

Green Finance and Islamic Finance

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Abstract: This study examines Islamic finance and green finance. Islamic finance is a system based on Sharia law that prohibits interest, uncertainty, and investment in unlawful sectors defined by Islam. Green finance is the financing investments that promote renewable energy, sustainable developments, and environmental products or policies. This paper shows that although Islamic finance and green finance have been showing an increasing trend in the world in the last two decades, these trends are observed in different regions and countries. The portion of the Murabahah among the Islamic financial products is very high compared the other Islamic financial instruments. This phenomenon can be an explanation why Islamic finance and green finance have showed an increasing trend in different regions and countries.

Keywords: Islamic Finance, Green Finance, Murakabah, Renewable Energy

1. Introduction

The most well-known difference between Islamic finance and conventional finance is that charging interest is forbidden by Islamic finance. The money has no value in itself according to Islamic rules known as Sharia law. Money is just a way of defining the value in Sharia's law. It is forbidden to generate money by money. Money can be generated by taking risk in Islamic finance. However the risk must be shared by the participant of the business activities. The principle of participation is one of key issue in Islamic finance that guarantees that wealth increased by productive activities. However there are other points that Islamic finance differentiates from conventional finance. Hazard or uncertainty or in Islamic terminology "Gharar" is forbidden in Islamic finance. Therefore speculation and gambling are forbidden in Islamic finance. The equity principle supports the avoidance of uncertainty. This principle is basically says that you cannot sell what you do not have. Islamic finance prohibits to invest non ethical industry like alcohol, tobacco, and pornography. Islamic finance encourages the investments that are beneficial for the society.

Green finance is defined in many ways in the publications. For instance, Lindenberg (2014) defines it as follow:

Green finance comprises:

-the financing of public and private green investments (including preparatory and capital costs) in the

following areas;

- environmental goods and services (such as water management or protection of biodiversity and landscapes);
- prevention, minimization and compensation of damages to the environment and to the climate (such as energy efficiency or dams);
- the financing of public policies (including operational costs) that encourage the implementation of environmental and environmental-damage mitigation or adaptation projects and initiatives (for example feed-in-tariffs for renewable energies);
- components of the financial system that deal specifically with green investments, such as the Green Climate Fund or financial instruments for green investments (e.g. green bonds and structured green funds), including their specific legal, economic and institutional framework conditions.

Höhne, Khosla, Fekete, and Gilbert (2012) include sustainability in the definition of green finance. They claim that green finance initiatives products and projects that aim the sustainable development. Green banking which is another concept has a broad definition. It can be defined as financing environmental friendly activities, green technology, and projects that reduces pollution (Bahl, 2012). Wilson (1997) argues that there is a clear sign that Muslim investors want to enrich their portfolios as it is observed by the results of survey in Islamic countries. He also states that Islamic world can benefit from the Western ethical criteria for green finance.

2. Islamic Finance and Green Finance

Islamic finance's history goes to 7th century. Islamic finance and banking were reborn in 1970s in our modern world. After that it shows an increasing trend year by year. It is estimated total value of Islamic assets reach the value of 3.4 trillion US dollar by the year 2018. Moreover there is a dramatic growth in both sustainable projects and socially responsible funds.

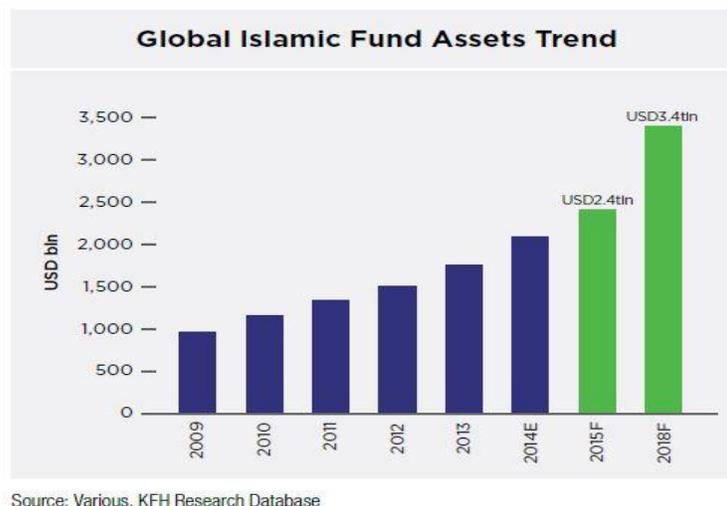


Figure 1: Global Islamic fund assets trend

According to US SIF Foundation-Report on US Sustainable, Responsible and Impact-, socially responsible investments in USA was less than 3 trillion US dollar in 2005 however it reached the almost 9 trillion US dollar in 2016.

