



FAITH-ALIGNED GREEN TAXONOMY FOR SMES: INTEGRATING MAQAŞID AL-SHARIAH INTO CLIMATE FINANCE CLASSIFICATION SYSTEMS

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ABSTRACT

Most existing sustainability assessment frameworks are primarily tailored for larger corporations, leaving MSMEs with limited resources and guidance to effectively evaluate their sustainability performance. To address this gap, this paper proposes a simplified, faith-aligned taxonomy tailored to Islamic MSMEs by adapting the ESG-i Framework into an ex-ante classification tool. Drawing on the EU Taxonomy, ASEAN Taxonomy, and Malaysia's CCPT, the model introduces four Environmental Objectives, a Do No Significant Harm (DNSH) screen rooted in the Islamic principle of Al-Darar (harm avoidance), and three Essential Criteria: Social Safeguards, Ethical Governance, and Shariah Compliance. Activities are categorised as Green, Amber, or Red, with built-in pathways for improvement. Designed to be accessible and values-driven, this taxonomy bridges Islamic ethical principles with sustainable finance goals, empowering Islamic financial institutions and MSMEs to participate more meaningfully in the green transition.

Keywords: Taxonomy; Islamic Finance; MSME; Maqasid al-Shariah; Do No Significant Harm

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INTRODUCTION

In response to the accelerating climate crisis, sustainable finance taxonomies have become essential tools for aligning capital flows with net-zero and climate-resilient development goals. These classification systems offer a structured approach to defining what qualifies as "green"





or “sustainable,” providing clarity for investors, regulators, and financial institutions. By promoting consistency, reducing greenwashing, and facilitating regulatory alignment, taxonomies enhance the integrity of sustainable finance. Crucially, taxonomies are not inherently secular or religious, they are classification frameworks that can be adapted to reflect diverse normative systems, including those rooted in faith.

However, most existing taxonomies, including the EU Taxonomy, ASEAN Taxonomy, and Malaysia’s Climate Change and Principle-based Taxonomy (CCPT) are designed for large financial institutions and corporations. Their technical complexity, reliance on sector-specific thresholds, and extensive documentation requirements make them difficult to apply in the context of micro, small, and medium enterprises (MSMEs), especially in developing economies. This poses a significant inclusion challenge, particularly in countries like Malaysia, where MSMEs account for over 97% of registered businesses and nearly half of national employment.

The challenge is further compounded in the domain of Islamic finance. While Islamic finance has grown into a USD 3 trillion global industry, most Shariah-compliant products remain decoupled from explicit environmental performance targets. Despite its ethical foundation grounded in Maqasid al-Shariah, which emphasises public benefit (*maslahah*), stewardship (*amanah*), and the avoidance of harm (*la darar*), Islamic finance lacks operational tools to integrate these principles into environmental classification and decision-making.

This paper proposes the development of a faith-aligned sustainable finance taxonomy tailored for Islamic financial institutions and MSMEs. Building on the ESG-i Framework, a values-based, MSME-friendly tool grounded in Islamic ethics, it introduces a revised classification logic that incorporates Environmental Objectives, Essential Criteria, and a Maqasid-aligned interpretation of “Do No Significant Harm” (DNSH). The aim is to create a practical, accessible taxonomy that supports both Shariah compliance and environmental integrity, while expanding the reach of sustainable finance to smaller enterprises and ethically motivated investors.

LITERATURE REVIEW

As the global economy transitions towards more sustainable and responsible business practices, and environmental, social, and governance (ESG) factors become increasingly scrutinised, MSMEs are presented with both opportunities and challenges to align their operations with sustainability practices and ESG requirements. Yet, most of the existing sustainability assessment frameworks tend to cater for the needs of large corporations. Therefore, it is critical that a framework be developed to cater to MSMEs and guide their transition towards sustainable practices.

