

Value-based intermediation for Islamic banking institutions directed towards sustainable development goals

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ABSTRACT

In Malaysia, the adoption of sustainable investing activity started with the initial development of the Islamic funds industry in the 1980s. Moving forward, the Islamic financial industry needs to realign their focus beyond compliance towards more wholesome value-based activities in ensuring long term sustainable growth. In moving towards this focus, the Central Bank of Malaysia issued a Strategy Paper titled Value-Based Intermediation (VBI): Strengthening the Roles and Impact of Islamic Finance in July 2017. This paper aims to provide a simulation of VBI banking practices in Malaysia. The simulation affirms the potential benefits identified in the Strategy Paper: (1) Innovation: Impact-driven mind-set creates new market opportunity through development of innovative financial solutions, (2) Efficiency: Adapting current practices to enhance impact, and (3) Effective Ecosystem: Improving existing skills, supply chain or solving common issues faced by communities or other stakeholders, which eventually facilitates business success and socioeconomic wellbeing of the nation.

Keywords: Value-Based Intermediation, Islamic Banking Institutions, Sustainable Development Goal, Sustainable Responsible Investment, Social Public-Private Partnership

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INTRODUCTION

At the United Nations Sustainable Development (UNDP) Summit on 25 September 2015, world leaders adopted Sustainable Development Goals (SDGs), officially known as Transforming our world: the 2030 Agenda for Sustainable Development which includes 17 goals to end poverty, fight inequality and injustice, and tackle climate change by 2030 (UNDP, 2015). This is a universal call for all countries to adopt in accordance with their own priorities to ensure people can enjoy peace and prosperity. The focus on SDGs has gained substantial momentum in developed markets as evidenced by a growing number of major institutional funds and investors subscribing in assets based on sustainable and responsible objectives or principles. The Global Sustainable Investment Review 2014 reported that assets under management incorporating sustainability investment strategies reached \$21.1 trillion globally at the beginning of 2014, representing an increase of 61% in 2012. In 2016, the Global Sustainable Investment Review reported that from 2014 to 2016, the fastest growing region has been Japan, due to greater reporting and sustainable investing activity by Japanese institutional asset owners, followed by Australia/New Zealand and Canada. In terms of assets, the largest three regions were Europe, the United States and Canada, respectively. Such rapid growth in value-based investments in developed countries indicate that developing countries need to realign their focus towards the adoption of SDGs in order to ensure continuous investments by the global investment community.

In Malaysia, the adoption of sustainable investing activity started with the initial development of the Islamic funds industry in the 1980s. While the inherent Islamic principles adopted are in line with value-based initiatives, the main focus is offering of Islamic financial products and services that meet the needs of customers for Shariah-compliant financial services that are free of prohibited elements such as usury (*riba*) and speculation (*maysir*). The Islamic banks activities continuously focus on compliance to Shariah in ensuring legitimacy of Islamic financial products and services. Through legitimacy gained, coupled with the support of comprehensive market infrastructure, robust regulatory framework and dynamic market participants, the market share of Islamic banks in Malaysia rose from 7.1% in 2010 to 28% in 2016. However, the annual growth rate of Islamic banks has declined from 24.2% in

2011 to 8.2% in 2016. Such significant decline signals that the Islamic financial industry needs to realign their focus beyond compliance towards more wholesome value creation and value-based activities in ensuring long term sustainable growth. In moving towards this focus, the Central Bank of Malaysia issued a Strategy Paper titled Value-Based Intermediation: Strengthening the Roles and Impact of Islamic Finance in July 2017. The Strategy Paper provides an overall strategy to facilitate Islamic Banking Institutions (IBIs) adopt relevant practices, offerings and conduct that generate positive and sustainable impact to the economy, community and environment, without compromising the financial returns to shareholders. While the Strategy Paper promotes value-based intermediation (VBI) concept as a new strategy, the intended outcomes expected from the implementation of VBI are similar with several well established concepts such as Environmental, Social and Corporate Governance (ESG), Ethical Finance and Sustainable, Responsible, Impact Investing (SRI). However, the main difference between VBI and these concepts is that the main reference applied in VBI is determining the underlying values, moral compass and priorities. The implementation approach of this strategy paper is based on level of readiness of the individual Islamic banking institution (IBI). Based on their level of readiness, each IBIs are expected to indicate their respective commitment and timeline, as part of the annual business plan discussion with the Central Bank.