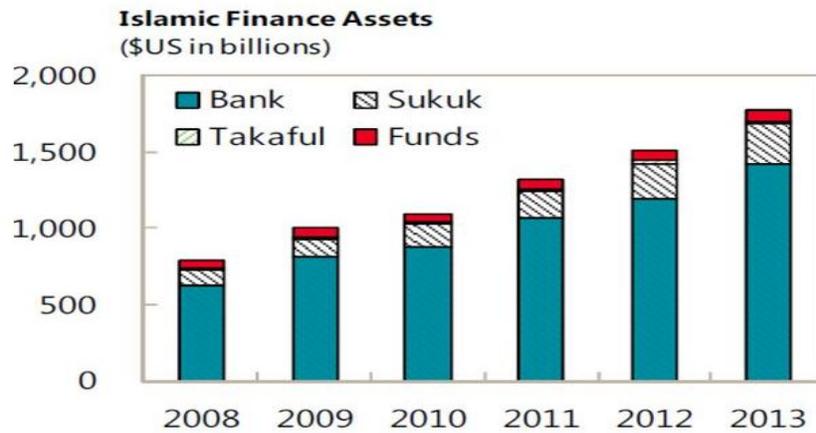


Figure 2: Islamic finance assets

Source: Islamic Finance: Opportunities, Challenges and Policy Options, IMF Staff Discussion Note No. 05/15

Islamic finance has been using several instruments that fit by Sharia rules. Main player in Islamic finance is the Islamic banks like banks in conventional finance. Islamic banking system is different than the conventional ones in terms of several aspects. First of all, there is no interest in Islamic banking. Islamic banks accept deposits in as a two types of accounts that can be named as current account and call accounts. Current accounts let the people save their money in the bank and have banking services. The money in those accounts can be withdrawn at any time by depositors. In the other option depositors deposit their money for a specified time period. The depositor and the bank make an agreement to sign a contract to assign the bank to invest the money and share the loss or profit by a pre-determined rates.

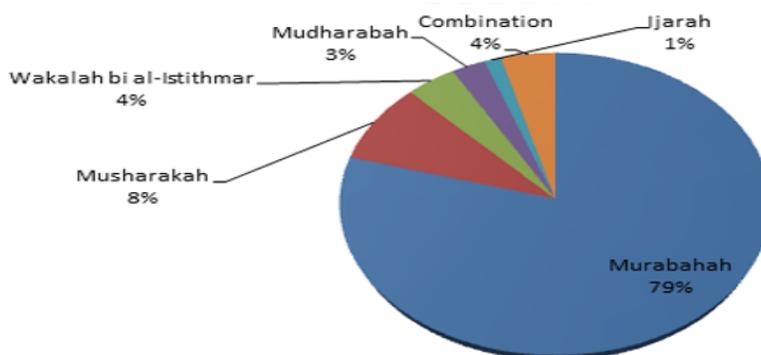


Figure 3: Portions of Islamic financial instruments
 Source: Malaysia Securities Commission

Haron (1996) stated that both Islamic banks and depositors have benefits by profit-loss sharing system in Islamic banking based on evidences that he got in his paper. Furthermore Olson and Zoubi (2016) stated by using data between the years 1999-2014 that Islamic banks outperformed than conventional banks. These facts stimulate the sector to grow during the two decades. Islamic finance has been using several instruments approved by the Sharia. The biggest portion among these instruments is Murabahah. Murabahah (or Murabaha) is a loan but not based on interest. It can be considered as a credit sale according to Sharia law. Islamic bank buys the property and sells to the customer according to an agreed price and bank retains ownership of the property until customer finishes the all payments.