Sustainable Taxonomies and Policy Guidance

Frameworks such as the EU Taxonomy, ASEAN Taxonomy, and Malaysia’s Climate Change and Principle-based Taxonomy (CCPT) aim to channel capital flows toward environmentally sustainable sectors. These taxonomies generally classify activities based on their contributions to climate mitigation, adaptation, or environmental degradation, using a tiered system to distinguish between green, transition, and non-aligned categories (World Economic Forum 2021; Mushtaq 2022). However, their technical depth, extensive disclosure demands, and lack of tailored support render them largely inaccessible to micro, small, and medium enterprises (MSMEs). This is particularly concerning in Malaysia, where MSMEs constitute 97.2% of





registered businesses and nearly half of the national workforce (Department of Statistics Malaysia 2023).

Recognising this disconnect, policy efforts in Malaysia are beginning to prioritise MSME inclusion, with emerging strategies linking halal certification and sustainability (Ministry of Economy, 2022; Ministry of Finance, 2023; Ministry of Investment, Trade and Industry, 2023). Yet, these frameworks remain secular in design and do not incorporate religious or ethical principles central to Islamic finance. Islamic finance, guided by Maqasid al-Shariah, emphasizes public welfare (*maslahah*), stewardship (*amanah*), and the prevention of harm (*la darar*) elements absent from conventional sustainability criteria. Without these ethical anchors, there is a misalignment between Shariah-based institutions and prevailing green finance mechanisms.

A faith-aligned taxonomy could address this gap. By integrating Islamic values into sustainability classification systems, Islamic financial institutions would be able to align investment decisions with both environmental objectives and Shariah principles. This integration could also support Shariah advisors, ethically motivated investors, and MSMEs seeking to align with values-based standards, thus enhancing inclusivity and ethical governance in sustainable finance.

Sustainable Bond and Sukuk

The market for sustainable sukuk—Islamic financial instruments linked to ESG outcomes—is expanding, particularly in jurisdictions where Islamic finance is well-established. It is projected that ESG-linked sukuk may comprise up to 15% of the global sukuk market in the near term (Louis Edmondes 2024). Malaysia has been at the forefront, introducing the SRI Sukuk Framework in 2014 and the Value-Based Intermediation (VBI) Framework in 2019. The 2022 ASEAN Sustainability-Linked Bond Standards further broadened the scope for ESG integration in sukuk issuance.

Despite this momentum, issuers still face challenges. These include the dual burden of meeting both ESG disclosure and Shariah compliance, inconsistent sustainability data, and low ESG literacy in many Islamic finance jurisdictions (Islamic Sustainable Finance & Investment 2024; UNDP & Kuwait Finance House 2025). As a result, green sukuk products often lack clarity, credibility, and mainstream traction.

It is essential to distinguish Islamic green finance from its conventional counterpart. Islamic finance is not simply a Shariah-compliant version of ESG investing; it embodies an ethical imperative for environmental protection and social equity. Islamic legal tradition allows for *ijtihad* (independent reasoning) to derive new rulings that respond to modern challenges, including climate change (Aldhaheeri 2025). Yet, systemic issues—such as fragmented standards, high compliance costs, and limited product innovation—continue to constrain market development and impact potential.

Maqasid al-Shariah in Islamic Finance

Maqasid al-Shariah is the higher objectives of Islamic law, provide a normative foundation for Islamic finance. These include the preservation of religion, life, intellect, wealth, and dignity. These goals resonate with many ESG principles, making Islamic finance a philosophically aligned partner to sustainability agendas (S&P Global, 2023; PwC, 2024). However, unlike conventional models that focus predominantly on material outcomes, Maqasid promotes long-term thinking, distributive justice, and moral integrity.





This ethical infrastructure underpins innovative instruments, such as green sukuk, Waqf-based blended finance, and Zakat-aligned SDG financing mechanisms (UNDP & Kuwait Finance House, 2025). In this sense, Maqasid offers both a framework and a methodology for operationalising faith-aligned sustainability practices in financial decision-making.

Islamic Finance and Climate Transition (Status Quo and Opportunities)

Islamic finance is gaining strategic importance in the climate transition, especially in fossil-fuel-reliant economies with strong Islamic finance sectors such as Saudi Arabia, the UAE, and Kuwait. These countries face significant exposure to energy transition risks, and Islamic finance could serve as a value-aligned channel for low-carbon development (S&P Global 2023).

