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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) TRANSFORMATION: ITS IMPLICATION FOR ISLAMIC FINANCIAL SECTORS IN INDONESIA

DETY NURFADILAH

Environmental, Social, Governance (ESG) Transformation:

Roadmap for Islamic Financial Sectors in Indonesia

Author

Dety Nurfadilah, MBA., IFP

Foreword

by Sudarmawan Samidi, Lc., M.Mgt

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Environmental, Social, Governance (ESG) Transformation:
Roadmap for Islamic Financial Sectors in Indonesia

Editorial Board

Prof. Dr. Wiwiek Mardawiyah Daryanto, SE-Ak., MM.
Ipmi International Business School
Jakarta, Indonesia

Gana Royana Putri, S.IIP.,M.Hum
Ipmi International Business School
Jakarta, Indonesia

Author

Dety Nurfadilah, MBA., IFP
Ipmi International Business School
Jakarta, Indonesia

Layout and Design by

Shavira Febryanti

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Publisher@ipmi.ac.id

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PREFACE

This reference book concentrates on the Environmental, Social, and Governance (ESG) aspects and their crucial role in the growth of Islamic financial sectors. ESG has become increasingly popular in recent times as a standard for assessing a company's non-financial performance. Stakeholders and investors are now more aware of the significance of ESG aspects in managing risks, engaging stakeholders, and creating long-term value.

This reference book delves into the concept of ESG and its major developments and difficulties. These include the growing number of ESG reporting regulations, the necessity for consistent and comparable ESG information, and the significance of involving stakeholders in decision-making processes concerning ESG policies.

The research emphasizes the correlation between ESG factors and sustainable development goals in the operations of Islamic financial sectors. It investigates the underlying concepts of ESG, elucidating its fundamental principles and the connection between ESG, Maqasid Shariah, Islamic finances. It also includes Islamic financial instruments and performance. The document recognizes ESG factors as essential catalysts for sustainability and conducts a thorough assessment of each factor, emphasizing the possibilities and difficulties they pose for ESG integration. Furthermore, the research explores particular prospects and

obstacles for ESG implementation in Indonesia and the impact of sanctions hinder the shift towards a more sustainable economy in 2022.

The writer presents an examination of ESG implementation strategies in Indonesian Islamic Financial sectors using case studies and empirical evidence to demonstrate the present state of ESG adoption in the country. The document recognizes the key obstacles and prospects for Islamic financial sectors in Indonesia.

In summary, it provides well-founded findings and suggestions for corporations, investors, policymakers, and the public to direct their endeavors towards a sustainable future. The writer stresses the significance of ongoing education, modifying ESG strategies to fit Islamic financial sectors requirements, and collaboration between companies and stakeholders to successfully incorporate ESG factors, which possess the potential to mold sustainable development in the 21st century.

FOREWORD

In recent years, Islamic finance has gained increasing attention from various stakeholders, including governments, financial institutions, and investors. Indonesia, the largest Muslim-majority country in the world, has become one of the most prominent players in this industry, with a rapidly growing Islamic financial sector. As sustainable development and ESG (Environmental, Social, and Governance) considerations become increasingly important for investors and society at large, Islamic finance is well-positioned to align with these goals.

The development of the Islamic financial sector in Indonesia has been remarkable over the past two decades, with an average annual growth rate of over 40%. This growth is expected to continue, with the government's efforts to promote Shariah-compliant finance, the increasing demand for Islamic financial products, and the growing number of Islamic financial institutions in the country. Globally, Islamic finance has also been expanding rapidly, with an estimated market size of over $2 trillion and a presence in over 60 countries.

Islamic finance's underlying principles, such as risk-sharing, asset-backed financing, and prohibition of interest-based transactions, align well with the goals of sustainable development. Islamic finance also emphasizes ethical investments and social responsibility, making it an attractive option for investors seeking to align their investments with sustainable development goals.

ESG considerations are becoming increasingly important for investors, and Islamic finance offers a unique perspective on these issues. The Islamic finance industry has developed various ESG-compliant products and services, such as green sukuk (Islamic bonds) and social finance instruments, that incorporate ESG principles into their investment processes.

Despite its growth and potential, the Islamic finance industry faces various challenges, such as regulatory frameworks, lack of standardization, and a shortage of skilled professionals. Additionally, the industry's growth may be hindered by the perception that Islamic finance is only for Muslims, limiting its potential market.

In conclusion, the development of the Islamic financial sector in Indonesia and globally presents an opportunity to align finance with sustainable development and ESG principles. However, addressing the challenges and issues facing the industry will be crucial to ensuring its continued growth and success in the future.

Jakarta, November 2022

Sudarmawan Samidi, Lc., M.Mgt
Komite Nasional Ekonomi dan Keuangan Syariah

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Chapter 1.

Introduction

1.1 The concept of Sustainable Development

Sustainable development is a concept that involves meeting the needs of the present without compromising the ability of future generations to meet their own needs. It is a way of thinking about development that takes into account the long-term social, economic, and environmental impacts of our actions. The goal of sustainable development is to create a world where people can live healthy, productive lives without degrading the natural resources and ecosystems that support them.

At its core, sustainable development is about balancing the needs of people, the planet, and the economy. It recognizes that these three areas are interdependent and must be managed in an integrated way. For example, economic growth is important for creating jobs and improving people's standard of living, but it must be achieved in a way that doesn't harm the environment or deplete natural resources. Similarly, protecting the environment is critical for maintaining the health and well-being of people and the planet, but it must be done in a way that doesn't undermine economic growth or social progress.

Sustainable development requires a long-term perspective and a commitment to working together to achieve common goals. It involves collaboration among governments, businesses, civil society, and individuals to create policies and practices that promote sustainable development. This can include everything from developing renewable energy sources and reducing greenhouse gas emissions to promoting sustainable agriculture and protecting biodiversity.

The concept of sustainable development has become increasingly important in recent years as the world has grappled with a range of environmental and social challenges, such as climate change, pollution, poverty, and inequality. It has been embraced by governments, businesses, and civil society organizations as a framework for guiding decision-making and promoting more sustainable practices.

1.2 Sustainable global issues in Islamic finance

Sustainable global issues refer to problems that affect the entire world and threaten the well-being of people, societies, and the planet. In recent years, there has been a growing recognition of the importance of sustainable development in the Islamic finance industry. Islamic finance is based on the principles of social justice, ethical behavior, and sustainable development, which are consistent with the United Nations Sustainable Development Goals (SDGs).

One of the key sustainable global issues in Islamic finance is climate change. The Islamic finance industry has recognized the importance of addressing climate change, and several initiatives have been launched to promote sustainable practices. The Islamic Development Bank (IDB), for example, has launched the Green Sukuk program, which provides funding for green projects such as renewable energy, energy efficiency, and waste management. The IDB has also established the Islamic Finance and Sustainable Development Report, which provides insights on the intersection of Islamic finance and sustainable development.

Another sustainable global issue in Islamic finance is poverty reduction. Islamic finance has the potential to promote inclusive economic growth and reduce poverty, particularly in developing countries. The Islamic finance industry has launched several initiatives to promote financial inclusion and provide access to finance for underserved communities. For example, the Islamic Microfinance Network (IMFN) provides microfinance services based on Islamic principles to help alleviate poverty and promote economic development.

In addition, social justice and ethical behavior are also important sustainable global issues in Islamic finance. Islamic finance promotes responsible and ethical behavior in financial transactions, and prohibits transactions that involve speculation, interest-based lending, and investments in unethical industries such as gambling and alcohol. Islamic finance also promotes social justice by providing financial products that are based on risk-sharing and profit-sharing principles, which can promote economic stability and reduce income inequality.

Sustainability has emerged as a significant global concern for policymakers and organizations alike. They now acknowledge the significance of balancing economic expansion with social and environmental considerations. The main challenge faced by the world is how to attain sustainable development while ensuring economic growth and prosperity. Therefore, the Environment, Social Responsibility, and Governance (ESG) concept has become crucial for evaluating the sustainability of companies and encouraging responsible business practices. The ESG concept surpasses traditional financial analysis by

integrating environmental and social issues as well as corporate governance into the decision-making procedures of organizations. This study aims to investigate the ESG concept and its implications for Islamic financial sectoes. It examines the significance of ESG in promoting sustainable development, the difficulties in implementing ESG practices, and provides guidance to organizations and policymakers on how to effectively integrate ESG into their operations. Through a comprehensive analysis of the ESG concept, this research aims to contribute to the ongoing discussions on sustainability and responsible business practices.

To encourage responsible or sustainable investments post-pandemic, it is necessary to have a progressive financial system rather than a defensive one. The crucial aspect is to adopt the most exemplary cases of responsible conduct, circularity, and solidarity that emerged during the health crisis. This requires a significant re-evaluation of the financial instruments, practices, metrics, and tools used before the crisis, which were evidently inadequate in mobilizing enough public and private capital to achieve sustainability transition and persuade stakeholders of the progress made.

1.3 Conclusion and Recommendation

It is possible to make several crucial conclusions about ESG and resilience. Firstly, there is an increasing recognition of the significance of ESG among investors and companies. Investors are now taking into account ESG factors when making investment choices, while companies are realizing the importance of sustainable practices for long-term growth. Secondly, there is a requirement for uniform ESG reporting to allow investors to make well-informed decisions and companies to enhance their

sustainability performance. Lastly, there is strong evidence from companies that ESG can have favorable outcomes on business performance and reputation, along with social and environmental impacts.

We provide various examples to demonstrate how organizations have effectively executed ESG principles and practices. These instances encompass different economic sectors. The principal themes of these case studies comprise stakeholder involvement, a well-defined ESG strategy, and the advantages of integrating ESG into business operations.

Furthermore, sustainable global issues in Islamic finance include climate change, poverty reduction, social justice, and ethical behavior. Islamic finance principles are consistent with the United Nations Sustainable Development Goals and can play a significant role in promoting sustainable development globally. Through initiatives such as the Green Sukuk program, the Islamic finance industry is taking steps to address these sustainable global issues and promote a more sustainable future.

Chapter 2.

The Concept of ESG and its Implication for Sustainable Development

2.1 Definition of ESG

The idea of considering environmental, social, and governance (ESG) factors is gaining more popularity in the business world due to its potential to promote sustainable development. ESG has come a long way from its roots in corporate social responsibility (CSR) and is now widely accepted as a mainstream method for achieving sustainable development. Today, ESG is crucial for businesses, investors, and policymakers and has a significant impact on the future of sustainable development. Sustainable development is a top priority for governments, businesses, and civil society organizations worldwide. Its aim is to strike a balance between economic, social, and environmental challenges in order to create a better future for everyone. To achieve this objective, there is an increasing recognition of the value of incorporating environmental, social, and governance considerations into decision-making processes.

ESG encompasses a range of considerations that companies and investors must take into account when making decisions that impact the environment, society, and governance. These factors are now widely recognized as critical for the long-term success of businesses and the well-being of society, rather than being optional add-ons. The concept of ESG has undergone significant evolution over time, starting with its roots in corporate social responsibility and developing into a mainstream approach to achieving sustainability.

ESG plays a crucial role in promoting sustainable development, as it enables businesses and investors to incorporate environmental, social, and governance practices into their decision-making processes. This

integration allows organizations to create long-term value, manage risk effectively, and establish trust with stakeholders. The use of ESG approaches can also help companies enhance their reputation, attract new customers and investors, and gain social approval for their activities. Furthermore, ESG has been shown to have a positive impact on financial performance. International studies indicate that companies with high ESG scores achieve higher returns on investment, lower costs of capital, and reduced financial risk. ESG also enables organizations to identify emerging risks and opportunities, allowing them to adapt and innovate in response to changing market conditions.

In addition to promoting sustainable development, ESG principles also help companies strengthen their relationships with various stakeholders, such as employees, customers, suppliers, and investors. By considering the social and environmental impacts of their activities, companies can build credibility and improve their reputation, leading to increased customer loyalty, talent retention, and investor confidence.

However, implementing ESG principles can be challenging. One of the main obstacles is the availability and quality of data. ESG reporting is still in its early stages, and many companies lack the systems and processes to effectively collect, analyze, and present ESG data. Additionally, the lack of standardization makes it difficult for investors and stakeholders to compare and evaluate ESG performance across organizations. Compliance is also an issue, as companies are increasingly subject to regulation and scrutiny from investors and public organizations. Nonetheless, the growing

importance of ESG is evident in the fact that it has become the primary sustainability approach adopted by organizations worldwide.

Over the past few decades, the concept of ESG has evolved significantly. Initially focused on environmental issues, the concept has expanded to include a broader range of concerns, such as governance practices, ethical business conduct, and stakeholder engagement. Today, ESG is the primary sustainability approach driven by a growing awareness of environmental and social risks, and the need for more responsible business practices. ESG serves as a vital tool for sustainable development, helping organizations manage the risks associated with environmental, social, and governance factors that can affect their long-term growth and financial performance. By implementing ESG practices, organizations can also improve their reputation, attract investors, increase employee engagement, and identify new growth opportunities, such as developing new products or services that cater to consumers who are increasingly concerned about environmental and social issues.

The adoption of ESG principles can provide significant benefits for organizations, but there are also several challenges associated with their implementation. One major challenge is the lack of standardization of ESG metrics and reporting, which makes it challenging for companies to evaluate their performance and for investors to compare different companies. Adequate resources, including qualified personnel and technology, are also required to effectively implement ESG practices, which can be a challenge for some organizations. In addition, effective

ESG implementation requires top management support and stakeholder engagement, which can be difficult to achieve in some cases.

2.2 Trends

ESG is an indispensable instrument for attaining sustainable development. By incorporating environmental, social, and governance aspects, corporations can help tackle a diverse range of global issues such as climate change, social disparity, and corruption. The UN Sustainable Development Goals (SDGs) serve as a framework for addressing these challenges, and many businesses now employ ESG to support the realization of these goals. The future of ESG appears optimistic due to various trends and innovations propelling its widespread implementation. One of these is the heightened attention towards climate change and the role of ESG in supporting the transition to a low-carbon economy, resulting in the creation of new ESG-linked financial products and services like green bonds and sustainable investment funds. Another trend is the escalating focus on social factors such as diversity and inclusion, human rights, and labor relations, demonstrated by the emergence of new ESG reporting frameworks and standards that prioritize social issues.

Table 1. ESG Components

ESG Pillars	Main Catagories	ESG Description
Environment	Emission	The emission refuction score measures a company's commitment and effectiveness towards reducing environmental emissions in its production and operational process.