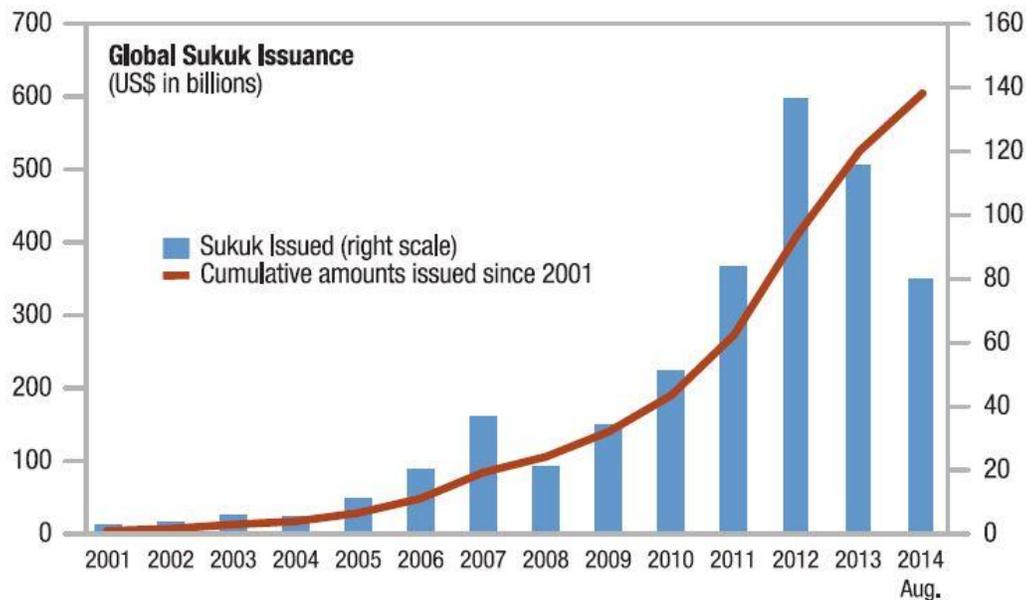


Figure 4: Global Sukuk issuance

Source: Global Sukuk Issuance

It can be seen that second biggest amount as financial asset in Islamic finance that outperformed than the others. It shows an outstanding performance in the last decades. The size of the Sukuk issuance and the percentage of the Sukuk among the instruments in Islamic finance have been increasing. Although there is a decrease after 2012 it is still huge when it is compared in 2000s.

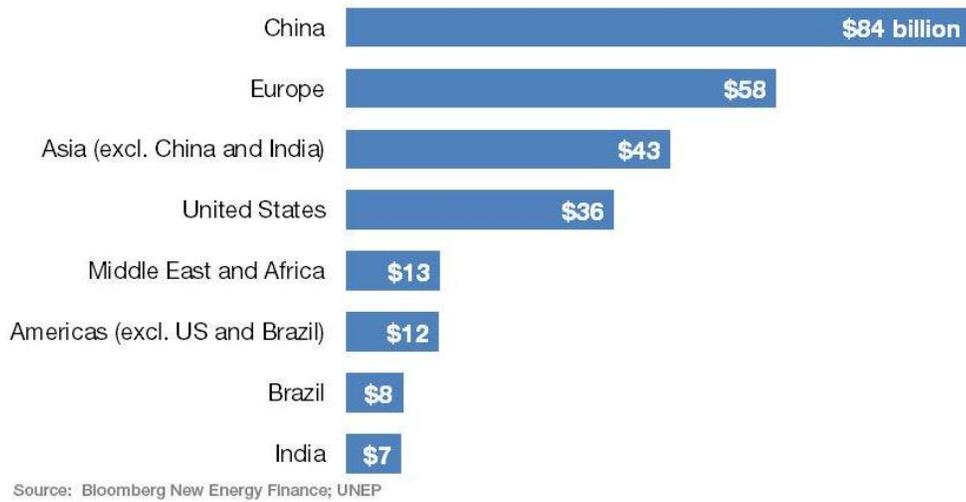


Figure 5: Top Investors in Renewable Energy 2014

As it can be seen from the figure showing the top investors in renewable energy Middle East countries and African countries are investing much less than China, Europe, Asia and USA. According UNEP report 2014, the total amount of investment in renewable energy between 2004 and 2014 is more than \$2 trillion. The growth rate in 2014 respect to the previous year is 17%.