Despite overlapping values, Islamic finance still lags behind ESG investing in product readiness, regulatory harmonisation, and investor awareness (Louis Edmondes, 2024). Many MSME clients struggle to meet ESG obligations due to the added costs of sustainability verification, limited technical capacity, or lack of access to compliant project pipelines (Alliance Bank, 2023). These realities highlight the need for Shariah-compliant tools that are adaptable, affordable, and accessible especially for smaller players.

Transforming the ESG-i Framework into a Faith-Based Taxonomy

The ESG-i Framework—originally designed to assess the post-financing impact of MSMEs through an Islamic lens—offers a viable platform for developing a faith-aligned sustainable finance taxonomy. By transforming the framework into a pre-financing classification tool, it could enable Islamic financial institutions to categorise MSME activities as Green, Transitioning, or Non-Aligned, based on both environmental and ethical criteria (Tabet et al., 2024).

This transformation would involve reinterpreting ESG-i's indicators to reflect Maqasid-driven priorities, while integrating standard sustainable finance features such as Environmental Objectives and Essential Criteria. Doing so could bridge the technical and philosophical divide between Islamic and conventional frameworks, promote halal-aligned sustainability, and improve access to finance for values-driven MSMEs. In turn, this could make a meaningful contribution to national and regional development goals, while reinforcing the ethical foundations of Islamic financial systems (Tabet et al., 2024).

METHODOLOGY

This paper adopts a three-step analytical approach to develop the conceptual foundation for a faith-aligned sustainable finance taxonomy anchored in Islamic principles. The methodology consists of the following stages: Exploration, Categorisation, and Alignment. This approach builds upon and adapts the methodology applied in the development of the ESG-i framework, extending it from assessment tools to a broader classification logic suitable for a taxonomy structure.





Step 1: Exploration – Reviewing the Landscape of Sustainable Finance Frameworks and Taxonomies and, Highlighting Similarities, Differences, and Gaps

To construct a faith-aligned green taxonomy that is both Shariah-compliant and environmentally credible, it is necessary to explore the current taxonomy landscape. This exploration focuses on three representative frameworks: the EU Taxonomy, ASEAN Taxonomy, Malaysia's Climate Change and Principle-based Taxonomy (CCPT), while comparing them with the ESG-i Framework. Each offers distinct insights into how environmental classification systems are conceptualised, operationalised, and adapted across jurisdictions and user groups. The review assesses these frameworks in terms of their target users, underlying principles, classification logic, technical requirements, regulatory enforcement, current application, and adaptability for Islamic MSMEs.

EU Taxonomy

The EU Taxonomy is a flagship regulatory tool for classifying environmentally sustainable economic activities within the European Union. It is legally binding for financial market participants offering products in the EU, large companies under the Non-Financial Reporting Directive (NFRD), and EU Member States when formulating green-related policies and standards. The framework is grounded in six environmental objectives: (i) climate change mitigation, (ii) climate change adaptation, (iii) sustainable use of water resources, (iv) circular economy, (v) pollution prevention, and (vi) biodiversity protection.

An activity is deemed taxonomy-aligned if it (i) contributes substantially to one environmental objective, (ii) does no significant harm (DNSH) to the others, and (iii) meets minimum social safeguards. The classification logic relies on detailed technical screening criteria linked to the NACE industrial classification system and measurable performance thresholds.

While the taxonomy sets a global benchmark, it is also highly technical and compliance-heavy. The documentation and impact verification burden pose a barrier for MSMEs, who are often not equipped to meet such standards. Nevertheless, the EU Taxonomy's environmental integrity and avoidance of greenwashing provide valuable reference points for designing classification criteria in simplified and adapted forms.

ASEAN Taxonomy

The ASEAN Taxonomy is designed to accommodate the diverse regulatory and developmental contexts of ASEAN Member States (AMS). Unlike the EU's rigid framework, the ASEAN model adopts a two-layered approach: the Foundation Framework (FF) and the Plus Standard (PS). The FF offers a qualitative, principle-based decision tree that categorises activities into Green (FF), Amber (FF), or Red (FF), based on four environmental objectives and three essential criteria: DNSH, Remedial Measures, and Social Aspects. The PS, introduced in Version 2.0, includes Technical Screening Criteria for selected sectors such as energy and carbon capture, utilisation, and storage (CCUS).