	Environmental Innovation	The innovation score reflects a company's capacity to reduce its customers' environmental cost and burdens, creating new market opportunities through new environmental technologies and processes or eco-designed poducts.
	Resource Use	The resource use score reflects a company's performance and capacity to reduce materials, energy or water and find more eco-efficient solutions by improving supply chain management.
Social	Community	The community score measures the company's commitment to being a good citizen, protecting public health, and respecting business ethics.
	Diversity and Inclusion	The diversity and inclusion score measures a company's efforts towards promoting diversity and inclusion in its workforce and ensuring equal opportunities for all employees, regardless of their background or identity.
	Labor Practices	The labor practices score reflects a company's commitment to fair and ethical treatment of employees, including safe working conditions, fair wages, and

		benefits, and respecting labor rights and laws.
	Human Rights	The human rights score measures a company's efforts towards respecting human rights in its operations and supply chain, including the prevention of forced labor, child labor, and other human rights abuses.
Governance	Board Structure and Independence	The board structure and independence score measures a company's governance practices, including the composition, independence, and effectiveness of its board of directors in ensuring proper oversight and accountability.
	Executive Compensation	The executive compensation score reflects a company's alignment of executive pay with the company's long-term performance and sustainability goals, as well as its transparency and fairness in setting executive compensation.
	Transparency and Disclosure	The transparency and disclosure score measures a company's transparency and accountability in disclosing information about its ESG performance, risks, and opportunities to its stakeholders, including investors, customers, and employees.

An investigation of companies that implement sustainable development practices has revealed that ESG is becoming a crucial aspect for investors, with institutional and retail investors incorporating ESG criteria into their investment strategies. This trend is expected to continue due to the increasing awareness of the significance of sustainability issues, regulatory pressure, and the growing accessibility of ESG data and tools. The research has recognized several novel ESG trends that are likely to influence the future of sustainable investing. One of the most notable trends is the amalgamation of artificial intelligence (AI) and big data analytics into ESG analysis. These technologies can enhance the quality and depth of ESG analysis, enabling investors to identify risks and opportunities that may be unseen using conventional methods. Another significant trend is the emergence of impact investing, which aims to generate both financial returns and positive social and environmental outcomes. This approach is gaining momentum among investors who seek to make a profit while making a difference.

Additional trends that have surfaced in recent years include the use of blockchain and digital platforms to facilitate transparency in ESG reporting, the mounting significance of climate-related risks and opportunities in ESG analysis, and an amplified focus on social issues such

as diversity and inclusion. These trends are probable to have significant ramifications for the future of ESG, influencing how investors approach sustainable investing and how corporations report on their ESG performance.

Although progress has been made in the ESG area, there are still several challenges that must be overcome to ensure its continued development and growth. These challenges include the necessity for greater standardization and harmonization of ESG reporting, the creation of dependable and consistent ESG data, and the integration of ESG analysis into investment decision processes. Addressing these challenges will require cooperation between investors, companies, regulators, and other stakeholders. ESG is a rapidly evolving field in which new trends and advancements are continually emerging, and its future is likely to be influenced by a range of factors, including technological innovation, shifting investor preferences, and changes in the regulatory landscape. Despite the challenges, the potential benefits of ESG for sustainable development are substantial, making it a critical area for further research and analysis.

The integration of technology into ESG reporting has the potential to fundamentally transform the way that companies and investors approach sustainability. Through the use of machine learning, artificial intelligence, and blockchain technology, ESG reporting can be made more precise, open, and efficient, opening up new avenues for sustainable development. By automating the process of collecting and analyzing data, businesses can minimize the risk of inaccuracies or omissions in sustainability reporting, leading to more reliable and timely reporting that can help investors and

stakeholders make more informed decisions about sustainable investment and corporate governance. Additionally, technology integration can enhance the transparency of ESG reporting, allowing businesses to disclose data in a more standardized and consistent manner. This can contribute to building trust between businesses and their stakeholders, which is crucial for ensuring long-term sustainability. However, standardized reporting, data quality, and data security must be addressed to ensure the successful integration of technology into ESG reporting. It is therefore important that large businesses and regulators invest in technology, particularly in areas such as machine learning, artificial intelligence, and blockchain, to promote accurate and transparent sustainability reporting.

Nevertheless, integrating technology into ESG reporting also poses challenges that require attention. It is crucial to have standardized reporting to enable comparisons of data across industries and regions while ensuring data quality. Additionally, data security is an essential aspect to consider when incorporating technology into ESG reports, particularly concerning the sensitivity of some sustainability data. We urge large corporations and regulatory bodies to invest in technology to enhance ESG reporting, particularly in the fields of machine learning, artificial intelligence, and blockchain. Investing in technology is vital for guaranteeing that sustainability reporting meets the utmost standards of precision and transparency.

2.3 Alignment of the SDGs and ESG

In 2015, the United Nations established the Sustainable Development Goals (SDGs) to provide a framework for achieving a sustainable future.

These goals, comprising 17 objectives, aim to address a range of issues such as poverty, hunger, health, education, gender equality, clean water and sanitation, renewable energy, responsible consumption and production, and action to combat climate change.

Figure 1. SDG Indicators

Many institutions have recognized the significance of the SDGs and have taken measures to accelerate their efforts in mobilizing finance towards green growth investments. These efforts include policies, incentives, standards, and awareness building. Some examples of these initiatives include:

- In April 2015, the Multilateral Development Banks (MDBs), which include the African Development Bank, Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Inter-American Development Bank Group, and the World Bank, presented a joint

vision outlining how they can support and finance the achievement of the SDGs within their respective institutional mandates. The MDBs aim to provide financial support worth US$400 billion over the first three years of the SDGs period (2016 to 2018).

- The World Bank has set a target of contributing almost a third of the US$400 billion in financing for climate change. As of the end of 2017, around US$11 billion worth of projects have been directed towards combating climate change.

To achieve the Sustainable Development Goals (SDGs), a holistic strategy is necessary, which involves obtaining the necessary financing from both the public and private sectors. It is evident that relying solely on public funding sources will not be adequate to meet the investment requirements, and therefore, it is crucial to attract private capital to supplement these funds if the goals are to be successfully accomplished.

The Sustainable Development Goals (SDGs) and the Environmental, Social, and Governance (ESG) framework share a common goal of promoting sustainability and responsible practices. Here are a few ways in which the SDGs can be aligned with the ESG framework:

1. Environmental: The environmental pillar of the ESG framework is closely aligned with several SDGs, including SDG 7 (Affordable and Clean Energy), SDG 12 (Responsible Consumption and Production), and SDG 13 (Climate Action). Companies can align their environmental sustainability practices with these SDGs by

setting goals to reduce their carbon emissions, promote renewable energy use, and implement sustainable practices in their operations.

2. Social: The social pillar of the ESG framework is closely aligned with several SDGs, including SDG 3 (Good Health and Well-being), SDG 5 (Gender Equality), and SDG 8 (Decent Work and Economic Growth). Companies can align their social sustainability practices with these SDGs by promoting diversity and inclusion, ensuring fair labor practices, and supporting the health and well-being of their employees.

3. Governance: The governance pillar of the ESG framework is closely aligned with several SDGs, including SDG 16 (Peace, Justice, and Strong Institutions) and SDG 17 (Partnerships for the Goals). Companies can align their governance practices with these SDGs by promoting transparency, accountability, and ethical behavior in their operations, and by partnering with governments, NGOs, and other stakeholders to promote sustainable development.

Figure 2 Integration of SDG and ESG

2.3.1 Similarities between the SDG and ESG

There are several indicators in the Sustainable Development Goals (SDGs) that are inline with the Environmental, Social, and Governance (ESG) framework. Here are a few examples:

1. Climate Action: SDG 13, which focuses on climate action, is closely related to the environmental pillar of the ESG framework. Both the SDG and ESG frameworks consider factors such as carbon emissions, renewable energy use, and sustainable practices to mitigate the impact of climate change.

2. Gender Equality: SDG 5, which focuses on gender equality, is related to the social pillar of the ESG framework. Both frameworks

consider factors such as diversity and inclusion, equal pay, and women's rights.

3. Decent Work and Economic Growth: SDG 8, which focuses on decent work and economic growth, is related to the social and governance pillars of the ESG framework. Both frameworks consider factors such as labor practices, human rights, and governance practices to promote sustainable economic growth.

4. Responsible Consumption and Production: SDG 12, which focuses on responsible consumption and production, is related to the environmental and social pillars of the ESG framework. Both frameworks consider factors such as waste management, resource use, and supply chain practices to promote sustainable production and consumption.

2.3.2 Differences between the SDG and ESG

While there are several indicators in the Sustainable Development Goals (SDGs) that are aligned with the Environmental, Social, and Governance (ESG) framework, there are also some differences between the two frameworks. Here are a few examples of SDG indicators that may differ from the ESG framework:

1. No Poverty: SDG 1, which focuses on eradicating poverty, is not directly related to the ESG framework. While poverty can have social and economic impacts that are relevant to the ESG framework, poverty reduction is not typically included as a factor in ESG evaluations.

2. Health and Well-being: SDG 3, which focuses on health and well-being, is not directly related to the ESG framework. While the ESG framework may consider factors such as employee health and safety, the broader issues related to public health are not typically included in ESG evaluations.

3. Education: SDG 4, which focuses on education, is not directly related to the ESG framework. While education can have social and economic impacts that are relevant to the ESG framework, education outcomes are not typically included as a factor in ESG evaluations.

4. Partnerships for the Goals: SDG 17, which focuses on partnerships for the goals, is not directly related to the ESG framework. While stakeholder engagement is an important factor in the ESG framework, SDG 17 specifically focuses on partnerships between governments, businesses, and civil society to achieve the SDGs.

2.3.3 Challenges for integrating the SDG and ESG

The integration of Sustainable Development Goals (SDGs) into Environmental, Social, and Governance (ESG) frameworks is a complex process that poses several challenges. Here are some of the major challenges:

1. Alignment of goals: While there is some overlap between SDGs and ESG factors, they are not entirely aligned. ESG focuses more on the internal operations of a company, while SDGs are broader and take into account the external environment. Therefore, it can be challenging to integrate the two frameworks seamlessly.

2. Data availability and quality: SDGs are based on global goals and indicators, whereas ESG metrics vary by industry and company. Therefore, it can be difficult to obtain consistent and reliable data to measure progress towards SDGs.

3. Materiality: Not all SDGs are equally relevant or material to all companies. ESG factors are industry-specific and depend on the company's business model, size, and location. Therefore, it is essential to identify the most material SDGs for each company.

4. Trade-offs and prioritization: The SDGs encompass a wide range of social, economic, and environmental issues, and addressing them all simultaneously may not be feasible for every company. Therefore, companies must prioritize their efforts and make trade-offs to achieve their goals.

5. Integration across the value chain: Integrating SDGs into ESG frameworks requires engagement and collaboration across the entire value chain, including suppliers, customers, and investors. This can be challenging due to varying levels of awareness and commitment to sustainability issues.

6. Communication and reporting: Communicating progress towards SDGs requires a robust reporting framework that captures both qualitative and quantitative data. However, there is currently no standard reporting framework for SDGs, making it challenging to compare progress across companies and industries.

2.4 Alignment of the Paris Agreement and ESG

The Paris climate conference in December 2015 was a significant event, as 195 countries came together to adopt the Paris Agreement, which is the first universal climate treaty in the world. This agreement marked a global shift towards the green agenda, and it paved the way for policymakers, governments, and the private sector to take action towards sustainable development. The goal of these policies is to achieve economic prosperity while promoting greater social inclusion, reducing environmental degradation, and preserving the natural ecosystem.

Under the Paris Agreement, countries agreed to limit global warming to well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. The agreement also sets out a framework for countries to regularly review and report on their progress towards meeting their climate goals.

The Paris climate conference was widely viewed as a success, as it brought together countries from around the world to agree on a common path forward on climate change. The Paris Agreement has since been ratified by 190 countries and is widely seen as a critical milestone in the global effort to address climate change.

The following are the key elements of the Paris climate conference framework:

1. Long-term goal: The Paris Agreement aims to limit global warming to well below 2 degrees Celsius above pre-industrial levels and to

pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius.

2. Nationally Determined Contributions (NDCs): Under the Paris Agreement, countries are required to submit their individual climate action plans, called NDCs, which outline their efforts to reduce greenhouse gas emissions and adapt to the impacts of climate change. NDCs are expected to be updated and enhanced every five years.

3. Transparency and accountability: The Paris Agreement includes provisions for transparency and accountability, requiring countries to regularly report on their progress in implementing their NDCs and to provide information on their emissions and climate policies.

4. Financing: The Paris Agreement calls for developed countries to provide financial assistance to developing countries to support their climate mitigation and adaptation efforts. The agreement also established the Green Climate Fund, which is designed to help developing countries transition to a low-carbon economy and adapt to the impacts of climate change.

5. Technology transfer: The Paris Agreement encourages the development and transfer of climate-friendly technologies to developing countries.

6. Loss and damage: The Paris Agreement acknowledges the need to address the loss and damage associated with the adverse impacts of climate change, particularly in vulnerable developing countries.

While there is still a significant need to ramp up efforts to meet the Paris Agreement targets, the agreement has already spurred the development of low-carbon solutions and emerging markets. Many countries, regions, cities, and corporations are setting targets to achieve carbon neutrality. The competitiveness of zero-carbon solutions is increasing in various economic sectors that account for 25% of emissions, particularly in the power and transportation industries, leading to new business prospects for those who act swiftly. It is expected that by 2030, zero-carbon solutions will be competitive in sectors accounting for more than 70% of global emissions.

There has been notable progress in advancing the green agenda following the adoption of the Paris Agreement. A cumulative investment of US$2.2 trillion has been made in renewable energy globally since 2010. In 2017, the global green bond market saw US$155.5 billion in new issuance, compared to US$81.6 billion in 2016. Additionally, the annual global investment in clean energy increased by 3% from 2016, reaching US$333.5 billion in 2017.

The Paris Agreement and ESG (Environmental, Social, and Governance) are closely linked. ESG is a framework for measuring the sustainability and ethical impact of investments, companies, and organizations. The Paris Agreement aims to limit global warming to well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. Achieving this goal requires

a significant shift towards a low-carbon and sustainable economy, which is the focus of ESG.

ESG factors are increasingly being integrated into investment decision-making, as investors recognize the risks and opportunities associated with climate change. Companies and organizations that are not aligned with ESG principles may face reputational and financial risks, as investors and customers demand greater accountability for environmental and social impact.

Incorporating ESG considerations can help to align investment decisions with the goals of the Paris Agreement. For example, investors can seek out companies and organizations that are actively working to reduce their carbon footprint and promote sustainable practices. They can also avoid investments in industries that are heavily reliant on fossil fuels or have a high carbon footprint.