Value-based initiatives have been adopted by the IBIs in Malaysia even before the issuance of the Strategy Paper by the Central Bank. For instance, Al-Waqf Home Financing-i initiative to provide affordable housing by Bank Islam, in partnership with Jabatan Agama Islam Pulau Pinang and a property development company, constructed 76 residential and 9 commercial lots on a 9-acre plot in Penang. Another example, Program Rakan Ladang BERNAS on community socioeconomic development was an initiative by Agrobank, in collaboration with BERNAS to improve productivity of paddy and farmers' standards of living through the provision of RM50 million worth of working capital by Agrobank to the farmers while BERNAS provided free technical consultation. However, in the absence of a concerted efforts towards the application of the VBI concept, these initiatives may have been consciously or unconsciously applied in line with the VBI concept, resulting in suboptimal socioeconomic impact. In enhancing the understanding on the implementation of the VBI concept, this paper aims to provide a simulation of VBI

banking practices based on of the IBI in Malaysia. The simulation presented can act as a starting point in operationalisation of the VBI strategies and further developed by future empirical research.

This paper is organized as follows. First, an overview of the VBI strategies issued by the Central Bank. This is followed by a simulation of the VBI banking practices from the perspective of Agrobank. The final part of this paper presents recommendations, conclusion, limitations and suggestions for future research.

1. Literature Review

1.1. Overview of Value-Based Intermediation Banking Practices

The strategy paper by the Central Bank defines VBI as an intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, without compromising the financial returns to shareholders (Central Bank of Malaysia, 2017). This definition realigns the current focus of IBIs from pursuing a short-term and narrow bottom line objective towards long-term and wider objectives that include profit, people and planet. In this context, the strategy paper reinforces that all IBIs must adopt VBI as a common vision for the industry in order to create a collective efforts in creating greater socioeconomic impact. The adoption of VBI will facilitate IBIs to deliver products and services that are Shariah compliant as well as the intended outcomes of Shariah. The intended outcomes of Shariah are in line with the SDGs as VBI focuses on enhancement of well-being of the people through preservation of wealth, faith, lives, posterity and intellect. Preservation of wealth in the context of VBI practices encompasses encouragement to generate, accumulate and distribute the wealth in a just and fair manner. Hence, the adoption of VBI provides a distinct competitive edge in positioning Islamic finance to become more prominent and leading agent of positive change to move the Islamic financial industry to the next level of growth that is sustainable and more importantly with clear value proposition.

Adoption of VBI approach will involve three significant shifts in the current IBIs banking practices: (1) focus on introducing innovative products and services to existing and new market segments in order to create greater socioeconomic impact,

(2) adopt innovative practices or techniques in delivering the innovative products and services and (3) leverage on specific skills and infrastructure that are critical but not owned by the IBIs. Overall, an overriding component in implementing the VBI approach with optimum value creation is innovation. In addition, it is also crucial that IBIs operate in a VBI network that involves multiple stakeholders such as knowledge providers, network institutions that share knowledge and experience on value-based best practices, advocacy groups to increase awareness and support, business ventures with shared value propositions and government agencies to strengthen the VBI ecosystem. The overall effects of the implementation of the VBI approach on the banking practices is summarised as below.

Table 1: What do value-based banking practices look like?

Impact-based Assessment	Comprehensive Measurement	Impact-focused Disclosure	Constructive Collaboration	Inclusive Governance
<i>Impact-based assessment</i> provides equal attention to applications' potential impact to the society, environment and economy	Comprehensive performance measurement, covering both <i>financial and non financial indicators</i>	<i>Impact-focused disclosure</i> covers details of customers that they lend to and invest in (i.e. purpose, location and result)	Constructive collaboration with wider stakeholders, including those with no direct business relationships such as NGOs, societies and governments	Active engagement with multistakeholders including traditional and non-traditional stakeholders in decision making process
Impact	Impact	Impact	Impact	Impact
Optimum allocation of resources to productive economic activities	Balanced motivation to achieve short-term and long-term outcomes	Enhanced confidence among customers and public	New insights, wider opportunity and knowledge in improving business impact	Greater alignment between stakeholders' expectation and business focus