This flexible and progressive architecture enables broader uptake across AMS, especially among jurisdictions still developing their sustainability ecosystems. Although the taxonomy is not MSME-specific, the Foundation Framework's sector-agnostic, qualitative nature offers an adaptable model that could be localised for smaller enterprises. Furthermore, the inclusion of social safeguards, such as respect for human rights, enhances the relevance of Islamic ethical finance.





Malaysia's Climate Change Principle-based Taxonomy

The CCPT is Malaysia's national taxonomy, developed by Bank Negara Malaysia (BNM) to support climate-aligned financial practices. It provides a principle-based classification system for financial institutions, particularly banks and insurers, to categorise economic activities based on their climate alignment. It distinguishes six categories (C1 to C5b), ranging from fully aligned activities (C1) to those requiring active transition or remediation (C3–C5b), with prohibited activities explicitly listed.

Importantly, the CCPT is designed with a nurturing approach, recognising Malaysia's developmental context and the varying capacities of financial actors. It focuses on climate mitigation and adaptation, guided by five core principles, and does not mandate detailed technical thresholds. This makes it comparatively more accessible to financial institutions serving MSMEs.

Although not designed with Islamic finance or Maqasid al-Shariah in mind, the CCPT's simplicity and principle-based categorisation align well with Islamic ethical values such as harm prevention (*la darar*) and stewardship (*amanah*). It therefore offers a practical template for how qualitative assessments can be structured to support sustainability screening at the MSME level.

The EU Taxonomy represents a high benchmark in terms of scientific rigor and environmental stringency, but is inaccessible to smaller entities. Frameworks like CCPT and the ASEAN Taxonomy Foundation Framework provide simpler, principle-based alternatives that are more suitable for MSME classification.

Elements from the ASEAN Foundation Framework (e.g., decision trees, tiered classification), the CCPT (e.g., flexible categories), and the ESG-i (e.g., ethical principles and MSME orientation) can be synthesised to develop a new dual-filter taxonomy. This taxonomy would support Islamic financial institutions in classifying renewable energy and carbon-neutral projects in a manner consistent with both environmental objectives and Maqasid al-Shariah. Please refer to Appendix A for a more comprehensive mapping of all the taxonomies.

Step 2: Categorisation – Adapting ESG-i for Activity-Level Assessment

The ESG-i questions are very simplified and MSME-friendly, making them more accessible for smaller businesses. On the other hand, CCPT is designed for all financial institutions. It also comes with an accompanying document, the CCPT Due Diligence Questions for Guiding Principles (GP) 3 and 4, as well as sector-specific guidance for SMEs. However, despite being targeted towards SMEs, these documents remain complex and difficult to navigate. GP3 and GP4 are broader and applicable to both large corporates and SMEs. Still, there is a learning curve for bank personnel who do not have a sustainability background when assessing their clients. ESG-i's questionnaire-based approach can help bridge this gap. Therefore, adapting ESG-i into an MSME-friendly taxonomy would be highly beneficial.

In CCPT, GP1 and GP2 are assessed at the transaction or economic activity level, while GP3 and GP4 are assessed at the company level. This means that when a client requests funding, banks are expected to assess the intended use of proceeds. Since ESG-i was not originally designed as a classification tool, it does not currently have an equivalent to GP1 and GP2. However, this can easily be adapted into a faith-based, MSME-friendly taxonomy.

GP3 under CCPT includes risk identification and risk management questions across five categories: general, pollution, ecosystem and biodiversity, efficient use of resources, and greenhouse gas emissions. If a client fails the risk identification stage, they must then be assessed for risk management measures that directly address the identified harm. If a client





fails GP3 altogether, they are then assessed under GP4, which requires a time-bound action plan, among other remedial measures.