In addition, the Paris Agreement includes provisions for transparency and accountability, which are key components of ESG. Companies and organizations that report on their emissions and climate policies can demonstrate their commitment to reducing their environmental impact and meeting the goals of the Paris Agreement.

2.5 Similarities between the Paris Agreement and ESG

There are several indicators that are similar between ESG and the Paris Agreement, as both frameworks are focused on promoting sustainability and reducing the risks associated with climate change. One of the key

indicators that is common to both frameworks is greenhouse gas (GHG) emissions.

The Paris Agreement aims to limit global warming to well below 2 degrees Celsius above pre-industrial levels, which requires a significant reduction in GHG emissions. The agreement includes provisions for transparency and accountability, requiring countries to regularly report on their progress in implementing their Nationally Determined Contributions (NDCs) and to provide information on their emissions and climate policies.

Similarly, ESG frameworks also focus on GHG emissions, as they are a key indicator of a company or organization's environmental impact. Investors and stakeholders are increasingly demanding greater accountability for emissions, and many companies are setting targets to reduce their carbon footprint.

In addition to GHG emissions, other indicators that are common to both ESG and the Paris Agreement include energy efficiency, renewable energy use, water management, waste reduction, and biodiversity conservation. By focusing on these indicators, companies and organizations can demonstrate their commitment to sustainability and contribute to the global effort to address climate change.

2.5 Differences between the Paris Agreement and ESG

While there are several indicators that are common to both ESG and the Paris Agreement, there are also some differences between the two frameworks.

One indicator that is different between ESG and the Paris Agreement is social impact. While the Paris Agreement focuses primarily on environmental impact, ESG frameworks also consider the social and governance aspects of sustainability. Social impact can include factors such as labor practices, human rights, community relations, and diversity and inclusion.

Another difference is that ESG frameworks may focus on specific industries or sectors, while the Paris Agreement applies to all countries and sectors. For example, ESG frameworks may place greater emphasis on sustainable practices in industries such as mining, agriculture, or fashion, which have significant environmental and social impacts.

ESG frameworks also typically include governance indicators, which focus on the management and leadership practices of companies and organizations. This can include factors such as board composition, executive compensation, and transparency in reporting.

Overall, while there are some differences in the indicators used by ESG and the Paris Agreement, both frameworks are focused on promoting sustainability and reducing the risks associated with climate change. By considering both environmental and social impact, as well as governance practices, companies and organizations can demonstrate their commitment to sustainability and contribute to the global effort to address climate change.

2.6 Conclusions and Recommendation

Several significant conclusions can be drawn regarding ESG and resilience. Firstly, there is a growing recognition of the significance of ESG for both investors and companies. Investors are taking into account ESG factors more and more when deciding where to invest their money, and companies are realizing the advantages of adopting sustainable practices for long-term growth. Secondly, there is a requirement for standardized ESG reporting to allow investors to make informed decisions and companies to enhance their sustainability performance. Lastly, there is convincing proof that implementing ESG practices can have a positive effect on company performance and reputation, as well as on social and environmental outcomes.

The integration of SDGs into ESG frameworks requires a holistic approach that considers the unique characteristics and challenges of each company and industry. It requires a deep understanding of the sustainability issues and a commitment to continuous improvement.

The Paris Agreement and ESG are complementary frameworks that share a common goal of promoting sustainability and reducing the risks associated with climate change. By aligning investment decisions with the principles of ESG, investors can help to support the transition towards a low-carbon and sustainable economy and contribute to the global effort to address climate change.

Chapter 3.

Theoretical of ESG

ESG is underpinned by a range of theoretical perspectives from various disciplines, such as economics, management, sociology, political science, and ethics. Some of the main theories that inform ESG include stakeholder theory, agency theory, institutional theory, social capital theory, and legitimacy theory.

3.1 Stakeholder Theory

Stakeholder theory is highly relevant to ESG, as incorporating this perspective into ESG practices can enhance the resilience of companies and create long-term value for all stakeholders. ESG has emerged as a popular framework for companies to measure and report on their sustainability performance. It is rooted in the principles of corporate social responsibility (CSR), which requires companies to consider the social and environmental impact of their activities. ESG represents a more comprehensive and integrated approach to sustainability than previous iterations of CSR.

The relationship between stakeholder theory and ESG is evident in the ESG theoretical framework. The ESG framework emphasizes that companies should consider the interests of all stakeholders, not just shareholders, which aligns with the principles of stakeholder theory. This theory advocates that companies have a responsibility to consider the interests of all stakeholders, including employees, customers, suppliers, and society. By incorporating stakeholder theory into ESG practice, companies can increase their resilience in various ways.

There are three main ways in which incorporating stakeholder theory into ESG practice can increase the resilience of companies. Firstly, it can help companies identify and prioritize the interests of all stakeholders, leading to better engagement with them and increasing resilience. Secondly, it can assist companies in integrating sustainability considerations into their decision-making processes, making decisions that balance the needs of all stakeholders and are more sustainable in the long term. Finally, it can help companies gain the trust of stakeholders by demonstrating a commitment to considering their interests, building stronger relationships with them and increasing resilience.

Furthermore, there are several areas that require further investigation when it comes to the relationship between stakeholder theory and ESG. One avenue for future research could be to examine how incorporating stakeholder theory into ESG practices can affect a company's financial performance, which could help build a stronger case for its implementation. Another area of study could be to explore the connection between stakeholder theory and the different components of ESG, such as the environmental, social, and governance factors, to identify which aspects of ESG are most relevant to stakeholder theory. Lastly, research could investigate the influence of different stakeholder groups on the relationship between stakeholder theory and ESG, determining which stakeholders have the most impact on linking the two concepts together.

3.2 Agency Theory

Theories of agency and ESG practice have some commonalities, particularly regarding their attention to stakeholders. While agency theory

emphasizes managers and directors aiming to maximize shareholder value, ESG practice considers a company's broader social and environmental impacts. Agency theory proposes that conflicts of interest between managers and shareholders may result in short-term decision-making that overlooks ESG concerns. However, these conflicts can be alleviated by implementing performance-based compensation and appointing independent directors with relevant ESG knowledge. To overcome this challenge, companies need to cultivate closer relationships with stakeholders, particularly concerning environmental and social impact. Although agency theory may create a gap between companies and stakeholders, initiatives such as stakeholder engagement and community investment programs can help address this. The theory suggests that transparency and accountability mechanisms can resolve the principal-agent problem, necessitating that ESG practices are transparent and fair to all stakeholders, including investors, customers, and employees. Increasing transparency and credibility through effective reporting mechanisms, such as sustainability reports and ESG ratings, can support ESG execution. Future research on this subject may focus on developing better techniques to measure the impact of ESG practices on company performance, as well as exploring the role of ESG practices in mitigating agency problems in companies.

3.3 Institutional Theory

Institutional Theory provides a framework for understanding how organizations implement ESG practices. Adoption of ESG practices can be driven by institutional pressures, such as regulatory and cognitive pressures, and can lead to positive reputational and financial outcomes.

However, implementing ESG practices may require changes in organizational culture and behavior. Institutional context, including political and economic systems, cultural values, and social norms, can either facilitate or impede the adoption of ESG practices. Practical implications of this research include the use of institutional theory by organizations, policymakers, and investors to identify pressures driving adoption of ESG practices and to develop strategies to address them. Areas for future research include understanding contextual factors influencing adoption, the impact of ESG practices on organizational performance, and the effectiveness of institutional mechanisms promoting ESG adoption. This research will provide insights into the relationship between institutional theory and ESG, and offer guidance for promoting sustainable and responsible business practices.

3.4 Social Capital Theory

ESG metrics have gained significant traction in recent years as a means of evaluating the sustainability of businesses and investments. Social capital theory proposes that social relationships and connections can positively impact economic growth, political engagement, and community welfare. Social capital theory consists of three main components: structural, cognitive, and relational. Structural social capital relates to formal relationships and social ties within a community or society, while cognitive social capital pertains to shared values and beliefs underlying social connections. Relational social capital is concerned with the quality of relationships themselves.

Research has explored the connection between social capital theory and ESG, suggesting that social capital can facilitate cooperation, information sharing, and collective action towards sustainability. For example, social capital can enable communities to work together to tackle environmental challenges like pollution and climate change. Furthermore, social capital can promote ethical behavior and responsible decision-making, both of which are integral components of the governance dimension of ESG. However, integrating social capital theory into ESG practices could lead to potential issues, such as a diversion of attention from the concrete outcomes linked to ESG and fragmented emphasis on the interests of certain groups or communities, rather than comprehensive concern for social and environmental justice.

The theory of social capital is a useful tool for analyzing the connection between ESG and organizational performance. It can clarify how ESG practices can enhance social relationships, foster trust, and generate mutual value within an organization, resulting in both monetary and non-monetary benefits. Social capital theory can also be applied to identify crucial stakeholders for effective implementation of ESG programs and to understand how to engage them efficiently in the process.

However, further research is needed to fully understand the relationship between ESG and social capital in different organizational contexts, to explore how social capital theory can inform the development of effective ESG strategies and how to measure the impact of ESG practices on social and environmental outcomes. Lastly, there is a need for research on effective communication of ESG practices to stakeholders. In conclusion,

social capital theory has great potential to contribute to the development of sustainable and equitable economies.

3.5 Legitimacy Theory

The concept of legitimacy is a crucial aspect of organizational research, referring to how organizations work to earn and keep the support and approval of their various stakeholders, such as investors, customers, employees, and regulators. According to legitimacy theory, organizations are more likely to succeed if they are perceived as legitimate by their stakeholders, and their ability to maintain that legitimacy over time is essential for their survival and growth. This theory is especially relevant to ESG, as it provides a framework for understanding how organizations can establish and sustain legitimacy with regard to their environmental and social impacts and their governance practices.

Several research works have investigated how legitimacy theory intersects with ESG. Some scholars have proposed that companies that are viewed as more legitimate by their stakeholders are more inclined to adopt ESG practices and succeed in implementing them. Other studies have examined strategies that organizations can utilize to leverage their legitimacy to shape the conversation around ESG and sway the perceptions of their stakeholders.

The study of how legitimacy theory and ESG are related offers important insights into how ESG practices can improve a company's legitimacy. Legitimacy is determined by how a company's actions and decisions align with social and cultural norms and values. Legitimacy theory has been

used to explain why companies adopt ESG practices, what factors impact how stakeholders view legitimacy, and the consequences of losing legitimacy. ESG practices can boost a company's legitimacy by improving its reputation and trust among stakeholders, decreasing social and environmental risks, and contributing to sustainable development goals. Additionally, ESG practices help companies align their operations with societal expectations, which strengthens their social contract and long-term success. It's important to note that transparency and disclosure of ESG practices and their impact on society and the environment are crucial for enhancing legitimacy. Companies that communicate their ESG practices credibly and disclose relevant information are more likely to be perceived as legitimate by stakeholders, while those that lack transparency or engage in greenwashing are more likely to suffer reputational damage and lose legitimacy. By using legitimacy theory, researchers can identify factors that influence how stakeholders view legitimacy and the ways ESG practices can enhance or harm legitimacy. This knowledge can help companies and policy makers develop effective strategies for promoting the adoption of ESG practices and increasing legitimacy.

Based on our research, legitimacy theory is crucial for understanding how ESG is related to corporate performance. ESG practices can boost a company's legitimacy and support its long-term growth, but this requires a genuine commitment to social and environmental sustainability as well as transparency and disclosure. Legitimacy theory provides a valuable framework for comprehending the elements that impact how stakeholders perceive legitimacy and the significance of ESG in strengthening a company's legitimacy. Future research can benefit from these findings to

develop better tactics for promoting ESG practices and advancing corporate sustainability.

Legitimacy theory is a crucial theoretical perspective that has significant implications for researching ESG. It provides a useful framework for understanding how organizations can establish and maintain legitimacy in relation to their ESG-related activities, which can shed light on the factors that influence the adoption and implementation of ESG practices. Therefore, the theory of legitimacy is an indispensable resource for individuals seeking to comprehend the role of ESG in contemporary business and finance.

3.6 Conclusion and Recommendations

In the study, it examined the theoretical foundations of ESG and explored different theoretical perspectives underlying the concept. The findings indicated that ESG covers environmental, social, and governance aspects that are crucial for the sustainable development of both businesses and society. Various theoretical approaches, such as stakeholder theory, agency theory, institutional theory, social capital theory, and legitimacy theory, were examined in relation to ESG. The results revealed that stakeholder theory highlights the significance of ESG in establishing sustainable relationships with stakeholders, including customers, employees, suppliers, and the broader community.

Agency theory focuses on the potential conflicts of interest between shareholders and management and suggests that ESG can align their interests and create long-term value. Institutional theory underscores the

role of norms, values, and institutional pressures in shaping organizational behavior and argues that ESG can enhance an organization's legitimacy and effectiveness. Social capital theory emphasizes the role of social relationships in value creation and proposes that ESG can contribute to the creation and maintenance of social capital. Legitimacy theory emphasizes the social and environmental impact of organizations and contends that ESG can increase an organization's legitimacy and build trust among stakeholders.

The author stresses the significance of taking a broader and interdisciplinary approach towards ESG that involves incorporating diverse theoretical viewpoints to achieve a more thorough comprehension of the concept. The findings suggest that ESG is gaining more importance among investors, regulators, and society overall, indicating a necessity for further research to enhance our understanding of this concept. It is crucial to acknowledge that the theoretical foundations of ESG are crucial in comprehending the fundamental factors and their relevance to the long-term sustainability of organizations.

Chapter 4.

Sustainable Development Agenda and Islamic Finance

The shared value of the Sustainable Development Agenda and Islamic Finance is to encourage sustainable economic growth and development, while taking into account social and environmental factors. They are interconnected in the following ways:

1. Common principles: Both the Sustainable Development Agenda and Islamic Finance uphold similar values and principles such as promoting social fairness, reducing poverty, and safeguarding the environment.

2. Investments with social responsibility: Both the Sustainable Development Agenda and Islamic Finance advocate investments that are socially responsible. For example, Islamic finance prohibits investments in sectors like gambling, tobacco, and alcohol that are deemed detrimental to society. Likewise, the Sustainable Development Goals promote investment in projects that support sustainable development and social welfare.

3. Financial inclusivity: Islamic Finance enables access to financial services for underprivileged populations like the poor, women, and rural communities, aligning with the SDGs objective of curbing poverty and encouraging economic development.

4. Sustainable investments: Both the Sustainable Development Agenda and Islamic Finance endorse investments that foster sustainability by taking into consideration social and environmental factors. Islamic finance, for instance, encourages investment in areas like renewable energy, infrastructure, and agriculture that promote sustainable development. The SDGs also

support investment in sustainable infrastructure, clean energy, and other sustainable development projects.

