendly initiatives, offering a unique contribution to the green finance landscape. This article delves into the common goals, principles, and potential challenges that unify Islamic finance and Green Banking in their pursuit of sustainable and eco-friendly financing.*

Keywords*: Green Banking, Islamic Finance, green bond, green Sukuk*

1. OVERVIEW OF GREEN BANKING

Green banking, synonymous with sustainable or ethical banking, prioritizes financial practices centered around environmental sustainability and social responsibility. The concept gained prominence in the late 20th century, with the term "green banking" first coined in the 1990s, driven by the increasing recognition of the financial sector's impact on the environment and society. The term green banking officially appeared in 2003 with the aim of protecting the environment. Hence, (The Equator Principle) were established and approved by some of the world's leading banks, such as: Giti group – Inc, The Royal Bank of Scotland, and Westpac Banking Corporation. (**Lalon**). Green banks are defined as the banks that adopt the financing of projects that mainly preserve the environment. Some define it as the banks that provide their financial services in a way that enhances economic well-being and does not harm the environment and society. Green banking is a type of banking activity in which banks take the initiative to conduct their everyday operations. Banks that engage in such banking operations are referred to be socially responsible, sustainable, green, or ethical banks (**Hossain, Zhixia**). Tariffs for green banking services vary, covering sustainable lending, investment in renewable energy projects, and eco-friendly investment portfolios. While specific rates differ among financial institutions, many green banking initiatives aim to provide competitive financial products aligning with both profitability and environmental/social goals. Green Banks are dedicated institutions utilizing innovative financing to expedite the shift to clean energy and combat climate change. Their mission-driven nature prioritizes deploying clean energy over profit maximization.



Actively cultivating a pipeline of clean projects, Green Banks proactively seek market opportunities, addressing climate change and pursuing goals such as enhancing resilience or serving low-income communities. As enduring institutions, Green Banks establish organizational culture and expertise, with the autonomy to adapt to real-world challenges. Unlike programs, institutions can experiment, learn from failures, and iterate. Green Banks employ financing, not grants, anticipating eventual capital return to maximize impact. They focus on markets with potential payback, emphasizing proven, technically viable projects beyond the research and development stage. Financing aligns with other market development activities. With a focus on accelerating the clean energy transition, Green Banks prioritize swift market penetration to replace dirty energy, distinguishing them from programs that passively provide capital.

2. OVERVIEW OF ISLAMIC FINANCE

As indicated by the Islamic Finance Development Report 2023, the international Islamic finance sector experienced an 11% growth in its asset size, reaching US$4.5 trillion in 2022, with Islamic banking responsible for 72% of the total industry assets. Moreover, the industry has exhibited remarkable growth, surging by 163% since 2012, and there are anticipations for a further expansion to US$6.7 trillion by 2027. Green and sustainability Sukuk emerge as a focal point at COP28 in Dubai, acting as a driving force for the expansion of sustainability initiatives and Environmental, Social, and Governance (ESG) Sukuk issuance in developing nations. The global ESG Sukuk issuance reached a noteworthy milestone, totaling US$8.4 billion in 2022, marking another record- breaking year and sustaining its rapid growth trajectory since the inception of such Sukuk in 2017. As of the close of 2022, the value of Islamic ESG funds stood at US$6.6 billion, exhibiting a 14% decrease from their peak of US$7.6 billion in 2021 (**IFDI report 2023**). Islamic finance has demonstrated a commitment to socially and environmentally effective products. This aligns with thebroader goals of responsible finance. Prohibiting usury and encouraging ethical investments, Islamicfinance has shown resilience during economic downturns, further highlighting the sustainability of its ethical principles.