Classification		Economic Activity (Transaction Level)		Overall Business	
		GP1 Climate Change Mitigation	GP2 Climate Change Adaptation	GP3 No Significant Harm to the Environment	GP4 Remedial Efforts to Promote Transition
Climate Supporting	C1	GP1 or GP2 or both		✓	
	C2	GP1 or GP2 or both		✗	✓
Transitioning	C3	✗		✗	✓
	C4	GP1 or GP2 or both		✗	✗
Watchlist	C5	✗		✗	✗

Figure 1: Classification Tiers under the Climate Change and Principle-based Taxonomy (CCPT)

Source: CCPT, Bank Negara Malaysia

The classification and assessment approach under the ASEAN Taxonomy Foundation Framework (FF) is similar to CCPT in that it is principle-based and qualitative. While the Plus Standard (PS) uses detailed Technical Screening Criteria, this paper focuses only on the Foundation Framework. Under FF, economic activities may be classified as Green, Amber, or Red. As with other taxonomies, all Environmental Objectives (EOs) in the ASEAN Taxonomy are assessed at the activity level. Hence, we believe that a similar approach is necessary for a faith-based MSME-friendly taxonomy. Unlike CCPT, the ASEAN FF assesses the DNSH (Do No Significant Harm) and remedial measures at the activity level, while social aspects are assessed at the company level.

A Green classification means the activity makes a substantial contribution to the EO. An Amber classification may be used temporarily when some harm has been identified, but a remedial plan is in place. A Red classification means the activity is either not aligned with any EO or is actively causing harm. An activity may contribute to multiple EOs, but it is important to determine the primary EO based on factors such as national priorities, relevance to the company, and strategic focus. After determining the primary EO, the activity is assessed using the relevant decision tree.