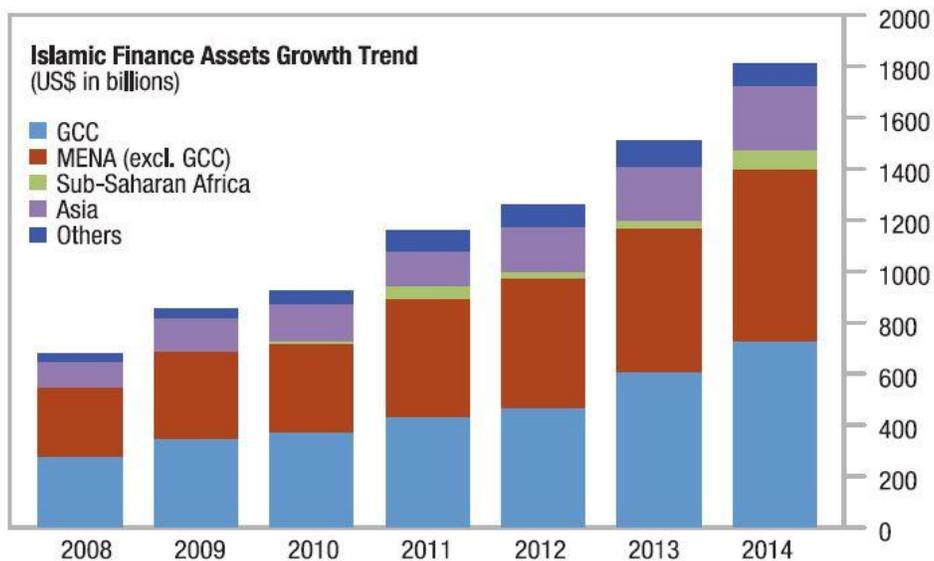


Figure 6: Islamic finance asset growth trend by region

Source: IMF Data

Islamic finance assets' growth show an increasing trend around the world. Furthermore, Gulf region countries and MENA (excluding Gulf region) countries outperform than the others. Especially the performance of these regions are quite more than the rest of regions.

	2012	2014	Growth
Europe	\$8,758	\$13,608	55%
United States	\$3,740	\$6,572	76%
Canada	\$589	\$945	60%
Australia/NZ	\$134	\$180	34%
Asia	\$40	\$53	32%
Total	\$13,261	\$21,358	61%

Note: Asset values are expressed in billions.

Figure 7: Total amount and rate of growth of socially responsible investments (SRI)

Source: Global Sustainable Investment Alliance

3. Conclusion

Islamic finance is an economical and financial system that approved by Sharia law or Sharia principles. Main characteristics of Islamic finance are prohibition of interest, uncertainty, speculation, investments that are considered unlawful such as alcohol, pork, pornography, or media related to gossip columns. Green finance is a broad term and there is no agreed definition among the papers. However it can be defined as financing the investments that stimulate sustainability, renewable energy, environmental products, policies that encouraging sustainable developments.

Both Islamic finance and green finance have been showing an increasing trends especially in the last two decades. Financing the socially responsible investments (SRI) and renewable energy investments are considered as green financing. Top investors in renewable energy and SRI and the countries where Islamic finance have showed an outstanding performance are different regions and countries. Therefore Islamic finance and green finance have been increasing in different regions. Moreover, growth in Islamic finance is mainly based on Murabaha which is a non-interest loan. 79% of the Islamic financial assets is Murabaha. On the other hand, portion of the Sukuk-that is sharing ownership of a tangible asset related to a project or investment- and Musharakah (or Musharaka)-that can be defined as joint enterprise allowing both parties sharing the profit or loss according to the pre-determined ratios- are relatively less than Murabaha. However Sukuk and Musharaka are the Islamic investments that can contribute and be used for green financing.

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