3. PRINCIPLES OF ENVIRONMENTAL PROTECTION IN ISLAM

Islam holds a wealth of principles that are apt for the preservation of the environment. Within Islamic teachings, there is a significant emphasis on the concept of "Amanah" or trust, signifying the responsibility entrusted to humans to safeguard the environment and its resources. It is imperative to delve into the principles of khalifah (stewardship) and trust (Amanah) (**Azmi Sharom**), as they serve

as the fundamental basis for environmental protection in Islam. This is primarily because these principles delineate the role of humans, created in this world as a caliph (khalifah). In the Qur'an, Allah conveys, "Behold, thy Lord said to the angels: 'I will create a vicegerent on earth' (**surah Al-Baqarah**). This verse elucidates those humans have been appointed as stewards on earth, tasked with the responsibility of managing the Earth to the best of their abilities. Humans, integral to God's creation, share a close relationship with the surrounding nature. Furthermore, the Qur'an asserts that the Earth is a living entity deserving of respect and careful treatment, aligning with the principle of justice. Allah S.W.T commands that the outcomes of the Earth's resources should be appropriately managed, distributed, and utilized by the inhabitants of a nation. This encompasses various resources such as agricultural produce, livestock, timber, petroleum, minerals, gold, and more (**Azmi Sharom**). It extends to human conduct towards the environment, emphasizing the avoidance of harm. It is essential to recognize that the numerous disasters and environmental harm witnessed globally stem from human greed and negligence. Hence, Muslims are enjoined to exercise caution, recognizing a moral duty to preserve the environment and uphold the rights of all living entities. Islam underscores the significance of conserving water, recognizing it as a vital natural resource essential for survival. The scarcity of water can have profound consequences on everyone, as humans can only endure for three days without it (**Mohd and Ibrahim**). Consequently, Muslims are urged to use water judiciously, and the act of wasting it is deemed a transgression. A common practice contributing to water waste is ablution, a ritual Muslims perform five times daily. Unfortunately, this often results in excessive water usage. The Prophet Muhammad (peace be upon him) explicitly discouraged such wastefulness: "'Abdallah b. 'Amr b. al- 'As said that the Prophet came upon, Sa'd when he was performing ablution and asked, "What is the meaning of this extravagance, Sa'd?" He replied, "Is there extravagance in ablution?" He said, "Yes, even if you are beside a flowing river.'' (**Ahmad and Ibn Majah**). Furthermore, Islam strongly condemns waste and extravagance. Muslims are encouraged to use resources wisely and avoid extravagance, fostering a mindset of conservation. Corruption on Earth, which includes environmental degradation, is strictly prohibited in Islam. Muslims are urged to prevent harm to the environment.

4. INTERRELATIONSHIPS BETWEEN GREEN BANKING AND ISLAMIC FINANCE

The interrelationships between Green Banking and Islamic Finance are intricately woven, sharing common principles rooted in ethical and sustainable practices. Islamic Finance, grounded in Shariah principles, prohibits usury, and ensures investments adhere to ethical considerations, while Green Banking, aligned with ethical goals, emphasizes socially responsible investments and sustainable practices. Both domains converge on the objective of environmental sustainability, with Islamic Finance focusing on ethical financing and sustainable economic development, and Green Banking directing funds towards eco-friendly projects and renewable energy. Moreover, both Islamic Finance and Green Banking endorse asset-backed financing, tying transactions to tangible assets to minimize speculative activities. They share the fundamental principles of risk-sharing and profit-and-loss sharing, fostering a partnership approach in financing. This alignment incentivizes commitment to environmentally friendly initiatives through shared risks and returns. Additionally, both sectors actively avoid investments in harmful activities, whether deemed ethically or environmentally detrimental. Islamic Finance prohibits investments in sectors such as alcohol and gambling, while Green Banking refrains from supporting environmentally harmful activities, directing funds toward

positive contributions to sustainability. Both Islamic Finance and Green Banking prioritize community welfare, with Islamic Finance seeking social justice and addressing economic disparities, and Green Banking viewing environmental sustainability as integral to community welfare. Their shared commitment to broader social good extends to global sustainable development efforts, with Islamic Finance contributing through adherence to ethical and environmentally conscious practices, and Green Banking directly aligning with global initiatives for environmental sustainability and climate action.