Source : Strategy Paper, Central Bank Malaysia (2017)

In the above diagram, one of the significant shift in the IBIs practices or techniques in delivering the innovative products and services is impact measurement. Impact measurement has attracted substantial interests in the commercial, government and social sectors to measure the social impact generated by investments. In the context of VBI implementation, the impact assessment will be focused on measuring the value creation resulting from the products or services provided. To date, the literature on impact measurement highlights that impact measurement is complex in practice, varies in approach and rigor, resulting in a number of methodologies and practices (Harvard Business School, 2015). While the availability of an array of methodologies allow the IBIs the flexibility to adopt the most appropriate measurement, it also carries the risk of the intended benefits associated with impact measurement to become diluted if a certain level of rigor is not established across the Islamic finance industry. Hence, there is an urgency for the Islamic finance industry to take the necessary initiatives in establishing a robust, credible and useful impact measurement in measuring the intended outcomes resulting from the adoption of VBI.

Of relevance to the discussion on the overview of the VBI banking practices is the promotion of Sustainable Responsible Investment (SRI) by the Islamic Finance Industry in Malaysia. SRI concept has many similarities with the VBI practices promoted in the Strategy Paper. The promotion of SRI is formalised through the issuance of the Islamic Fund and Wealth Management Blueprint by Securities Commission Malaysia in January 2017. The Blueprint promotes the integration of the principles of Islamic finance and those of Sustainable and Responsible Investment (SRI). The aim is to develop a new growth driver for the industry to enhance its value proposition and ensure its sustainability.

There is an array of definitions to describe SRI, Marwan and Ali (2015) define it as Sustainable, Responsible, and Impactful investments (Centre for Islamic Wealth Management, 2015), Socially Responsible Investment (M.S. Bennet & Iqbal, 2013; Renneboog et al., 2008), Social Responsible Investment (Ministry of Finance Malaysia, 2013) and Sustainable and Responsible Investment (CIMB, 2015; Securities Commission Malaysia, 2017). Sustainable investing is an investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management. Globally, there are now \$22.89 trillion of assets

being professionally managed under responsible investment strategies, an increase of 25 percent since 2014 (Global Sustainable Investment Alliance, 2016).

The global standard of classification, known as strategy of SRI published in the Global Sustainable Investment Alliance (2016) includes:

Table 2: Strategy of SRI

Strategy	Description
Negative/ exclusionary screening	The exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria
Positive/best-in-class screening	Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers
Norms-based screening	Screening of investments against minimum standards of business practice based on international norms
ESG integration	The systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis
Sustainability themed investing	Investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture)
Impact/community investing	Targeted investments, typically made in private markets, aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose
Corporate engagement and shareholder action	The use of shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

Source: Global Sustainable Investment Alliance, 2016

SRI strategies continued to experience growth between 2014 and 2016 as shown in Table 2.

Table 3: Growth of strategies 2014-2016

Strategy	2014 (billion)	2016 (billion)	Growth (billion)
Impact/ community investing	\$101	\$248	146%
Sustainability themed investing	\$137	\$331	140%
Positive/best-in-class-screening	\$890	\$1,030	16%
Norms-based screening	\$4,385	\$6,210	42%
Corporate engagement and shareholder action	\$5,919	\$8,365	41%
ESG integration	\$7,527	\$10,369	38%
Negative/ exclusionary screening	\$12,046	\$15,023	25%

Source: Global Sustainable Investment Alliance, 2016

The fastest growing strategies were impact or community investing (146 percent) and sustainability themed investing (140 percent). Europe and the United States were the largest contribution to both of these categories.

The ultimate aim in promoting SRI in the Islamic finance industry in the Blueprint is in tandem with the Strategy Paper, to strengthen Malaysia's positioning as a global hub for Islamic funds; to establish Malaysia as a regional centre for Shariah-compliant sustainable and responsible investments; and to develop Malaysia as an international provider of Islamic wealth management services.