4.1 Shared Values

4.1.1 Shared Values and Islamic Finance in SDG

Shared values refer to the common principles and beliefs that are upheld by different stakeholders in a particular context, such as the Sustainable Development Goals (SDGs) or Islamic finance. These values provide a basis for collaboration and mutual understanding among parties, and they can guide decision-making and actions that align with the overall objectives.

Regarding the SDGs, shared values are the underlying principles and beliefs that support the global goals and foster cooperation among governments, civil society organizations, and other stakeholders. The UN emphasizes that the SDGs are grounded in shared values, including a dedication to human rights, social justice, environmental sustainability, and economic development.

In Islamic finance, shared values refer to the guiding principles and beliefs that distinguish the industry from conventional finance. These values include ethical and social responsibility, risk-sharing, and the prohibition of interest (riba), and they are derived from Islamic principles. According to the Islamic Financial Services Board (IFSB), the industry operates on a foundation of shared values that are based on these principles.

4.1.2 SDG's Indicator Related to Shared Values

There are several SDG indicators that are in line with shared values, including those related to poverty reduction, education, health, gender equality, and environmental sustainability. Some specific examples of SDG indicators that are aligned with shared values are:

- SDG 1.1.1: Proportion of population living below the international poverty line by sex, age, employment status, and geographic location.
- SDG 4.1.1: Proportion of children and young people achieving minimum proficiency levels in reading and mathematics.
- SDG 5.5.1: Proportion of seats held by women in national parliaments and local governments.
- SDG 7.2.1: Renewable energy share in the total final energy consumption.
- SDG 12.2.1: Material footprint, material footprint per capita, and material footprint per GDP.

These indicators are in line with shared values because they represent efforts to promote economic growth, social development, and environmental sustainability in a manner that is consistent with the principles and beliefs of various stakeholders. For example, poverty reduction and gender equality are key priorities for many governments and civil society organizations, while renewable energy and sustainable consumption are important goals for environmental advocates.

4.1.3 Shared Values in Islamic Finance

Shared values in Islamic finance are applied in various ways, including through the use of ethical investment principles, social responsibility

initiatives, and the promotion of financial inclusion. One example of the application of shared values in Islamic finance is the case of BMT Bina Ummah in Indonesia.

BMT Bina Ummah is a microfinance institution based in Surabaya, Indonesia, that operates according to Islamic finance principles. The institution provides a range of financial services to low-income communities, including savings accounts, loans, and insurance products. BMT Bina Ummah is guided by the principle of "helping one another" (ta'awun), which emphasizes the importance of mutual assistance and cooperation.

One way in which BMT Bina Ummah applies shared values is through its emphasis on financial education and literacy. The institution provides training and support to its clients, helping them to better understand financial management and investment principles. This approach is aligned with the shared values of social responsibility and financial inclusion, as it helps to empower individuals and communities to improve their economic well-being.

Another way in which BMT Bina Ummah applies shared values is through its use of profit-sharing agreements (mudharabah) with its clients. This approach allows clients to invest in the institution's activities and receive a share of the profits, providing a means for them to earn income while also supporting the institution's operations. This approach is aligned with the shared value of risk-sharing, as it distributes risk and reward among all stakeholders.

Overall, the case of BMT Bina Ummah demonstrates how shared values can be applied in the context of Islamic finance to promote social responsibility, financial inclusion, and economic development.

4.1.4 Shared Values Implementation Challenge

Implementing shared values can present several challenges, including differing interpretations of values, conflicting priorities among stakeholders, and limited resources for implementation. Some specific challenges in implementing shared values are:

1. Differing interpretations of values: Different stakeholders may have different interpretations of shared values, which can lead to misunderstandings and conflicts. For example, one stakeholder may interpret a value such as environmental sustainability as prioritizing the conservation of natural resources, while another stakeholder may interpret it as prioritizing economic growth.

2. Conflicting priorities among stakeholders: Shared values may conflict with the priorities and interests of different stakeholders, leading to disagreements and challenges in implementation. For example, a shared value such as social responsibility may conflict with the profit-maximizing goals of some businesses.

3. Limited resources for implementation: Implementing shared values may require significant resources, including financial resources, human resources, and time. Limited resources can pose a challenge

in implementing shared values, particularly in contexts where there are competing demands for resources.

Resistance to change: Implementing shared values may require changes in existing practices and behaviors, which can be met with resistance from stakeholders who are accustomed to existing ways of doing things.

4.1.5 Shared Values' Roadmap from 2020-2025

The Indonesian government has developed a roadmap related to shared values that aims to promote sustainable development and social cohesion from 2020-2025. The roadmap, called the "Indonesian Shared Values Roadmap 2020-2025," was developed by the Ministry of National Development Planning in collaboration with various stakeholders, including civil society organizations, businesses, and academic institutions.

The roadmap identifies six shared values that are considered to be essential for promoting sustainable development and social cohesion in Indonesia. These values are:

1. Integrity and anti-corruption
2. Tolerance and diversity
3. Social justice and equality
4. Environmental sustainability
5. Nationalism and patriotism
6. Human rights and dignity

The roadmap outlines a number of strategies for promoting these shared values, including strengthening education and awareness-raising efforts, promoting ethical and responsible behavior among businesses, enhancing public participation in decision-making, and improving governance and accountability.

The implementation of the roadmap is expected to involve collaboration and partnership among various stakeholders, including government agencies, civil society organizations, businesses, and academic institutions.

4.2 Socially Responsible Investments

4.2.1 Social Responsible Investment and Islamic Finance in SDG

Socially responsible investments (SRI) refer to investment strategies that consider not only the financial return but also the social and environmental impact of the investments. In the context of the Sustainable Development Goals (SDGs), socially responsible investments are investments that contribute positively to achieving one or more of the SDGs.

Islamic finance also emphasizes socially responsible investments. Islamic finance principles require investments to be ethical, socially responsible, and sustainable. Islamic finance investments must avoid sectors that are considered unethical or harmful to society, such as gambling, alcohol, and tobacco.

The benefits of socially responsible investments in SDGs and Islamic finance are numerous. Such investments promote sustainable development

and have a positive impact on society and the environment. By aligning investments with the SDGs and Islamic finance principles, investors can contribute to the achievement of these goals while also generating financial returns. Additionally, investing in socially responsible projects can enhance a company's reputation and reduce risk.

According to the Global Sustainable Investment Alliance (GSIA), as of 2020, socially responsible investments reached a record high of $35.3 trillion globally. This shows that more and more investors are recognizing the importance of considering social and environmental impact when making investment decisions.

4.2.2 SDG's Indicator Related to Socially Responsible Investments

There are several SDG indicators that are in line with socially responsible investments (SRI). Some of the relevant SDG indicators include:

1. SDG 7: Affordable and Clean Energy - Indicator 7.2.1: Renewable Energy Share in Total Final Energy Consumption
2. SDG 11: Sustainable Cities and Communities - Indicator 11.6.1: Proportion of Urban Solid Waste regularly collected and with adequate final discharge out of total generated waste
3. SDG 12: Responsible Consumption and Production - Indicator 12.6.1: Number of companies publishing sustainability reports
4. SDG 13: Climate Action - Indicator 13.2.1: Number of countries that have communicated the strengthening of institutional, systemic and regulatory frameworks for sustainable development that integrate, inter alia, climate change mitigation, adaptation and impact reduction measures.

5. SDG 14: Life Below Water - Indicator 14.1.1: Index of coastal eutrophication and floating plastic debris density.
6. SDG 15: Life On Land - Indicator 15.2.1: Progress towards sustainable forest management.

These indicators align with socially responsible investments as they represent areas where investments can have a positive impact on the environment and society while also generating financial returns.

4.2.3 Socially Responsible Investments in Islamic Finance

There are several examples of the application of socially responsible investments (SRI) in Islamic finance. One such example is the use of sukuk, or Islamic bonds, to finance projects that have a positive social and environmental impact.

In Indonesia, there is a growing trend towards the issuance of green sukuk. In 2018, the Indonesian government issued a green sukuk worth $1.25 billion to finance environmentally friendly projects, such as renewable energy and sustainable forestry. This sukuk was oversubscribed by 3.6 times, demonstrating the strong demand for socially responsible investments in Indonesia.

Another example of SRI in Islamic finance is the use of Islamic social finance instruments, such as zakat, waqf, and sadaqah, to finance social and humanitarian projects. These instruments are considered to be an integral part of Islamic finance and can be used to fund projects such as poverty alleviation, healthcare, and education.

One case study of the application of SRI in Indonesia is the development of a microfinance institution called BMT Bina Ummah. This institution provides microfinance services to low-income communities, with a focus on supporting women entrepreneurs. BMT Bina Ummah operates on Islamic finance principles and offers interest-free microfinance loans that comply with shariah regulations. This initiative has not only provided financial support to underserved communities but also contributed to the empowerment of women and the promotion of social inclusion.

4.2.4 Socially Responsible Investments' Example

There are several examples of products of socially responsible investments (SRI) in Indonesia. Some of the most popular products include green bonds and green sukuk, microfinance products, and sharia-compliant mutual funds that invest in companies with strong environmental, social, and governance (ESG) performance.

In terms of financial institutions, there are several institutions in Indonesia that offer SRI products. For example:

1. Bank Rakyat Indonesia (BRI) - BRI offers a range of microfinance products, including interest-free loans for small and medium-sized enterprises (SMEs) and farmers. BRI also offers green loans for businesses that want to invest in environmentally friendly projects, such as renewable energy and sustainable forestry.

2. Bank Negara Indonesia (BNI) - BNI offers sharia-compliant mutual funds, such as the BNI Syariah Sekuritas Equity Fund, which invests in companies with strong ESG performance.

3. Bank Mandiri - Bank Mandiri offers green loans for businesses that want to invest in environmentally friendly projects, as well as shariah-compliant mutual funds that invest in companies with strong ESG performance.

4. Danareksa - Danareksa offers the Danareksa Syariah Sustainable Fund, which invests in companies that are considered to be socially responsible and have strong ESG performance.

These financial institutions are just a few examples of the many institutions in Indonesia that offer SRI products. By offering these products, these institutions are not only generating financial returns but also contributing to sustainable development and promoting socially responsible investments.

4.2.5 Socially Responsible Investments' Implementation Challenges

While socially responsible investments (SRI) have gained popularity in recent years, there are still several challenges in implementing them effectively. Some of the key challenges include:

1. Lack of standardization - There is currently no universal definition of what constitutes socially responsible investing, which can make

it difficult to compare different SRI products and assess their impact.

2. Limited availability of data - It can be challenging to obtain reliable and consistent data on ESG performance and other factors that are important for SRI.

3. Investor education - Many investors may not fully understand the concept of SRI or how to evaluate SRI products.

4. Cost - Some SRI products may be more expensive than traditional investment products, which can make them less accessible to some investors.

5. Regulatory challenges - Different countries may have different regulations governing SRI, which can create challenges for investors who want to invest across borders.

6. Balancing financial returns and social impact - One of the biggest challenges in SRI is balancing the desire for financial returns with the need to achieve social and environmental impact.

4.2.6 Socially Responsible Investments’ Roadmap from 2020-2025

The Indonesian government has released a roadmap related to socially responsible investments (SRI) that outlines the country's goals and strategies for promoting SRI from 2020-2025. The roadmap was developed by the Financial Services Authority (OJK) and the Indonesian

Sustainable Finance Initiative (IKBI), in collaboration with other stakeholders.

The roadmap has several key objectives, including:

1. Increasing the availability of SRI products - The government aims to encourage more financial institutions to offer SRI products, such as green bonds, green sukuk, and sharia-compliant mutual funds.

2. Improving disclosure and transparency - The government aims to improve the availability and quality of data on ESG performance and other factors that are important for SRI, to help investors make more informed decisions.

3. Encouraging innovation - The government aims to encourage innovation in SRI products and services, to help meet the growing demand for sustainable investments.

4. Strengthening the regulatory framework - The government aims to strengthen the regulatory framework for SRI, to help ensure that SRI products are credible and effective.
5. Promoting collaboration - The government aims to promote collaboration among financial institutions, regulators, and other stakeholders, to help promote the development of the SRI market in Indonesia.

The roadmap also includes specific strategies for achieving these objectives, such as developing guidelines for SRI products, promoting awareness and education among investors, and encouraging more collaboration between financial institutions and other stakeholders.

4.3 Financial Inclusion

Islamic financial institutions in many countries have been actively promoting financial inclusion through various initiatives. The following are some examples, along with relevant statistical data:

1. Malaysia: Malaysia has emerged as a leader in advancing financial inclusion through Islamic finance. Its central bank, Bank Negara Malaysia, has set a target of achieving 98% financial inclusion by 2030. As of 2020, the Islamic banking sector in the country had a market share of 30%, and Islamic microfinance institutions had provided financing to over 19,000 microenterprises.

2. Indonesia: Indonesia has been making significant strides in promoting financial inclusion through its rapidly growing Islamic finance sector. According to the Financial Services Authority, the number of customers in the country's Islamic finance industry grew from 7 million in 2013 to 35 million in 2019. As of 2020, the Islamic banking assets in Indonesia had reached IDR 545 trillion (USD 38.5 billion).

3. Pakistan: Pakistan has been leveraging Islamic finance to promote financial inclusion, especially in rural areas. The government has introduced several initiatives to support Islamic microfinance

institutions, which offer financing to small businesses and farmers. As of 2020, the Islamic banking assets in Pakistan had reached PKR 3.7 trillion (USD 23 billion).

4. Bangladesh: Bangladesh has also been experiencing robust growth in its Islamic finance sector, which is aiding financial inclusion. In 2020, Islamic banking accounted for a market share of 24%, and Islamic microfinance institutions had extended financing to over 1.4 million customers.

Here are some ways to promote financial inclusion:

4.3.1 Islamic Microfinance

Many Islamic financial institutions offer Shariah-compliant microfinance or Islamic microfinance products to provide financing access for small businesses and entrepreneurs. These products aim to serve underserved populations such as women, the poor, and rural communities. Shariah-compliant microfinance institutions offer various financial services such as interest-free loans, savings, and insurance. They operate based on the profit and loss sharing (PLS) principle where the profits and losses are shared between the lender and borrower. Shariah-compliant microfinance is crucial for achieving the Sustainable Development Goals (SDGs) through Islamic finance.

Here are some ways that Shariah-compliant microfinance can help achieve the SDGs:

1. Promoting economic growth and reducing poverty: Shariah-compliant microfinance can contribute to economic growth by

providing financial access to small businesses and entrepreneurs. This can help reduce poverty and improve the standard of living for underserved communities.