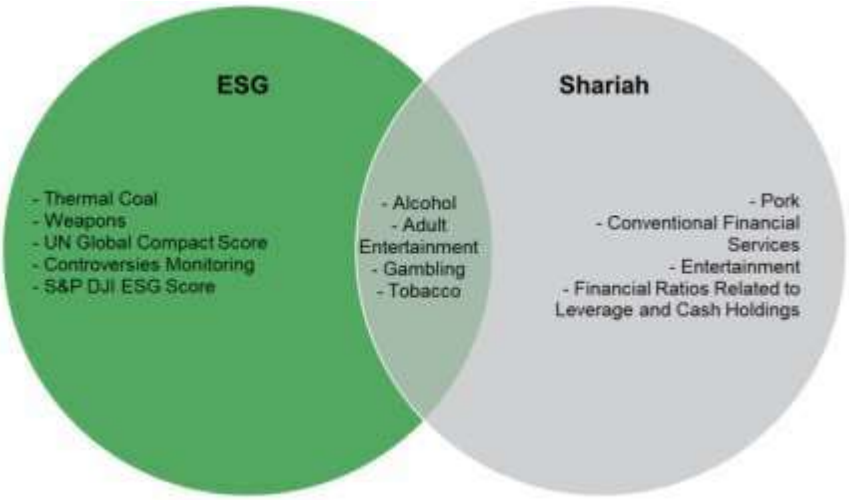
In meeting the requirements of international standards, both Green Banking and Islamic financing have their own and appropriate approaches: In the domain of Green Banking, **Corporate Social Responsibility** (CSR) involves initiatives aimed at reducing ecological footprints, supporting sustainable projects, and engaging in community welfare programs. Simultaneously, Islamic Financing embeds CSR principles by avoiding investments in activities harmful to society or the environment.

Environmental, Social, and Governance (ESG) criteria guide Green Banking to consider environmental sustainability and socially responsible investments in its decision-making processes. Similarly, Islamic Financing integrates ESG principles, emphasizing ethical and socially responsible investments in alignment with Shariah compliance.

Green banking actively contributes to achieving **UN Sustainable Development Goals** (SDGs) related to environmental sustainability, clean energy, and poverty alleviation. Islamic Financing aligns with various SDGs, contributing to poverty reduction and sustainable economic development etc.

In the realm of **Socially Responsible Investing** (SRI), Green Banking follows SRI principles by directing funds toward environmentally friendly projects and socially responsible initiatives. Islamic Financing, too, aligns with SRI by avoiding investments in harmful sectors and prioritizing ethical and socially responsible projects.

Value-Based Intermediation (VBI) is particularly relevant to Islamic Financing, where VBI emphasizes value-based decisions, ethical conduct, and social responsibility in alignment with Shariah principles (**BNM**).



Source: S&P Dow Jones Indices LLC. Chart is provided for illustrative purposes.

5. ETHICAL AND ECO-FRIENDLY FINANCING IN ISLAMIC FINANCE

Islamic finance has demonstrated a commitment to socially and environmentally effective products. Countries such as Malaysia, Indonesia, and the Gulf Cooperation Council (GCC) nations have been pioneers in integrating Islamic finance with green principles. For instance, Malaysia's Green Technology Financing Scheme, supported by Bank Negara Malaysia, has been a success story in promoting eco-friendly initiatives(**gtfs.my**). Indonesia has seen the issuance of green Sukuk to fund environmentally sustainable projects. In the GCC countries, there is a growing emphasis on Shariah-compliant sustainable finance products, aligning with their broader economic diversificationgoals. Fitch Ratings foresees continued prominence of ESG sukuk in the latter half of 2023 and beyond, driven by government sustainability initiatives in OIC countries. ESG sukuk experienced strong growth in 2Q23, totaling USD 30.5 billion, up 22% quarter on quarter. The projection is for ESG sukuk to surpass 7.5% of global sukuk in the next five years. Key issuers are concentrated in Saudi Arabia, Indonesia, Malaysia, and the UAE. In core Islamic finance markets, sukuk holds a significant share of ESG debt. The UAE has introduced regulations exempting companies listing green or sustainability sukuk or bonds from registration fees in 2023 (**Fitch ratings**).