The impacts on the adoption of VBI as summarised in Diagram 1 indicate that VBI will benefits the IBIs as well as other relevant stakeholders. The overall effect of the adoption of VBI on the finance industry landscape is summarised in Table 3 below:

Table 4: Current perceived landscape and future end game

	Perceived Current Financial Landscape	Envisioned Future Financial Landscape
1	Driven by short -term and narrow bottom line	Driven by long term and wider objectives (profit, people and planet)
2	Performance measurement focuses on financial aspect	Performance measurement considers both financial and non-financial aspects
3	Innovation mainly to create competitive advantage for shareholders and players	Innovation to create values for all
4	Good conduct driven by regulation	Impact-based approach that fosters

		good conduct
5	Minimal roles of other stakeholders	Meaningful and active roles of key stakeholders (consumers, employees and public)

Source : Strategy Paper, Central Bank Malaysia (2017)

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Source: Strategy Paper, Central Bank Malaysia (2017)

The envisioned future financial landscape can be explained as follows:

1. Driven by long term and wider objectives (profit, people and planet). This requires IBIs to identify the relevant value creation in identifying any particular products or services to be offered to the customers.
2. Performance measurement considers both financial and non-financial aspects. Islamic banking industry need to identify the relevant measures of non-financial aspects, in particular, the value creation or impact resulting from the products or services offered. It is crucial to provide some guidelines for the IBIs to adopt and flexible enough to cater for the needs of individual IBI. It is

equally important to formulate some mechanism in providing the assurance on the information reported based on the performance measures adopted.

3. Innovation to create values for all. Innovation in this context is not only confined to the products and services offered. For instance, IBIs collaboration with wider stakeholders is in line with the social public private partnership promoted by the Eleventh Malaysia Plan in solving social issues. This in turn will involve capability assessment of the relevant stakeholder in creating value, value creation assessment and the financing mechanism between various parties involved.
4. Impact-based approach that fosters good conduct. This approach promotes good conduct practices among the various stakeholders and also the voluntary disclosure in communicating the good conduct practices. For instance, a social purpose organisation may be one of the collaborator in delivering a value driven service to the customer. The collaborator will initially provide a forecast information regarding the expected values to be created and good governance practices in ensuring efficient and effective delivery of the services. These good conduct practices will have to be maintained in order to continue being part of the value-based network.
5. Meaningful and active roles of key stakeholders (consumers, employees and public). As the awareness on value-based initiatives increases among the key stakeholders, there will be a concerted efforts in demanding the value-driven initiatives, resulting in greater impact on the socioeconomic wellbeing of the nation.

2. Results and discussion

2.1. Simulation of Value-Based Intermediation Implementation

In this section, a simulation of the VBI implementation will be demonstrated with the aim to deepen the understanding of the Strategy Paper. For the purpose of the simulation, this paper select Agrobank, one of the Islamic Banks in Malaysia.

Agrobank was established in 1969 under the name Bank Pertanian Malaysia Berhad or BPMB (Agricultural Bank of Malaysia) by the Act of Parliament, Bank Pertanian Act No. 9/69 with an authorised capital of RM50 million and paid-up capital of RM42 million. The main function of the bank then was to co-ordinate and supervise granting

of financing facilities for agricultural purposes and mobilise savings, particularly from the agriculture sector and community. In 2005, the Central Bank of Malaysia initiated the restructuring of the bank's operations and structure to allow for bigger capital as well as to widen the scope of Agrobank's banking products, which was then limited to offering loans to farmers and entrepreneurs in the food-production industry. On 1 April 2008, the bank was corporatised as Bank Pertanian Malaysia Berhad, allowing it to operate as a commercial bank for the agriculture sector. Following the corporatisation exercise, the bank was rebranded under a new corporate identity under the name Agrobank. Since then, Agrobank has accelerated its offering of Islamic banking products and services under its Islamic banking window. This signals a positive development in tandem with the rapid growth of the Islamic banking sector in Malaysia. It is also in line with the government's target to increase Islamic financing up to 40% of total financing by 2020. As at 1st July 2015, Agrobank officially becomes a Full-Fledged Islamic Bank (FFIB) to support the Government's initiative to establish Malaysia as a conducive, strong and dynamic Islamic financial hub.