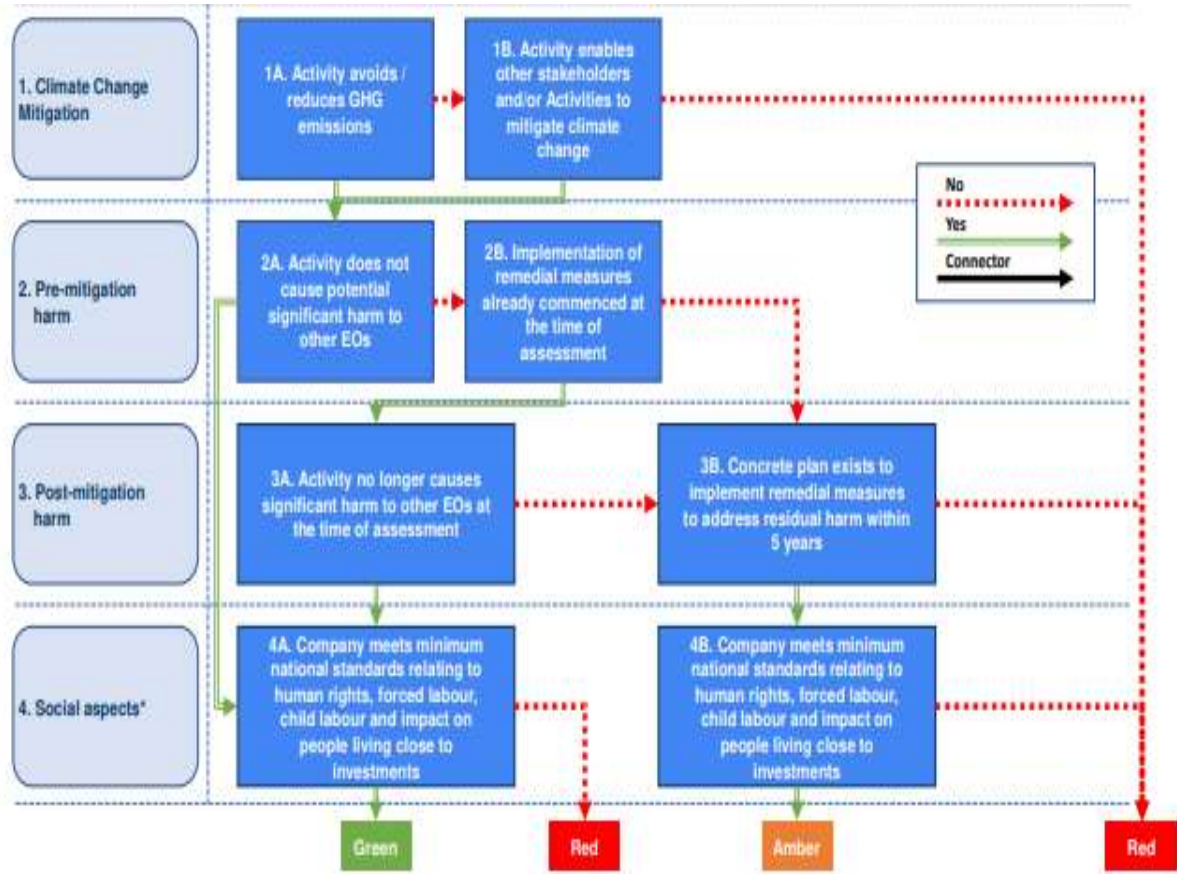


Figure 2: ASEAN Taxonomy Foundation Framework Classification Flow: Green, Amber, Red Categories
Source: ASEAN Taxonomy

We did not delve deeper into the classification logic of the EU Taxonomy, as it is too technical and complicated to be adopted into an MSME-friendly taxonomy. However, we note that its overarching structure is similar to the ASEAN Taxonomy, requiring that an activity substantially contributes to at least one environmental objective, does no significant harm to any other, and meets other essential criteria or minimum safeguards. Compared to CCPT, both the EU and ASEAN taxonomies address a broader set of environmental objectives, whereas CCPT remains more climate-focused in line with current national priorities in Malaysia.



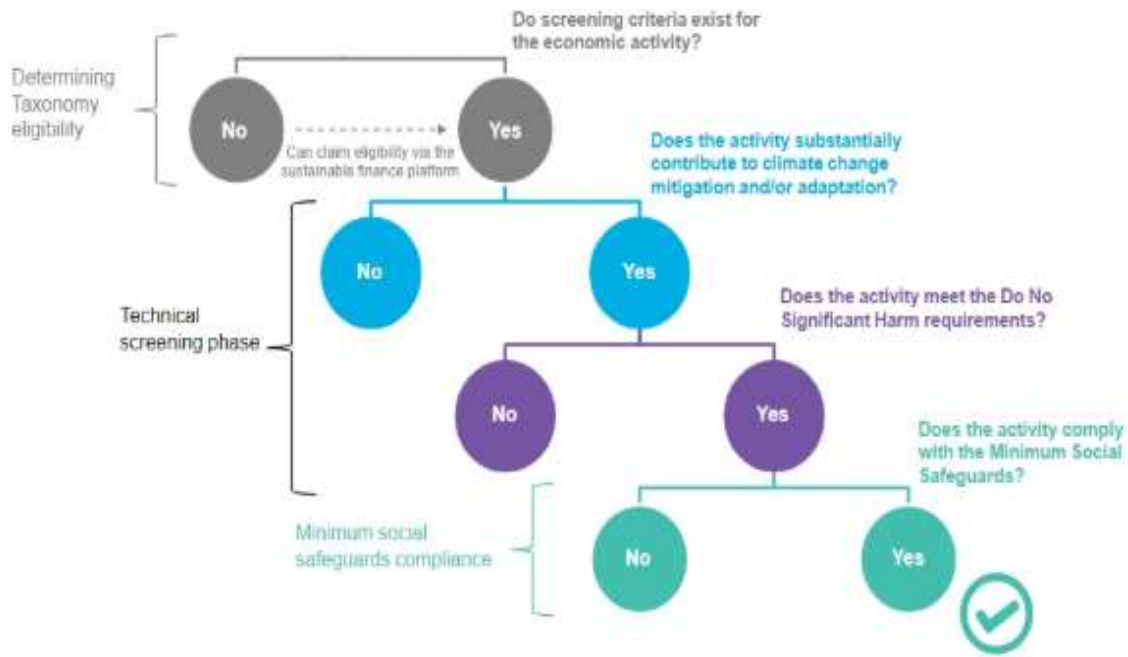


Figure 3: EU Taxonomy Decision Flow for Sustainable Activities
 Source: EU Taxonomy