6. CHALLENGES

Non-eco-friendly financing poses negative effects on both society and nature. This includes environmental degradation, loss of biodiversity, and social inequality. Green banking and Islamic finance offer opportunities to address these challenges through sustainable financial practices, fostering economic growth that considers environmental and social well-being. The following issues are pertinent to the sustainable development of social and economic sectors that are beneficial for both society and the environment, as well as in the establishment of an ecosystem that adheres to international standards:

Capacity Building *- developing the necessary expertise within financial institutions stands as a common challenge. This includes training professionals to assess, fund, and manage projects aligned with green and ethical principles. Capacity building is crucial for both Green Banking and Islamic Financing to navigate the complexities of environmentally conscious and Shariah-compliant investments.*

Waste Management *- financing projects related to waste reduction, recycling, and sustainable waste management poses challenges for both sectors. Effective waste management strategies are integral to the success of green financing initiatives and must comply with Shariah principles in the context of Islamic Financing.*

Financial Institutions Frameworks *– a lack of well-defined frameworks for integrating environmental, social, and ethical considerations into decision-making processes is a common hurdle. Establishing robust frameworks that align with both green principles and Shariah requirements is imperative for financial institutions operating in these domains.*

Government Regulations *- clear and supportive regulations from governments are essential for fostering a conducive environment for green and ethical financing. Both Green Banking and Islamic Financing rely on government support to create regulatory frameworks that incentivize and facilitate their respective initiatives.*

Industries Readiness *- industries may not be fully prepared or equipped to meet the stringent criteria required for sustainable and ethical financing. The commitment and investment needed for industries to transition towards sustainability are challenges shared by both sectors.*

Awareness of Society *- a lack of awareness among the general public about the benefits and options in green and ethical financing is a common challenge. Building awareness is crucial for garnering support and participation in initiatives that align with both environmental and Shariah-compliant standards.*

7. FUTURE TRENDS

The future of green financing in Islamic finance envisions a stronger embrace of technology, particularly blockchain, for enhanced transparency in Green Sukuk transactions. Smart contracts on blockchain platforms will automate processes, ensuring adherence to stringent green standards. Fintech solutions will streamline Social Islamic finance, including Cash Waqf processes and innovative structures like Cash Waqf-linked Sukuk (CWLS) issuance. *For example,* Indonesia is a country that has implemented CWLS and is effectively using its capabilities. CWLS is a mechanism for depositing waqf funds (cash waqf) in State Sukuk (SBSN) to assist the Government's social facility development program (**Hafandi & Handayati**). The CWLS scheme is considered suitable for funding environmental and social-based projects, including renewable energy projects. In addition, green construction and solar energy sectors will continue to develop through green financing (Green bonds, Green Sukuk).

Anticipated trends suggest a continued integration of fintech and blockchain across Islamic finance, ensuring transparent and secure transactions, especially in the issuance and trading of Islamic financial instruments like Green Sukuk. The commitment to refine and expand regulatory frameworks reflects an evolving, supportive environment for green finance initiatives. This transformative journey is driven by the capabilities of fintech and blockchain, securing a sustainable and environmentally conscious future for Islamic finance.

8. CONCLUSION

In conclusion, the interplay between Green Banking and Islamic finance offers a promising path toward ethical and eco-friendly financing. As global awareness of environmental and social responsibilities grows, this synergy not only contributes to sustainable development but also positions financial institutions as key players in shaping a conscientious and resilient global economy. The collaboration between these two domains represents a crucial step towards fostering a financial sector that values both profit and ethical considerations, mitigating the negative impacts of non-eco-friendly financing and contributing to the well-being of societies and the environment. The principles of Islam are embedded in Islamic finance. The operational foundation of Islamic finance and banking based on these principles means that it has the capability to meet all the criteria of green banking. Green finance and ethical investments are gaining traction in Islamic finance, aligning with principles of sustainable development. Furthermore, Implementing the extensive and beneficial opportunities presented by green banking and Islamic finance encounters several challenges. These include the need for staff capacity building, a scarcity of local ESG-focused investors and issuers, regulatory constraints, a heightened complexity in the issuance process, uncertainties surrounding pricing advantages, and additional challenges arising from market dynamics and evolving global financial landscapes.

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