In line with the main function of Agrobank, the bank focuses on two SDGs established by the UNDP: no hunger and no poverty. Currently, Agrobank is offering a range of Islamic banking products and services such as Sahabat Agro, Hartani-*i*, Ar Rahn, AgroCash-*i*, Special Advance for Investment Assets-*i* (SAFIA-*i*), under personnel financing facilities, while Modal Usahawan 1Malaysia (MUS1M-*i*), Tanaman Semula Kelapa Sawit-*i* (SAWIT-*i*), Term Financing-*i*, Paddy-*i*, Kemudahan Pembiayaan Modal Kerja-*i*, Machinery and Equipment Financing-*i* (MAEF-*i*), AgroCash Line-*i*, Strategic Alliance Financing-*i* (SALF-*i*), Fund For Food (3F).

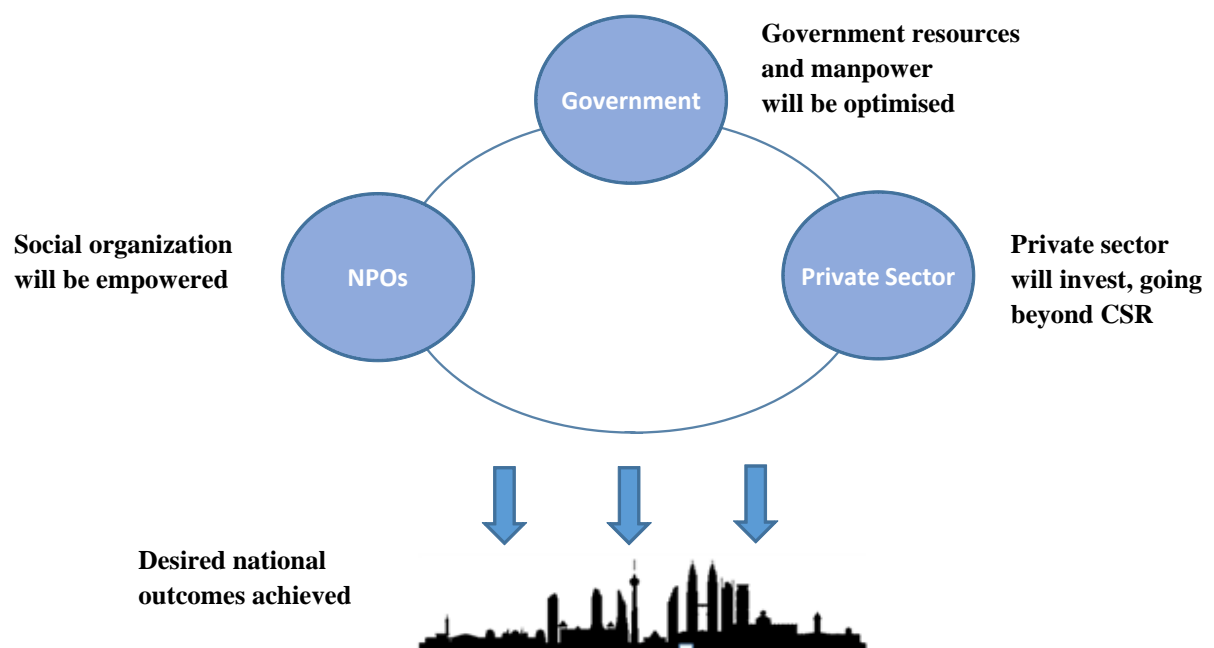
In this simulation, assume a project to provide financing to a community of farmers in enabling them to scale their production and increase their household income. The proposed project will be able to enhance the farmers' agricultural produce to support the food consumption of the nation as well as increase their socioeconomic wellbeing. The steps involved in this proposed project will be described from the perspective of the Strategy Paper (Central Bank of Malaysia, 2017).