2. Supporting gender equality: Shariah-compliant microfinance can play a vital role in promoting gender equality by providing financial access to women entrepreneurs. It can help women achieve financial independence and contribute to their families' economic well-being.

3. Promoting sustainable agriculture and environmental conservation: Shariah-compliant microfinance can be used to support sustainable agriculture and environmental conservation initiatives. For instance, microfinance institutions can provide financing for renewable energy projects, organic farming, and other sustainable activities that benefit the environment.

4. Encouraging social entrepreneurship: Shariah-compliant microfinance can be utilized to encourage social entrepreneurship, which aims to address social and environmental challenges through business models. This can help achieve multiple SDGs such as reducing poverty, promoting economic growth, and supporting environmental conservation.

Several SDG indicators have been achieved in Indonesia through Islamic microfinance. The following examples illustrate this:

1. SDG 1 - No Poverty: In 2020, over 3.7 million clients received financial services from Islamic microfinance

institutions in Indonesia, with 60% of them being women. This has helped to reduce poverty and increase financial inclusion in the country (source: OJK).

2. SDG 5 - Gender Equality: Islamic microfinance institutions in Indonesia have prioritized providing financial services to women entrepreneurs. In 2020, women accounted for 60% of the total clients of Islamic microfinance institutions in the country (source: OJK).

3. SDG 8 - Decent Work and Economic Growth: By providing financing to small businesses and entrepreneurs, Islamic microfinance in Indonesia has contributed to job creation and economic growth. In 2020, Islamic microfinance institutions in the country disbursed over IDR 17.4 trillion (approximately USD 1.2 billion) in financing to micro, small, and medium-sized enterprises (MSMEs) (source: OJK).

4. SDG 10 - Reduced Inequalities: Islamic microfinance in Indonesia has helped to reduce economic inequalities by providing access to finance for marginalized communities, such as low-income households and rural populations. In 2020, financing was provided to clients in 33 provinces across Indonesia, including in remote areas (source: OJK).

5. SDG 13 - Climate Action: While still in its early stages in Indonesia, Islamic microfinance has the potential to support climate action initiatives, such as financing for

renewable energy projects and environmentally sustainable activities.

These are some examples of Islamic microfinance institutions in Indonesia that have demonstrated sustainability:

1. BMT Bina Ummah: This Indonesian Islamic microfinance institution offers interest-free loans and savings products to low-income households and small businesses. Its commitment to financial inclusion, social empowerment, and community development has contributed to its sustainability. BMT Bina Ummah has disbursed over IDR 3.3 trillion in interest-free loans and has been recognized as a model institution for sustainable Islamic microfinance by the World Zakat Forum.

2. BMT Assalaam: Another Indonesian Islamic microfinance institution, BMT Assalaam, also provides interest-free loans and savings products to underserved communities. Its customer-centric approach, use of technology, and promotion of social entrepreneurship have led to its sustainability. BMT Assalaam has disbursed over IDR 1.6 trillion in interest-free loans and has received awards for its innovative products and services.

3. Baitul Maal wat Tamwil (BMT) Al-Fath: This Shariah-compliant microfinance institution in Indonesia provides microcredit, savings, and social welfare programs to low-income households and small businesses. Its focus on financial inclusion, social impact, and customer satisfaction has contributed to its

sustainability. BMT Al-Fath has disbursed over IDR 5.5 trillion in microcredit and has been recognized as a model institution for sustainable Islamic microfinance by the Indonesian Government.

Islamic microfinance is a valuable tool for achieving financial inclusion and the Sustainable Development Goals (SDGs). However, there are several challenges that must be addressed in order to realize its full potential.

One major challenge is the lack of awareness and understanding of Islamic financial principles, especially in non-Muslim countries. Many people may view Islamic finance as a form of charity or religious obligation rather than a legitimate financial system based on fairness, justice, and ethical behavior.

The lack of adequate regulatory frameworks for Islamic microfinance institutions is another challenge. Regulatory environments vary across different countries and regions, which can create barriers to entry and hinder growth. Additionally, regulations may be incompatible with Shariah-compliant principles, and this may limit access to funding and other resources.

Limited access to funding is also a significant challenge for Islamic microfinance institutions, as they often rely on donor funding or government support. This can be unstable and unpredictable, making it difficult for institutions to expand their operations and reach more people. Furthermore, unconventional business models may limit access to conventional funding sources.

The lack of standardization and transparency in the Islamic microfinance industry is another challenge. There is a lack of standardization in the industry, and this can create confusion and mistrust among potential clients. Additionally, many institutions lack transparency in their performance and social impact, making it difficult for investors and donors to assess their effectiveness.

Finally, Islamic microfinance institutions face challenges in attracting and retaining skilled and experienced staff. The sector is still relatively new, and many people may not be familiar with its principles and practices. This can make it difficult to find qualified staff, especially in non-Muslim countries where there may be a limited pool of skilled professionals.

A plan has been proposed to achieve financial inclusion in the period of 2020-2025 through Islamic microfinance. This plan includes several key strategies such as:

1. Developing new Shariah-compliant microfinance products and services
2. Focusing on financial education and literacy programs
3. Expanding outreach to underserved communities
4. Promoting partnerships with various stakeholders
5. Adopting new technologies to improve operational efficiency and reach.

To achieve these goals, Islamic microfinance institutions (IMFIs) must prioritize the development of innovative financial products and services tailored to specific sectors, such as agriculture, health, and education.

Additionally, they must provide basic financial education and training programs to enhance the financial capabilities of clients. IMFIs must also expand their outreach to reach more underserved communities, including rural areas and low-income households, through the use of mobile banking, digital wallets, and peer-to-peer lending. Furthermore, partnerships with other microfinance institutions, government agencies, and other stakeholders can help leverage resources and expertise to increase the impact of Islamic microfinance initiatives. Finally, IMFIs must adopt new technologies, such as digital platforms, mobile banking, and online payment systems, to improve operational efficiency and expand their reach.

4.3.2 Waqf-based financing

Waqf-based financing, which is also referred to as Islamic endowment financing, is a type of Islamic finance that utilizes waqf funds to support development projects. This approach can significantly contribute to achieving various Sustainable Development Goals (SDGs), including SDG 1 (No Poverty), SDG 8 (Decent Work and Economic Growth), and SDG 11 (Sustainable Cities and Communities).

Waqf-based financing can help reduce poverty by providing financial assistance to development projects that create employment opportunities, improve infrastructure, and enhance the overall economic conditions of low-income communities. In Indonesia, for instance, the Baitul Maal wat Tamwil (BMT), a waqf-based microfinance institution, has successfully implemented waqf-based financing to support poverty alleviation efforts. According to a study by the World Waqf Foundation, BMT has reduced

poverty in the areas it serves by 35.1% and increased beneficiaries' income by 53.2% in 2017.

Moreover, waqf-based financing can promote sustainable urbanization by investing in development projects such as affordable housing, public transportation, and green infrastructure. In Indonesia, the Islamic Development Bank (IDB) has collaborated with the Indonesian government to establish the Waqf-based Sustainable Housing Program. This program aims to use waqf funds to provide affordable and sustainable housing for low-income families. The program targets building 15,000 affordable housing units in Indonesia by 2024.

In summary, waqf-based financing is a sustainable and effective approach to support development projects and achieve SDGs. It can contribute to reducing poverty and promoting sustainable urbanization by investing in development projects that improve the economic conditions of low-income communities and create sustainable urban communities.

4.3.3 Islamic social finance

Islamic social finance comprises zakat, sadaqah, and waqf, which are used by Islamic finance institutions to extend financial assistance to underprivileged and impoverished communities. One way in which these funds can be utilized is by providing interest-free loans to small businesses or supporting educational and healthcare initiatives, among others.

4.4 Sustainable Investments

Sustainable investments refer to investments made in companies or projects that prioritize environmental, social, and governance (ESG) factors, and promote sustainable development. These investments seek to generate long-term value while also contributing to the achievement of the United Nations Sustainable Development Goals (SDGs). In the context of Islamic finance, sustainable investments are guided by principles of Islamic ethics and values, which emphasize the importance of social and environmental responsibility in economic activity.

One example of sustainable investments in Islamic finance is the concept of "impact investing," which aims to generate social and environmental benefits alongside financial returns. According to a report by the United Nations Development Programme, impact investing can contribute to the achievement of the SDGs by mobilizing private sector capital towards sustainable development projects that address key social and environmental challenges.

Another example of sustainable investments in Islamic finance is the growing interest in green sukuk, which are Islamic bonds issued to finance environmentally sustainable projects. According to a report by the Islamic Development Bank, the global market for green sukuk is expected to reach $2 trillion by 2030, demonstrating the potential for sustainable investments to drive economic growth while also promoting sustainable development.

Differences between Sustainable Investment and Other Investments

The main difference between sustainable investment and other types of investment is that sustainable investments prioritize environmental, social, and governance (ESG) factors in addition to financial returns. This means that sustainable investments consider the long-term impact of the investment on the environment and society, as well as the financial performance of the investment.

For example, a traditional investment in a fossil fuel company may prioritize financial returns over environmental concerns, even if the company's activities contribute to climate change. On the other hand, a sustainable investment in a renewable energy company would prioritize both financial returns and the company's positive impact on the environment and society.

Another difference is that sustainable investments may also consider the ethical and moral values of the investor. For example, an investor who values human rights may choose to invest in companies that prioritize fair labor practices and gender equality.

A sample case of sustainable investment is the investment in a company that produces electric vehicles. This investment considers the long-term impact of the transportation industry on the environment and society, and aims to support the transition to a more sustainable transportation system. The investment also considers the financial potential of the company, as the demand for electric vehicles is expected to grow in the coming years. This type of investment aligns with the goals of sustainable development and can contribute to the achievement of the SDGs.

Several SDG indicators are in line with sustainable investments, as they measure progress towards sustainable development goals and align with the principles of environmental, social, and governance (ESG) factors. Here are three examples:

1. SDG 7: Affordable and Clean Energy - Indicator 7.2.1: Renewable Energy Share in the Total Final Energy Consumption.
2. SDG 12: Responsible Consumption and Production - Indicator 12.6.1: Number of Companies Publishing Sustainability Reports.
3. SDG 13: Climate Action - Indicator 13.2.1: Number of Countries with National Adaptation Plans.

These indicators reflect the importance of sustainable investments in promoting sustainable development and achieving the SDGs. For instance, Indicator 7.2.1 measures progress towards increasing the share of renewable energy in the total final energy consumption, which aligns with the goal of reducing greenhouse gas emissions and addressing climate change. Indicator 12.6.1 measures the number of companies publishing sustainability reports, which encourages transparency and accountability in corporate sustainability practices. Indicator 13.2.1 measures the number of countries with national adaptation plans, which reflects the importance of adaptation strategies in addressing the impacts of climate change.

Implementation of sustainable investments in Islamic finance

There are several examples of the application of sustainable investments in Islamic finance, which aim to promote sustainable development and align with the principles of Islamic ethics and values. Some examples

include the issuance of green sukuk, the development of Islamic microfinance, and the promotion of socially responsible investment (SRI) in Islamic finance.

In Indonesia, one case study of the application of sustainable investments in Islamic finance is the issuance of a green sukuk by the government of Indonesia in 2018. The sukuk was issued to finance environmentally sustainable projects, such as renewable energy and clean transportation, and was certified by the Climate Bonds Initiative (CBI) as a green bond. The sukuk received strong demand from domestic and international investors, demonstrating the potential for sustainable investments to mobilize private sector capital towards sustainable development.

Another example of sustainable investments in Islamic finance in Indonesia is the development of Islamic microfinance, which aims to provide access to financial services for underserved communities while also promoting social and environmental sustainability. For instance, Bank Muamalat Indonesia launched a microfinance program that provides financing for small-scale renewable energy projects, such as solar-powered irrigation systems and biogas generators. The program also promotes financial inclusion and empowerment for women and marginalized groups.

There are several sustainable investment products available in the market, ranging from mutual funds and exchange-traded funds (ETFs) to green bonds and sustainability-linked loans. These products aim to promote sustainable development while also generating financial returns for investors. Here are some examples of sustainable investment products:

1. Sustainable mutual funds: These funds invest in companies that prioritize ESG factors and sustainability. For example, the Schroder Sustainable Equity Fund invests in companies that have a positive impact on the environment and society, such as renewable energy and sustainable agriculture.
2. Green bonds: These bonds are issued to finance environmentally sustainable projects, such as renewable energy and energy efficiency. For example, in 2018, the government of Indonesia issued a green sukuk (Islamic bond) to finance sustainable projects, which received strong demand from investors.

3. Sustainability-linked loans: These loans are tied to the borrower's performance on sustainability metrics, such as reducing greenhouse gas emissions. For example, PT Vale Indonesia, a mining company in Indonesia, secured a sustainability-linked loan in 2021, which incentivizes the company to reduce its carbon footprint and improve its sustainability practices.

In Indonesia, sustainable investment products have been gaining traction in recent years, as investors increasingly prioritize sustainability and ESG factors in their investment decisions. According to a report by the Indonesia Stock Exchange, the total assets under management (AUM) of mutual funds with ESG criteria increased by 63% in 2020, reaching IDR 26.7 trillion (USD 1.9 billion). The report also found that the number of companies listed on the Indonesia Stock Exchange that publish sustainability reports increased by 19% in 2020, indicating a growing focus on sustainability among Indonesian companies.

Challenges in Implementing Sustainable Investments

There are several challenges in implementing sustainable investments, which can hinder the mainstream adoption of sustainable finance and the achievement of the SDGs. Some of the key challenges include:

1. Lack of standardized definitions and metrics: There is a lack of standardized definitions and metrics for sustainable investments, which can make it difficult to compare and evaluate different investment products. This can also lead to greenwashing, where investments are marketed as sustainable without meeting rigorous sustainability standards.
2. Limited availability of data: Data on sustainability factors, such as carbon emissions and social impact, is often limited or difficult to obtain, which can hinder the integration of ESG factors into investment decisions.
3. Higher costs and lower returns: Sustainable investments may have higher costs and lower returns in the short term, which can deter investors who prioritize financial returns over social and environmental impact.
4. Limited awareness and education: There is limited awareness and education about sustainable investments among investors and financial institutions, which can hinder the adoption of sustainable finance practices.
5. Regulatory barriers: Regulatory frameworks may not provide sufficient support for sustainable investments, which can discourage financial institutions from investing in sustainable projects.

These challenges highlight the need for greater collaboration and coordination among stakeholders to overcome barriers to sustainable investments and promote sustainable development.