Step 3: Alignment – Proposing a Maqasid-Integrated Taxonomy Logic

Based on these insights from existing taxonomies, several key additions are needed to adapt ESG-i into a fully functioning classification taxonomy. First, ESG-i must incorporate an ex-ante screening mechanism at the activity level to mirror the role of CCPT GP1 and GP2, as well as the activity-based assessments of the ASEAN and EU taxonomies. This requires establishing clear eligibility criteria or guiding questions to determine whether an MSME’s proposed activity substantially contributes to an environmental or Maqasid objective, and whether it causes any significant harm. Second, ESG-i must embed a logic flow that reflects remedial and transition pathways, similar to CCPT GP3 and GP4 or the ASEAN Taxonomy’s Amber category, to accommodate MSMEs that may not yet be fully aligned but are actively taking steps to improve. Third, ESG-i will need to define minimum safeguards and ethical thresholds in line with Maqasid al-Shariah to ensure that activities meet both sustainability and faith-based standards. These enhancements would transform ESG-i from an impact assessment tool into a practical, faith-aligned taxonomy that enables Islamic financial institutions to classify MSME activities and support informed, values-based financing decisions.

The final step introduces a faith-aligned classification logic that can form the basis for a Maqasid-based sustainable finance taxonomy. Building upon the ESG-i logic model, this paper proposes a taxonomy structure guided by the Quadruple Bottom Line (QBL):

1. Planet (environmental sustainability, harm avoidance).
2. People (social justice and rights).
3. Profit (economic resilience and fairness).
4. Principle (Shariah compliance, ethical integrity).





FINDINGS, ANALYSIS AND DISCUSSION

Understanding “Do No Significant Harm” (DNSH) Through the Lens of Shariah Principle *Al-Darar* (Avoidance of Harm)

Transforming the major themes under the Planet pillar into Environmental Objectives for the ESG-i Taxonomy is relatively straightforward. Similarly, incorporating social safeguards and governance principles as Essential Criteria aligns naturally with the taxonomy’s ethical foundation. However, the current ESG-i questionnaire lacks several key components commonly found in standard sustainable finance taxonomies, particularly mechanisms to assess negative externalities.

To address this gap, it is essential to deepen our understanding of the “Do No Significant Harm” (DNSH) principle and its alignment with the Shariah concept of *Al-Darar* (the avoidance of harm). Integrating DNSH through this ethical lens will help ensure that activities not only contribute positively to environmental goals but also do not cause undue harm, either environmentally or socially, thereby upholding the integrity of both sustainability and faith-based standards.

The Do No Significant Harm (DNSH) principle is a foundational safeguard in sustainable finance taxonomies, most notably the EU Taxonomy. Under this principle, an economic activity can only be classified as environmentally sustainable if it not only contributes substantially to at least one environmental objective but also avoids causing significant harm to any of the others (S&P Global, 2022). For example, an initiative that reduces carbon emissions must also avoid contributing to water pollution or biodiversity loss. This holistic approach prevents burden shifting, where gains in one area lead to unintended environmental degradation elsewhere (EEB, 2022).

The DNSH requirement adds rigor and integrity to classification systems by ensuring that activities are environmentally coherent and ethically defensible. However, the technical detail required often involving life-cycle assessments and quantitative benchmarks, poses challenges for smaller entities like MSMEs, who may lack the resources to meet such standards (LSEG, 2022). As a result, simplified DNSH logic and transitional categories (e.g., “Amber” for partially aligned activities) are increasingly proposed to broaden accessibility while maintaining credibility.

This concept of harm avoidance is strongly mirrored in Islamic ethical finance through the principle of *Al-Darar*, one of the core tenets of Maqasid al-Shariah. *Al-Darar* obligates the prevention or removal of harm (*darar*) as a necessary condition for upholding the objectives of Shariah, such as the protection of life, property, and the environment. The concept is encapsulated in the legal maxim *la darar wa la dirar* (“no harm shall be inflicted or reciprocated”), which plays a similar ethical role to DNSH in taxonomy design (Kamali, 2008).

Incorporating DNSH within a faith-aligned taxonomy thus means screening not just for environmental benefits but also for potential ethical and societal harms. Aligning DNSH with *Al-Darar* reinforces both environmental responsibility and religious accountability, creating a classification system that is not only technically robust but also spiritually grounded. This makes DNSH an essential criterion in any taxonomy aspiring to serve Islamic Financial Institutions and ethically motivated MSMEs.