Step 1: Consultations with wider stakeholders, including those with no direct business relationships such as NGOs, societies and governments

This step aims to identify the opportunity to improve business impact in creating value to the community, such as new growth areas or undeserved segment. In this

context, the business focus of Agrobank is more realign with the enhancement of the socioeconomic goals by the government. The consultation process is also in line with the current approach promoted by the government in addressing social issues in Malaysia. Currently, the government is promoting a collaborative approach between the government, private organisations and social organisations in enhancing the socioeconomic development. This collaborative approach is known as “Social Private and Public Partnership” or SPPP. The SPPP is an initiative under The National Blue Ocean Strategy (NBOS). SPPP taps into the strengths of the government, the private sector, and the social sector to address social disparities by looking at new ways of delivering social service. SPPP strives towards strengthening collaboration through a whole – society approach’, as part of strategies for ‘Translating Innovation to Wealth’, which is one of the six game changers under the 11th Malaysia Plan. An overview of the SPPP initiative is illustrated in Diagram 1 below.

Diagram 1: Overview of Social Public-Private Partnership in Malaysia



Step 2: Impact-based assessment on the applications’ potential impact to the society, environment and economy

Once the potential applicants have been shortlisted, the bank will then conduct an assessment on their capabilities to manage the funds and the relevant activities

effectively and efficiently in maximising the expected financial and non-financial impacts. Therefore, it is crucial that the applicants are able to demonstrate their accountability in managing the funds and delivering their social goods. Accountability in this context includes good governance mechanisms practised by the applicants and the disclosures of these practices. This in turn promotes good conduct by the applicants, even in the absence of mandatory requirements.

Assuming that an appropriate impact assessment measure is available, the objective of making an impact assessment at this stage is for due diligence pre-investment by the bank. Once the bank is satisfied with the impact and other relevant assessments, the fund will be disbursed to the applicants. Once the targeted impacts measures have been agreed between the relevant stakeholders, it will also be used throughout the period of the project. Overall, the impact measurement efforts can be grouped into four key measurement objectives (Harvard Business School, 2015): 1. estimating impact: conducting due diligence pre-investment

At this stage, impact investing organizations are interested in estimating the impact that a potential investment may create. This will facilitate the bank/investor to make more informed decisions in prioritizing its resources to create the intended impact.

2. planning impact: deriving metrics and data collection methods to monitor impact

During this stage, the bank/impact investors will devise a plan to measure impact, monitor and evaluate impact during the life of the investment project.

3. monitoring impact: measuring and analyzing impact to ensure mission alignment and performance

The impact measurement methodologies used at this stage will supplement financial data to inform whether the investee's performance is progressing accordingly. This will be conducted continuously throughout the life of the investment.

4. evaluating impact: understanding post-investment social impact of an intermediation by the bank.

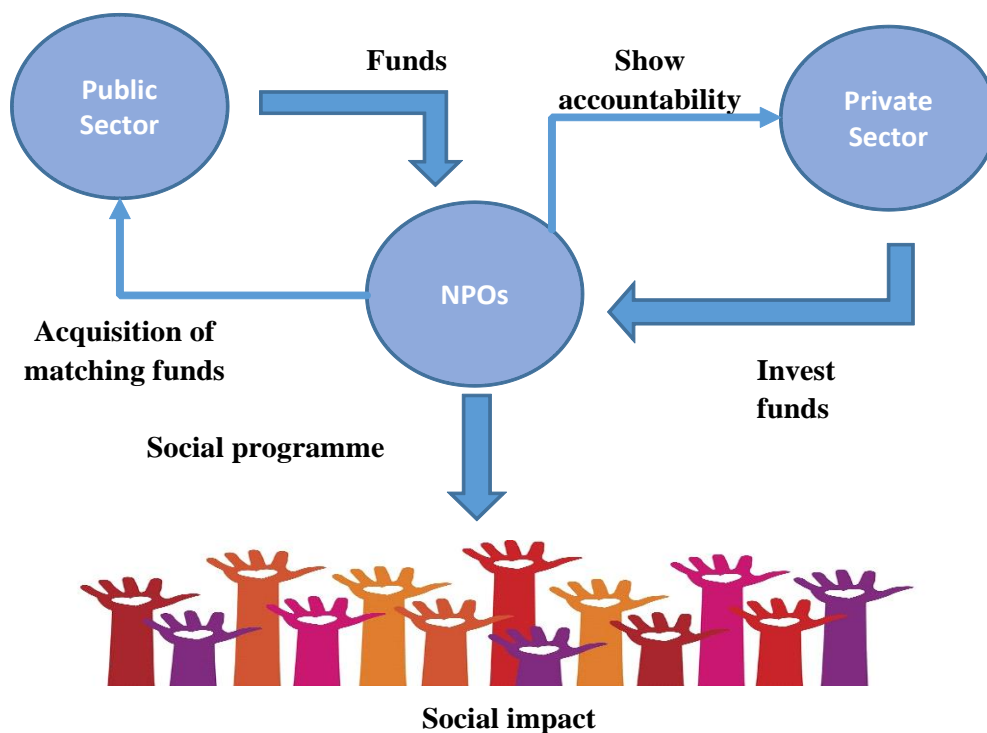
Identifying a high impact market segment through the SPPP approach is in line with the Government Transformation Programme and National Blue Ocean Strategy initiatives in finding innovative approaches in delivering high impact, low cost, and rapidly executed public services to the society. The SPPP model adopted is still at an early stage and has some differences relative to the more matured implementation of