Roadmap for Sustainable Investments in Indonesia

In 2020, the Indonesian Financial Services Authority (OJK) launched a Sustainable Finance Roadmap for 2020-2025, which outlines the country's strategy for promoting sustainable investments and aligning with the SDGs. The roadmap includes several key initiatives and targets, including:

1. Developing sustainable finance regulations and guidelines: The OJK plans to develop regulations and guidelines that promote sustainable finance practices, including ESG integration and disclosure, green bonds, and sustainability-linked loans.

2. Building capacity and awareness: The OJK aims to build capacity and awareness among stakeholders, including financial institutions, regulators, and investors, to promote sustainable finance practices and improve understanding of sustainability issues.

3. Encouraging investment in sustainable projects: The OJK plans to encourage investment in sustainable projects, including renewable energy, energy efficiency, and sustainable agriculture, by providing incentives and creating a supportive regulatory environment.

4. Facilitating the development of sustainable finance products: The OJK aims to facilitate the development of sustainable finance products, including green bonds, green sukuk, and sustainability-linked loans, to support sustainable development.

5. Monitoring and evaluating progress: The OJK plans to monitor and evaluate progress on sustainable finance initiatives and report on key indicators, including the number of sustainable finance products and the amount of financing for sustainable projects.

The Sustainable Finance Roadmap demonstrates Indonesia's commitment to promoting sustainable investments and aligning with the SDGs. It also highlights the role of financial institutions and regulators in promoting sustainable finance practices and supporting sustainable development.

4.5 Conclusion and Recommendation

To summarize, Islamic microfinance can play a crucial role in attaining the SDGs, particularly in enhancing financial inclusion and reducing poverty. However, the sector's challenges need to be tackled to fully utilize its potential. Supportive regulatory frameworks and policies must be created by governments and regulatory authorities, while sustainable funding should be provided by donors and investors. Furthermore, the industry should standardize its practices, enhance transparency, and attract and retain qualified staff to build its capacity. By overcoming these obstacles, Islamic microfinance can emerge as a potent force for sustainable development.

Shared values are the common principles and beliefs that guide decision-making and actions of different stakeholders towards achieving common objectives. In the context of Sustainable Development Goals (SDGs), shared values support the global goals and foster cooperation among stakeholders. In Islamic finance, shared values distinguish the industry from conventional finance, such as ethical and social responsibility, risk-sharing, and prohibition of interest. Implementing shared values can present several challenges, such as differing interpretations, conflicting priorities, limited resources, and resistance to change. Efforts are being made to promote shared values in various sectors, including Indonesia's roadmap related to shared values for sustainable development and social cohesion.

Sustainable investments prioritize ESG factors in addition to financial returns. Islamic finance principles also guide sustainable investments, emphasizing social and environmental responsibility. Examples in Islamic finance include impact investing and green sukuk. These investments align with several SDG indicators, including affordable and clean energy, responsible consumption and production, and climate action. In Indonesia, the government has issued green sukuk to finance environmentally sustainable projects, and Islamic microfinance has been developed to promote social and environmental sustainability. Sustainable investment products available in the market include sustainable mutual funds, green bonds, and sustainability-linked loans. The Schroder Sustainable Equity Fund in Indonesia invests in companies that positively impact the environment and society.

Chapter 5.

Integration of ESG, Maqasid Shariah, and Islamic Finance

5.1 Maqasid Shariah and ESG

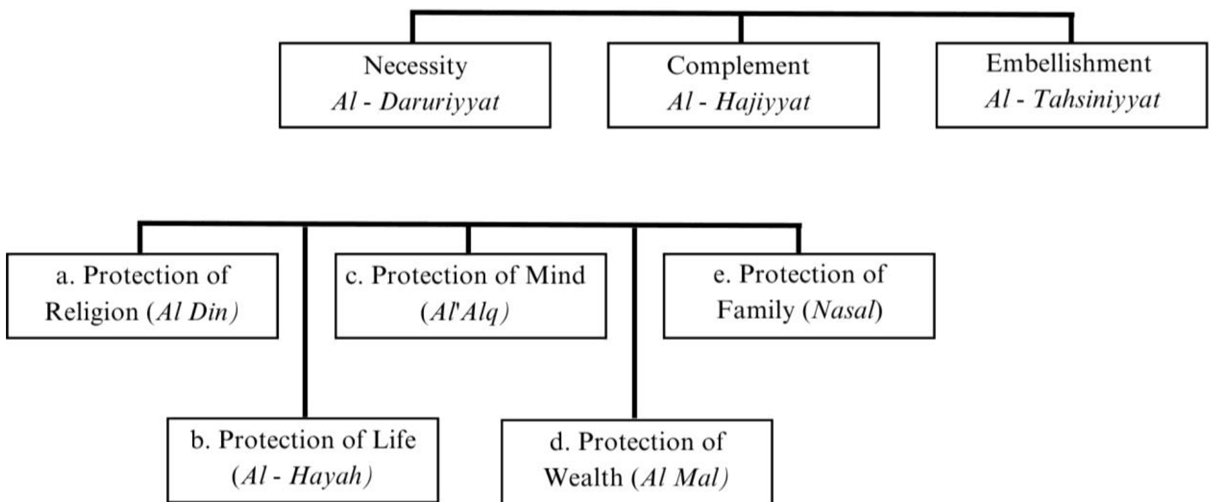
The fundamental foundations of Shari'ah come from the Qur'an and the Sunnah, which include the sayings and actions of Prophet Muhammad SAW. Over time, Islamic scholars have developed Maqasid Shari'ah, which aims to uphold moral standards and approve necessary behaviors for the well-being and advancement of a moral society. The term "Maqasid" is derived from the word "maqsad," which means purpose, goal, or objective. Thus, Maqasid Shari'ah pertains to the objectives and goals of Shari'ah. Al-Ghazali stated that Shari'ah's goal is to safeguard five primary elements, which include faith (din), self (nafs), intellect ('aql), posterity (nasl), and money (mal), as the absence of these five elements can harm society. Other aspects are considered as corollaries (tabi'ah).

Al-Ghazali identified the main purpose of maslahah as the preservation of Maqasid Shari’ah. Al-Shatibi expanded on this idea and classified Al-Ghazali's work into three categories: essential, complementary, and embellishment. The essential category includes faith, life, intellect, posterity, and riches, which are considered necessary for people's religious and daily concerns. The complementary category is designed to alleviate any hardship, while the embellishment category involves enhancing and refining people's behaviors and customs at all levels of achievement.

Ibn Ashur has outlined two fundamental components of Maqasid Shari’ah, which are promoting welfare and avoiding harm. This includes promoting welfare in areas such as combating corruption, responsibly using natural resources, and enhancing the Islamic way of life. On the other hand, Abu Zahra has expanded on Maqasid Shari’ah by including education and

justice as well, dividing it into three main categories: educating individuals, upholding justice, and promoting the public interest. The promotion of public interest covers essential, complementary, and embellishment components. Overall, the objectives of Shari'ah are considered essential for individuals' well-being and existence and must be upheld to maintain the normal functioning of society.

ESG and Maqasid Shariah are two separate but interrelated frameworks that have a common objective of encouraging ethical and sustainable business practices. ESG evaluates a company's performance based on its



impact on the environment, society, and corporate governance. Meanwhile, Maqasid Shariah is a framework that is rooted in Islamic law and aims to ensure that business activities adhere to the fundamental objectives and principles of Shariah.

Combining ESG and Maqasid Shariah entails utilizing the ethical and social principles of Maqasid Shariah in assessing ESG performance. Maqasid Shariah principles provide guidance on the moral and societal aspects of business practices, which can aid in identifying and mitigating ESG-related risks and opportunities that align with Shariah-compliant investments.

Indicators of ESG and Principles of Maqasid Shariah

It is possible to align ESG indicators with the principles of Maqasid Shariah, which prioritize the protection of five essential values: life, religion, intellect, lineage, and property. ESG factors such as environmental sustainability, social justice, and good governance can contribute to achieving these goals. For instance, ESG metrics related to reducing carbon emissions, promoting human rights, and enhancing board diversity can support the Maqasid Shariah objectives of preserving life, promoting justice, and safeguarding property. By integrating ESG considerations into Shariah-compliant investments and financial products, Islamic finance institutions can demonstrate their commitment to responsible investing and contribute to broader sustainable development goals. (Source: "ESG Integration in Islamic Finance: Prospects and Challenges" by Umar A. Oseni and Salman Ahmed Shaikh)

Challenges in Integrating ESG and Maqasid Shariah

However, integrating ESG and Maqasid Shariah poses several challenges. One of the main challenges is the lack of standardized ESG metrics that are tailored to Islamic finance principles and values. While some global

ESG standards, such as the United Nations Sustainable Development Goals (SDGs) and the Global Reporting Initiative (GRI), may be relevant to Islamic finance, they may not fully align with Maqasid Shariah objectives or take into account the unique features of Islamic finance products and services. Therefore, there is a need for developing Islamic-specific ESG metrics that reflect the Shariah principles and are consistent with Maqasid Shariah objectives.

Another challenge is the need for greater awareness and education among stakeholders, including investors, regulators, and scholars, about the potential benefits and risks of ESG integration in Islamic finance. Many stakeholders may have limited understanding of ESG factors, their relevance to Shariah-compliant investments, and their potential impact on financial performance and social outcomes. Finally, there is a risk of conflicting values and priorities between ESG and Maqasid Shariah, especially if ESG factors are viewed as a Western or secular concept that may not fully align with Islamic values and norms. Therefore, it is essential to ensure that ESG integration in Islamic finance is rooted in Islamic ethical principles and guidelines and is consistent with the Shariah supervisory board's views and opinions. (Source: "Integrating ESG and Islamic Finance: Challenges and Opportunities" by Nazli Mahmud and Mansor Ibrahim)

Opportunities in Integrating ESG and Islamic Finance

Despite these challenges, there are many opportunities for creating sustainable development through ESG integration in Islamic finance. By promoting responsible investing and corporate behavior, Islamic finance

institutions can contribute to social and environmental well-being and support the Maqasid Shariah objectives of promoting justice and preserving life. Moreover, ESG integration can foster greater social and environmental awareness among stakeholders and enhance transparency and disclosure in Islamic finance practices. By aligning financial goals with long-term societal benefits and stakeholders' needs, Islamic finance institutions can demonstrate their commitment to Maqasid Shariah and sustainable development and differentiate themselves from conventional finance competitors.

5.2 Islamic Finance and ESG

Islamic finance shares fundamental principles with sustainable finance, such as promoting financial stability and economic growth, poverty alleviation and wealth distribution, financial and social inclusion, as well as environmental preservation. These shared principles have provided Islamic finance with the opportunity to leverage its alignment with sustainable finance and become a natural means of promoting the concepts of green finance.

Islamic banking, as a core element of Islamic finance, involves more than just offering Shari'ah-compliant financial products and services. It should be designed to promote the public good by prioritizing the public interest over self-interest and profit maximization, while also taking into account both the negative and positive consequences of transactions. Without these components, Islamic banking transactions may be perceived as merely a formality, similar to those of conventional banking. Therefore, the operations of the Islamic banking system must align with the Maqasid

Shari'ah, which are the higher objectives of Islamic law. Achieving the Maqasid Shari'ah in Islamic banking requires a collaborative effort and a strong commitment to moral obligations from all stakeholders, particularly management and Shari'ah scholars, in promoting permissible transactions that serve the public good.

Islamic finance and ESG (Environmental, Social, and Governance) investing may have evolved in different cultural and historical contexts, but they are complementary approaches to capital-raising and investment. Both share fundamental principles, such as being responsible stewards of society and the environment. Despite their differences, Islamic finance and ESG investing offer products that can benefit both Muslim and non-Muslim investors, and each approach has strong practices and policies that can be learned from by the other. Ultimately, both Islamic finance and ESG investing are aimed at promoting sustainable development and creating a positive impact on society and the environment.

Avoiding investments in specific industries like tobacco, alcohol, pork, pornography, weapons, gambling, human trafficking, and other prohibited products and activities is a crucial aspect of Islamic finance. The process of screening shariah-compliant products to exclude such industries is similar to the approach used in ESG investing. Both types of investors refrain from investing in certain products and activities to ensure that their portfolios are aligned with their values, support the development of a sustainable and equitable society, and do not cause any harm to the environment or people.

ESG investment strategies typically evaluate the financial worth of various environmental, social, and governance aspects and incorporate that worth into their investment analysis, decision-making, and procedures. ESG strategies may also involve active ownership practices, such as company engagement and voting, to manage risks, increase returns, and enhance the ESG performance and transparency of the companies/issuers.

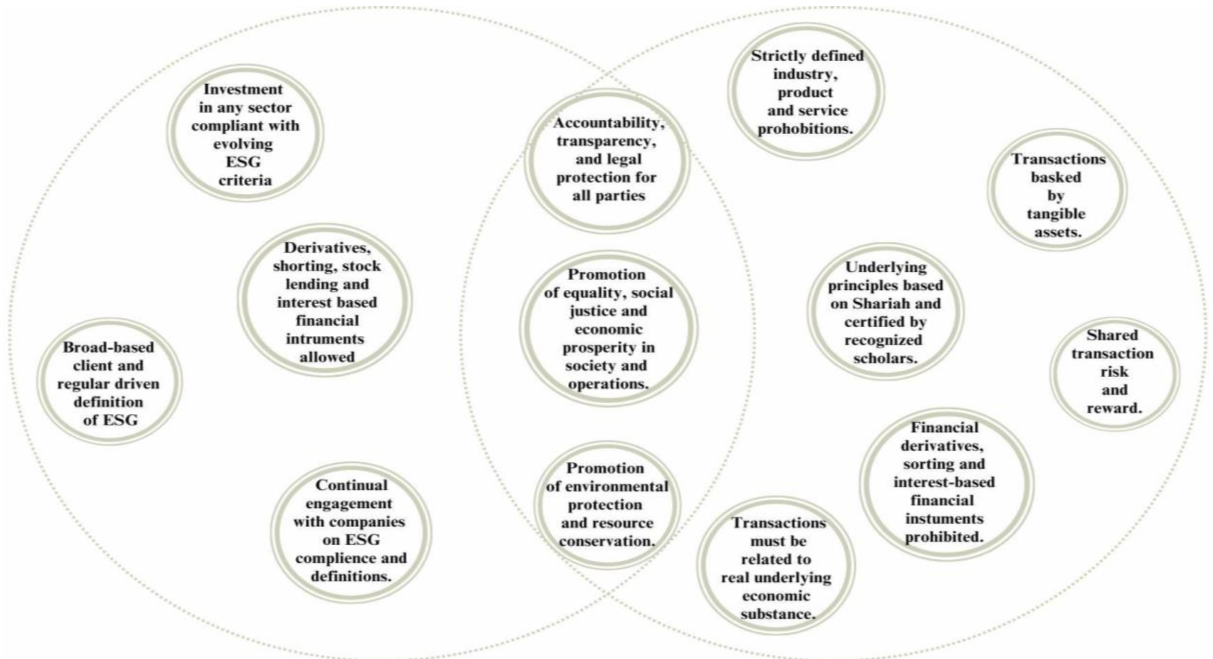
Comprehending the parallels between ESG and Islamic Finance investment principles is crucial for banks and asset managers in the Middle East to seize the opportunity. Islamic Finance and sustainable or responsible investing share a core principle of avoiding harm, which could potentially lead to a convergence between these two branches of finance. This is an intriguing possibility, as it could allow Middle Eastern banks with Islamic Finance capabilities to access a large and fast-growing global market by certifying their IF products as ESG compliant. Many of the principles of IF resemble those of ESG, which could enable products such as Sharia-compliant sukuk bonds or 'Waqf' funds to become part of the portfolios of ESG investors worldwide. This could give Islamic banking institutions a growing share of what is expected to become one of the largest and possibly dominant investment sectors in the future.

Although a convergence between Islamic Finance and sustainable investing has not yet occurred, it is still a possibility. However, for this to happen, ESG investors and Islamic Finance professionals must acknowledge both the similarities and differences between the two approaches. It is important to recognize that they are still distinct markets, where certification, metrics, and underlying mindsets are not fully aligned.

Understanding these differences is crucial to seizing the opportunity of convergence.

The similarities between Islamic Finance and ESG investing are based on their shared focus on long-term risk reduction and impact metrics to limit harm. Both approaches prioritize accountability and transparency, and aim to ensure stability and sustainability of investments. Islamic Finance uses principles such as shared reward, reliance on real assets, avoidance of pure financial transactions, and prohibition of certain products and services, while ESG investing has a wider scope that covers environmental, social, and governance factors, including carbon emissions, pollution, biodiversity, human rights, and compensation. However, there are still significant differences between the two approaches in terms of underlying principles and metrics, and finance professionals need to understand these differences in order to develop a common ESG/IF investment proposition.

ESG vs. IF at glance



Although Islamic Finance and ESG investing share a common purpose, their paths diverge in several ways. ESG investing is goal-based and focuses on selecting businesses that have a positive impact, rather than solely relying on exclusionary screening based on industry or sector. On the other hand, Islamic Finance investing primarily uses exclusionary screening based on widely-accepted principles, although some funds may also use selective screening.

ESG investing also emphasizes ongoing activist engagement and shareholder voting, which are not typically features of Islamic Finance. Additionally, ESG investing often integrates ESG principles into the entire financial analysis and investment practice, while Islamic Finance is usually

a stand-alone practice. Finally, there are specific financial restrictions in Islamic Finance that do not apply in the ESG world.

Additionally, there are differences in the geographic distribution of the two investment approaches. Islamic Finance has a strong presence in the Middle East, Southeast Asia, and parts of Africa, while ESG investing is more widespread across the globe. This geographic mismatch may make it more challenging for Middle Eastern banks and investors to expand into ESG investing and may require collaboration with global ESG investment firms and institutions.

Finally, there are differences in the regulatory landscape of the two investment approaches. Islamic Finance has its own set of regulatory frameworks and institutions, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), while ESG investing is subject to a broader range of regulatory frameworks and initiatives at both national and international levels. This means that Middle Eastern banks and investors may need to navigate unfamiliar regulatory environments as they enter the ESG market.

Another opportunity for finance professionals seeking to connect the worlds of ESG and IF investing is to recognise the potential for cross-fertilisation of ideas. While the differences in mindset and approach may present challenges, they also offer opportunities for mutual learning and exploration. For example, there is potential for ESG investors to learn from the strong governance and ethical principles of Islamic Finance, while IF investors could benefit from the broader ESG focus on positive engagement with companies and stakeholders.

Moreover, there is potential for the two worlds to collaborate on areas of common interest, such as financing sustainable infrastructure projects or supporting the transition to a low-carbon economy. As the global sustainable finance landscape continues to evolve, there is likely to be increasing demand for investment products that blend the principles and practices of ESG and IF investing, and finance professionals who can navigate these two worlds are likely to be well-positioned to meet that demand.

It's true that the current economic climate presents an opportunity for Islamic Finance to leverage its defensive and resilient investment philosophy. As investors look for safe and stable investment strategies in times of market uncertainty, Islamic Finance's focus on low gearing and defensive sectors could be particularly appealing.

Furthermore, as ESG investing continues to grow rapidly, there is an opportunity for Islamic Finance to leverage its existing expertise in responsible investing and certification to expand into this space. By building markets and brand in the ESG market, Islamic Finance providers could tap into the world's fastest growing investment space and further diversify their offerings.

Overall, while there are certainly challenges to reconciling the worlds of ESG and Islamic Finance, there are also opportunities for Islamic Finance providers to leverage their existing strengths and expertise to expand into this fast-growing and increasingly important space.

5.3 ESG Measurement in Islamic Finance

5.3.1 ESG Reporting

ESG (Environmental, Social, and Governance) is a set of criteria used to assess a company's or organization's performance on environmental, social, and governance issues. Environmental criteria include factors such as climate change, natural resource use, pollution, and waste management. Social criteria include issues such as human rights, labor standards, community development, and diversity and inclusion. Governance criteria include factors such as transparency, accountability, and ethics. Standard reporting frameworks for ESG provide guidance on how to report on these issues, the key indicators to track, and the data collection and reporting methodologies.

The Global Reporting Initiative (GRI) is one of the most widely used ESG reporting frameworks. It provides a comprehensive set of sustainability reporting guidelines that cover environmental, social, and governance issues. The Sustainability Accounting Standards Board (SASB) is another widely used framework that focuses on identifying the most relevant sustainability issues for each industry and providing standardized reporting guidelines for those issues. The Task Force on Climate-related Financial Disclosures (TCFD) is a framework that provides guidance on how to report on the financial risks and opportunities associated with climate change.

5.3.2 Indicators for Measuring ESG in Islamic Finance

In Islamic finance, ESG can be measured using a set of indicators that reflect the Maqasid Shariah principles and values. These indicators include

environmental sustainability, social justice, good governance, and ethical conduct. For example, the environmental sustainability indicators may include reducing carbon emissions, promoting renewable energy, and conserving natural resources. The social justice indicators may include promoting human rights, labor standards, and community development. The good governance indicators may include enhancing board diversity, transparency, and accountability. The ethical conduct indicators may include avoiding investments in industries such as gambling, tobacco, and alcohol.

To measure ESG performance in Islamic finance, some researchers have proposed a set of Islamic-specific ESG indicators that reflect the Maqasid Shariah principles and values. For example, the Islamic Finance Services Board (IFSB) has proposed a set of ESG indicators that cover environmental, social, and governance issues and are aligned with the Maqasid Shariah objectives.

5.3.3 The Implementation of ESG in Islamic Financial Sectors in Indonesia

In Indonesia, Islamic finance institutions have started to integrate ESG considerations into their operations and investment decisions. The Financial Services Authority (OJK) has issued guidelines on sustainable finance that apply to all financial institutions, including Islamic finance. These guidelines encourage financial institutions to integrate ESG factors into their risk management processes, products, and services. In addition, some Islamic finance institutions have developed their own sustainability reports to communicate their ESG performance to stakeholders.

According to a report by the OJK, there were 20 Islamic banks and 10 Islamic non-bank financial institutions operating in Indonesia as of December 2020. These institutions are subject to the OJK's guidelines on sustainable finance, which require them to report on their ESG performance and disclose their ESG-related policies and practices. However, the adoption of ESG in Islamic finance in Indonesia is still at an early stage, and more efforts are needed to raise awareness and build capacity among stakeholders.

The number of Islamic finance institutions that have adopted ESG principles and practices is growing globally. According to a report by the Islamic Development Bank, there were 38 Islamic finance institutions that had issued sustainability reports as of 2019. These institutions included banks, asset managers, and insurance companies from various countries, including Malaysia, Saudi Arabia, Bahrain, and the United Arab Emirates.

The report also noted that the adoption of ESG in Islamic finance was still at an early stage, and more awareness-raising and capacity-building efforts were needed. Some of the challenges to ESG integration in Islamic finance include the lack of standardized ESG metrics that reflect the Maqasid Shariah principles and values, the limited availability of ESG data on Islamic finance products and companies, and the need to build capacity among Islamic finance professionals to integrate ESG considerations into their decision-making processes.

5.3.4 Challenges in Measuring ESG in Islamic Finance

One of the main challenges to measuring ESG in Islamic finance is the lack of standardized ESG metrics that are aligned with Maqasid Shariah principles and values. While there are several ESG frameworks and reporting standards available, they may not fully capture the unique characteristics and values of Islamic finance. To address this challenge, some researchers have proposed developing Islamic-specific ESG indicators that are tailored to the needs of Islamic finance institutions.

Another challenge is the limited availability of ESG data on Islamic finance products and companies. While there is a growing interest in ESG integration in Islamic finance, the lack of reliable and comparable ESG data makes it difficult for investors and stakeholders to evaluate the ESG performance of Islamic finance institutions and products. To overcome this challenge, more efforts are needed to improve data collection and reporting practices in Islamic finance.

Finally, there is a need to build capacity among Islamic finance professionals to integrate ESG considerations into their decision-making processes. This includes providing training and education on ESG principles and practices, as well as promoting a culture of ESG awareness and accountability within Islamic finance institutions.

5.3.5 Roadmap for Integrating ESG and Islamic Financial Sectors in Indonesia

The Financial Services Authority (OJK) in Indonesia has developed a roadmap for integrating ESG into Islamic finance. The roadmap includes several initiatives to promote sustainable finance, including:

- Developing ESG guidelines that are tailored to the needs of Islamic finance institutions
- Promoting ESG reporting and disclosure among Islamic finance institutions
- Providing training and capacity-building support to Islamic finance professionals on ESG integration
- Encouraging Islamic finance institutions to develop innovative ESG products and services
- Collaborating with stakeholders to develop a common language and understanding of ESG principles and practices in Islamic finance.

The OJK's roadmap aims to create a supportive regulatory environment for ESG integration in Islamic finance and to build momentum for sustainable finance in Indonesia.

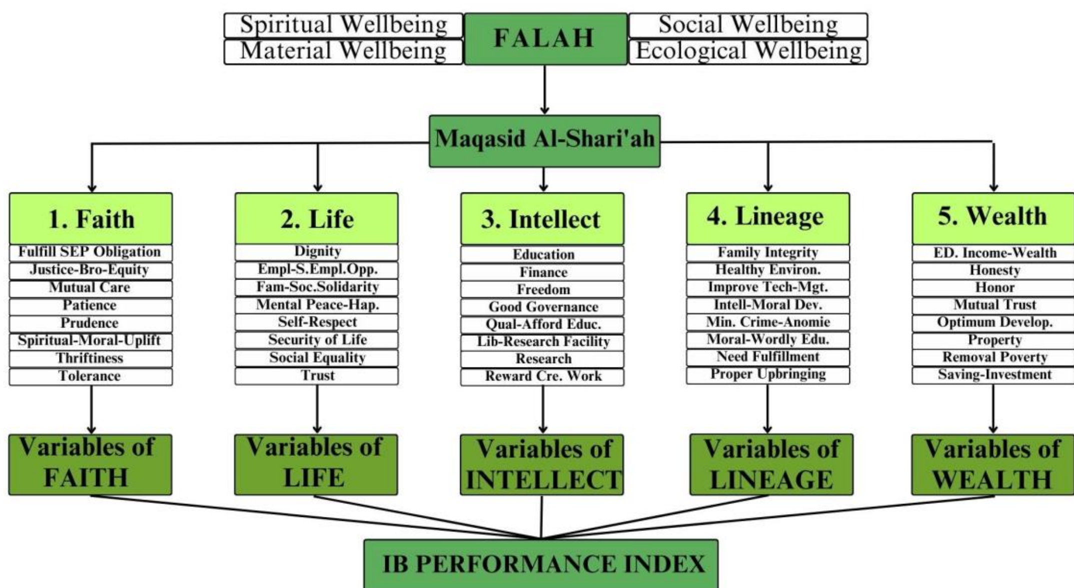


Figure 2 – IB Performance Index

5.4 Conclusion and Recomendation

In conclusion, Maqasid Shariah is a framework that aims to promote the objectives and principles of Shariah, while ESG evaluates companies' performance based on their environmental, social, and governance impact. By aligning ESG indicators with Maqasid Shariah principles, it is possible to promote ethical and sustainable business practices in Islamic finance. However, integrating ESG and Maqasid Shariah faces several challenges, including the lack of standardized ESG metrics tailored to Islamic finance principles and the need for greater awareness and education among stakeholders. Nevertheless, there are many opportunities for creating sustainable development through ESG integration in Islamic finance by promoting responsible investing and corporate behavior. Therefore, developing Islamic-specific ESG metrics and ensuring ESG integration is

rooted in Islamic ethical principles are essential to achieving sustainable development through Islamic finance.

Furthermore, Islamic finance and ESG investing share similar fundamental principles, such as being responsible stewards of society and the environment, and promoting sustainable development. Both approaches prioritize accountability and transparency and aim to ensure stability and sustainability of investments. Avoiding investments in specific industries and promoting permissible transactions that serve the public good are essential aspects of Islamic finance. On the other hand, ESG investing evaluates the financial worth of various environmental, social, and governance aspects and incorporates them into investment analysis, decision-making, and procedures. Although the two approaches have diverging paths, they offer products that can benefit both Muslim and non-Muslim investors. The potential convergence between Islamic finance and ESG investing presents an intriguing possibility for Middle Eastern banks to access the fast-growing global market of ESG investing by certifying their Islamic finance products as ESG compliant. However, understanding the differences between the two approaches is crucial for developing a common ESG/IF investment proposition.

Moreover, ESG (Environmental, Social, and Governance) is an important set of criteria used to assess the performance of companies and organizations on environmental, social, and governance issues. In Islamic finance, ESG can be measured using a set of indicators that reflect the Maqasid Shariah principles and values. The adoption of ESG in Islamic finance is still at an early stage, and more efforts are needed to build

capacity and awareness among stakeholders. The challenges to ESG integration in Islamic finance include the lack of standardized ESG metrics, the limited availability of ESG data, and the need to build capacity among Islamic finance professionals. The Financial Services Authority (OJK) in Indonesia has developed a roadmap to integrate ESG into Islamic finance, which includes initiatives to promote sustainable finance, develop ESG guidelines, and encourage ESG reporting and disclosure. Despite the challenges, the adoption of ESG in Islamic finance is expected to grow in the future, as more investors and stakeholders recognize the importance of sustainable and socially responsible investing.