the impact investing concept. The phases involved in implementing the SPPP model in Malaysia are as follows:

- i. It starts with the social organisations identifying the social intervention programmes that can bring measurable social outcomes,
- ii. This is followed by the social organisations securing funds from the private organisations or investors to run the social intervention programmes, and
- iii. The social organisations will then proceed to the acquisition of matching fund stage from the governments and associated institutions. Unlike the more matured PPP model, this phase is where the governments and associated institutions make payment to the amount initially provided by the investors based on measurable improved social outcomes of social projects that lead to tangible public financial savings (such as less crime and increase in employment).

The delivery of high impact products or services by the bank through the SPPP initiative is illustrated in the following diagram.

Diagram 2: High impact business focus through social public-private partnership



Step 3: Impact-focused disclosure covers details of customers that they lend to and invest in (i.e. purpose, location and result)

As multistakeholders, traditional and non-traditional stakeholders, in a VBI environment, it is important to communicate the impact findings. Hence, at this stage, impact-focused disclosure will be communicated to the relevant stakeholders. The information provided serves the following purpose:

- active engagement by multistakeholders involved in the investment in decision making process, and
- greater alignment between the stakeholders' expectations and business focus.

In achieving the above purpose, it is recommended that some guidelines are formulated in enhancing the overall impact. One example of such guideline is Principles of Good Impact Reporting produced by National Council for Voluntary Organisations in collaborations with other organisations (2012). The Principles highlighted that if applied appropriately, the principles can the relevant stakeholders to: • demonstrate accountability, a platform to engage in open and honest dialogue; • engage and inspire supporters and potential supporters; • review activities and impact against vision and purpose; • challenge assumptions and revise strategies and plans; • motivate and involve staff and volunteers; and • enhance impact to beneficiaries in the best way possible.

In summary, the above simulation highlights the benefits identified in the Strategy Paper to Agrobank as follows:

Innovation: • Impact-driven mind-set creates new market opportunity through development of innovative financial solutions that address unserved or underserved segments.

Efficiency: • Adapting current practices to enhance impact, which include effective use of resources, employees and business partners.

Effective Ecosystem: • Improving existing skills, supply chain and supporting institutions or solving common issues faced by communities or other stakeholders, which eventually facilitates business success.

Ultimately, the above benefits would improve and enhance the banks's branding image and reputation over time.

SUMMARY AND CONCLUSION

The focus on SDGs has gained substantial momentum in developed markets, creating a coercive force for developing countries to adopt. In line with this, the Malaysian government, through the Securities Commission and Central Bank, issued publications to facilitate the creation of an enabling environment in moving towards the adoption of sustainable responsible investment. The main focus of this paper is to enhance the understanding on the implementation of the VBI concept described in the Strategy Paper issued by the Central Bank. Specifically, this paper provides a simulation of VBI banking practices based on of the IBI in Malaysia. The simulation presented can act as a starting point in operationalisation of the VBI strategies in the finance industry and further developed by future empirical research.

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