Chapter 6.

Islamic Financial Instruments

There are various religious duties in Islam, such as zakat (mandatory almsgiving), sadaqa (voluntary almsgiving), and waqf/awqaf (charitable endowments) that could have a positive impact on social finance. While not considered Islamic finance instruments per se, they are included in this analysis. Islamic banking transactions typically use instruments like murabaha (a non-interest-bearing loan with cost-plus financing), which accounts for a significant portion of Islamic financing, as well as ijara (leasing), mudarabah (a partnership between capital and labor), and musharaka (a partnership based on profit- and loss-sharing). Although not all forms are intended for social impact, sukuk (Islamic fixed income) have become increasingly popular in various parts of the world.

Instrument	Description
Zakat	Alms-giving in Islam which is obligatory on all Muslims who meet certain wealth criteria. One of the five pillars of Islam.
Sadaqa	Voluntary alms-giving in Islam.
Waqf /Awqaf	Endowment on property is made to a religious, educational, or charitable causes.
Sukuk	Islamic asset-based financial certificate, can be compared to conventional bonds (which are debt-, equity- or quasi-equity based).
Musharaka	Joint enterprise or partnership where partners share profits and losses.
Murabaha	Receivables created are trade receivables from the cost-plus sale, often structured to deliver similar economic outcomes as a loan.
Mudarabah	Partnership contract where delegated authority is given to an agent to carry out trades and transactions. Money is provided from one party and expertise/labour from the other.

Islamic finance, particularly Islamic social finance, is in a favorable position to provide innovative forms of development aid that benefit both donors and recipients. The upcoming sections will concentrate on the instruments that have the most potential for development cooperation, which are:

6.1 Islamic Social finance

In Islam, it is encouraged to support one's immediate community and ensure that the less fortunate are provided for as a priority. Islamic finance aims to promote the fair distribution of wealth among communities. Islamic social finance concepts, such as zakat and awqaf, are means of fulfilling this obligation through continuous charitable means and are considered a religious duty for Muslims (and the only one with a financial component). Therefore, the redistributive and socially equitable aspects of Islamic social finance are essential in achieving SDG1, which is to "End poverty in all its forms everywhere."

It is not surprising that zakat and awqaf are not well-organized enough to achieve development goals. They are often not included in development finance flows and are under-reported in development figures, just like Islamic finance more generally. Additionally, there are specific reasons why these tools are relatively under-reported:

- For zakat, some of it is spent in-country, which is not relevant from a development co-operation perspective. Also, a significant portion of charitable giving is done privately through informal means, which means it is not accounted for in development figures. Creating effective channels for zakat to be used towards SDG-related activities could make it an effective way to raise capital for both humanitarian and development responses.

Zakat is an obligatory form of alms-giving in Islam, representing one of the five pillars of the faith. It is mandatory for all Muslims who meet certain wealth criteria and is calculated as 2.5% of accumulated net personal assets over the course of an Islamic year. Zakat can be given in financial or in-kind form, such as crops or livestock.

The collection and distribution of zakat varies across different Muslim-majority countries, with some governments assuming responsibility for its collection and distribution, while in others it is not organised by the state. In DAC countries, official zakat delivery systems are not fully developed, so Muslim citizens commonly use non-governmental organisations (NGOs) for zakat services.

Zakat is given to those in need and is usually provided as humanitarian assistance, rather than long-term development assistance. It can be effectively aligned with social SDGs, such as reducing poverty, hunger, and inequalities, improving health and education, and promoting decent work and economic growth. However, the impact of zakat for development is still not fully understood.

The challenge

The effective utilization of zakat to respond to the SDGs requires better management and distribution. In Islamic tradition, giving zakat and alms

is encouraged to be done with humility and without ostentation. Muslims often give their zakat through informal channels such as local charities or by directly donating to beneficiaries, which are not recorded in official systems. This makes it difficult to accurately estimate the levels of wealth in Muslim communities.

Additionally, if zakat is given to family or friends, it is not captured in official records. High net worth individuals' wealth can be calculated by the amount of zakat they give. As zakat can be given directly to beneficiaries, its impact and magnitude are difficult to calculate accurately. However, if zakat distribution remains sharia-compliant, it can be used to support development objectives. While giving zakat for international development was not common in the past, it is becoming more prevalent nowadays.

- Awqaf are relatively large but may have been managed inefficiently, generating low social returns. Raising awareness of the potential social returns that awqaf can deliver and building on current good practices could make it an attractive investment opportunity and lead to better integration into the global development community.

Despite the prevalence of these two Islamic finance mechanisms, only a few developing countries have explored their potential as a source of revenue for social assistance and poverty alleviation. However, there are some experiences that point to the growth and potential of these two tools in the future.

The concept of awqaf involves dedicating an asset to a religious, educational, or charitable cause that provides returns to the community. These returns could be used to finance projects such as schools, hospitals, and housing in developing countries. Typically, real estate is used as the asset for awqaf, but other types of assets can also be used if the legal framework of the country allows for it.

Awqaf is established in perpetuity, with no intention of reclaiming the assets. Instead, they seek to benefit a community over time by providing a social good and generating returns. Managed according to sharia, awqaf can be used as vehicles for public and private giving, with funding from government, private donors, businesses, or communities.

Awqaf has the potential to contribute to social infrastructure in developing countries for extended periods, which can be used for humanitarian or development purposes. They can particularly contribute to SDG4 (Quality Education), SDG6 (Clean Water and Sanitation), SDG7 (Affordable and Clean Energy), and SDG11 (Sustainable Cities and Communities). However, for awqaf to contribute effectively to the SDGs, they need to reference these goals in their deeds. Nonetheless, most awqaf currently do not reference the SDGs, and further research is needed to understand their potential impact on development.

The challenge

In Islamic social finance, waqf (also known as awqaf) is an important tool for collecting funds from both private and public sources. It can be used to distribute wealth to communities and individuals over an extended period of time, enabling the creation of social infrastructure such as housing, schools, hospitals, and other basic facilities. While there is limited data on awqaf, recent estimates suggest that in Indonesia, it has the potential to generate up to 0.85% of the country's GDP.

Although awqaf have been effective in providing public goods, they have not been widely utilized as a financing tool for development due to a lack of reform. The management of these funds often results in low social returns. In the United Kingdom, charitable giving (zakat) is preferred over investing in awqaf, as the latter has not shown significant social benefits. However, the UK can serve as an example of how awqaf can contribute to sustainable development and generate financial and social returns. This aligns with the recent growth in social impact investment, which aims to achieve strong social returns and impact.

Despite the fact awqaf provide reliable and predictable returns, their main drawback is that investments are made for an indefinite period, creating limitations on how easily money can be withdrawn and how actively funds need to be managed to generate returns. Typically, investors seek mechanisms that generate positive returns while mobilizing finance. Since endowments offer limited flexibility and control to investors, there are few incentives to encourage stronger investment. Additionally, many waqf assets have conditions set by the original donor that remain in effect indefinitely. These religious-based restrictions make modifying the

purpose difficult, posing significant reputational risk for waqf trustees who attempt to do so.

6.2 Islamic Financing and Microfinancing

Sukuk, a type of sharia-compliant asset-based security, and Islamic finance lending are two financial tools that can be utilized to implement infrastructure and large-scale programs in Muslim-majority countries and beyond. Sukuk provides investors with low risks and guaranteed returns, as detailed in Box 3.1. Meanwhile, Islamic microfinance programs can address financial exclusion by reducing risk and debt levels, promoting social welfare and economic security. These two Islamic finance instruments can effectively contribute to achieving the SDGs. The DAC can enhance its expertise in this field by collaborating with Arab organizations like the IsDB and partnering with the private sector to expand the use of these instruments. Furthermore, incorporating innovative financial technology such as blockchain technology can improve these instruments, as demonstrated by Blossom Finance in 2020.

6.2.1 Sukuk

Box 3.1. Sukuk

- Sukuk are securities similar to conventional bonds that are asset-based and have a debt-based structure, where an event of default triggers a purchase of the asset from the obligor in exchange for payment liability to investors.
- These securities offer ownership in a designated asset or pool of

assets, granting access to a share of revenue or income. However, a fixed asset, such as property, land, or commodity, is required to issue sukuk.

- The return on sukuk is equivalent to conventional bonds, and their present value is affected by changes in interest rates in newly issued bonds.
- Sukuk can be used to provide concessional loans in a development context and can be combined with grant financing from conventional and Islamic sources with cooperation from Arab and DAC donors. Sharia-compliant funds are typically segregated from interest-based finance.
- Sukuk can be aligned with a variety of SDGs, including SDG3 through SDG16.
- Although the growth of green and social sukuk is promising, commercial Islamic financing is still not adequately contributing to social and environmental goals and impact.

According to the World Bank and Islamic Development Bank Group, sukuk is becoming an important tool for sovereign and corporate actors to mobilize resources. Sukuk and other forms of Islamic financing can help finance large-scale programs and address infrastructure needs in partner countries. Many developing countries face significant financial shortages in these areas. The Organization of Islamic Cooperation (OIC) estimates that infrastructure needs will total USD 7.2 trillion over the period 2016-2040 in a sample of 13 OIC member countries. However, investments currently estimated at USD 5.6 trillion will result in a deficit of USD 1.6

trillion over the same period. The global infrastructure finance gap is even larger, with the World Economic Forum estimating that it will reach USD 15 trillion by 2040.

According to Ahmed (2017), in 2016 Islamic banking assets amounted to USD 1.45 trillion, while sukuk made up a further USD 341 billion. The sukuk market is still expanding and holds potential for further development, with current annual issuance at USD 123 billion, and outstanding sukuk between USD 450 billion and USD 530 billion, up from just USD 6 billion in 2004. Developing countries have also started issuing sukuk, such as Senegal, which issued the largest sukuk in 2014 worth USD 208 million, followed by a second one worth USD 350 million in 2016, both used for urban development, water supply, road and street lighting programmes. Other African countries have followed suit, including South Africa, Cote d'Ivoire, and Togo, with several countries preparing legislation to facilitate sukuk issuances. Malaysia launched the world's first green sukuk, and Indonesia also launched a green sukuk in 2018. In 2019, sukuk issuance has been driving growth of Islamic finance, with over USD 1 billion in infrastructure projects linked with sharia-compliant financing issued in Indonesia and USD 1.3 billion issued by the IsDB. The IsDB has been issuing sukuk since 2003, raising over USD 21 billion to finance development projects in its member countries, and recently launched its first green sukuk, raising EUR 1 billion for climate change and green projects. Despite these volumes, the sector has been considered a niche activity by Western economies.

Donors have faced difficulties in mobilizing financial resources from the private sector for development purposes in many developing Muslim-

majority countries due to the lack of incentives. Weak regulatory frameworks have further hindered this process, making it challenging for donors to attract private actors to invest in large-scale infrastructure and development programs. To address this issue, donors could consider leveraging commercial Islamic finance tools, like sukuk, and build on the successful practices of some Islamic finance operators. This approach could encourage more private actors, including sovereign wealth funds and pension funds, to align their incentives with the SDGs and invest in development projects through Islamic finance.

6.2.2 Islamic Microfinance

The success of social development programs is directly influenced by the level of financial inclusion in a community. Financial inclusion can be a means for underserved populations to access financial systems and can lead to economic and social advantages, including poverty reduction. Given the growing number of fragile states and displaced persons, donors should focus more on financial inclusion. Additionally, increased financial inclusion aligns with sharia principles and can have positive effects.

Islamic microfinance operates differently from other sharia-compliant lending approaches that are typically designed for larger-scale borrowing. Islamic microfinance provides individuals with direct financial access, and its structures and mechanisms are more flexible. Unlike sukuk or other forms of Islamic lending that require institutional or governmental involvement, Islamic microfinance often establishes a direct connection between donors and beneficiaries, although microfinance funds and institutions can also facilitate funding channels.

The limited availability of Islamic microfinance can be attributed to several factors. Firstly, microfinance is only offered in a few countries and by a small number of institutions that have a development focus. Additionally, the regulatory frameworks governing Islamic microfinance need to evolve to better support its growth. Currently, most operations are carried out at the national level, but efforts to support institutions capable of working at the local level or expanding to other developing contexts could have a greater impact. Despite the growing popularity of mobile banking technology in many developing countries, there are few solutions that incorporate sharia-compliant microfinance instruments, despite the fact that OIC countries have a high rate of mobile penetration.

Table 2. Islamic Finance instruments to help offset COVID-19 effects

Stage	Instruments	Features & benefits
Short term: Emergency support	Zakat	- Immediate disbursement - Poverty alleviation impact - Cash transfers
	Qard Hassan	- The borrower is required to repay only the principal
	Individual philanthropy and corporate giving	- Breadth and flexibility - Strategic impact
Medium term: Response & recovery Asset and trade financing		- Supports businesses and individuals in securing means of livelihood
	Impact investing	- Prioritizes the flow of private capital to businesses with social impact
Long term: Recovery & resilience	Sukuk	- Provide long term funding to governments and businesses
	Waqf endowments	- Provide permanent assets for sustainable social development

6.3 Conclusion and Recommendations

In conclusion, Islamic finance, particularly Islamic social finance, has the potential to provide innovative forms of development aid that benefit both donors and recipients. Islamic social finance concepts such as zakat and awqaf can fulfill the religious duty of providing continuous charitable means and promoting the fair distribution of wealth among communities. These concepts can be aligned with social SDGs, such as reducing poverty, hunger, and inequalities, improving health and education, and promoting decent work and economic growth. However, their effective utilization to respond to the SDGs requires better management and distribution. While there are specific challenges in using these tools for development goals,

creating effective channels for zakat to be used towards SDG-related activities could make it an effective way to raise capital for both humanitarian and development responses. Raising awareness of the potential social returns that awqaf can deliver and building on current good practices could make it an attractive investment opportunity and lead to better integration into the global development community.

Moreover, sukuk and Islamic microfinance are financial instruments that can effectively contribute to achieving the SDGs, particularly in Muslim-majority countries and beyond. Sukuk offers investors low risk and guaranteed returns and can be used to finance large-scale programs and infrastructure needs. Islamic microfinance programs can address financial exclusion by reducing risk and debt levels and promoting social welfare and economic security. Donors can leverage these instruments, along with innovative financial technology like blockchain, to enhance their expertise and attract private actors to invest in development projects through Islamic finance. By promoting financial inclusion through these instruments, the international community can help achieve the SDGs and create economic and social benefits for underserved populations.

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