ESG-i Taxonomy Decision Tree

The ESG-i Framework is built on four core pillars: Planet, People, Principle, and Profit. For the purpose of developing a faith-aligned MSME taxonomy, the profit pillar will be omitted,





focusing instead on the ethical and environmental dimensions most relevant to Islamic sustainable finance. Under this taxonomy logic, the Planet pillar will serve as the foundation for defining Environmental Objectives (EOs), which will be used to assess whether an MSME's activities substantially contribute to environmental sustainability. These four EOs are: (1) Environmental Stewardship, which reflects efforts to adopt responsible practices across offices and facilities such as energy efficiency, waste reduction, and sustainable procurement; (2) Air and Climate, which focuses on managing and reducing GHG emissions through renewable energy use, low-carbon transport, and energy monitoring; (3) Water Management, which covers the conservation, monitoring, and responsible usage of water resources, including setting and achieving reduction targets; and (4) Waste Management, which promotes circularity, minimisation of waste generation, and targets such as zero waste to landfill or ocean. These EOs will form the environmental backbone of the taxonomy, guiding the classification of MSME activities through simplified, yet structured, sustainability questions aligned with both Maqasid al-Shariah and climate finance objectives.

Incorporated into this logic is a critical addition inspired by international best practices and aligned with Islamic ethical principles: Do No Significant Harm (DNSH) requirement, framed through the lens of *Al-Darar*, the principle of avoiding harm. This intermediate screening step reflects a foundational component of sustainable finance taxonomies, which requires that any activity that contributes positively to an environmental objective must also avoid causing significant harm to other environmental or social domains. In the context of a faith-aligned taxonomy, this concept resonates strongly with the Islamic emphasis on harm prevention and responsible action. The DNSH/*Al-Darar* layer serves as an integrity checkpoint, ensuring that the net impact of the activity remains consistent with both sustainability standards and Shariah values.

Following the structure of the ASEAN and EU Taxonomies, the remaining two pillars of the ESG-i Framework: People and Principle will serve as the Essential Criteria within this MSME-friendly, faith-aligned taxonomy. These Essential Criteria will be used to determine whether an activity that contributes to environmental objectives and passes the DNSH/*Al-Darar* screen also aligns with broader ethical and social safeguards. Specifically, the People pillar will cover social aspects such as fair labour practices, human rights, and employee well-being. The Principle pillar, meanwhile, will be partially adapted Shariah compliance, originally embedded under Principle, will be extracted and treated as a third Essential Criterion in its own right. This recognises the critical importance of Shariah alignment in Islamic finance, beyond governance and ethical culture, and positions it as a core safeguard alongside environmental and social dimensions.

Together, these three Essential Criteria: Social Safeguards, Governance and Ethical Oversight, and Shariah Compliance will form the integrity check of the taxonomy, ensuring that activities are not only environmentally beneficial but also socially responsible and religiously sound.

The resulting classification logic follows a structured decision tree that mirrors the logic of leading taxonomies. Activities are first assessed against their contribution to one or more Environmental Objectives (EOs). If a substantial contribution is demonstrated, the activity is then screened for Do No Significant Harm (DNSH), contextualised through the principle of *Al-Darar*. Only if the activity passes this screen does it proceed to the evaluation of the three Essential Criteria (ECs). Based on the outcomes of all assessments, the activity is then categorised as Green (fully aligned), Amber (transitioning, with credible remedial measures), or Red (not aligned or causing significant harm).

This expanded classification logic not only enhances the robustness of the ESG-i Framework but also strengthens its relevance and applicability for Islamic financial institutions





seeking to support MSMEs in an inclusive, values-based, and environmentally credible manner. To support the application of this classification system, a set of guiding questions adapted from the original ESG-i questionnaire has been developed to help determine whether a specific MSME activity qualifies under each Environmental Objective and Essential Criterion. These questions are broad enough to accommodate the diversity of MSMEs yet specific enough to inform clear classification outcomes. For the full set of guiding questions, please refer to Appendix B-F.



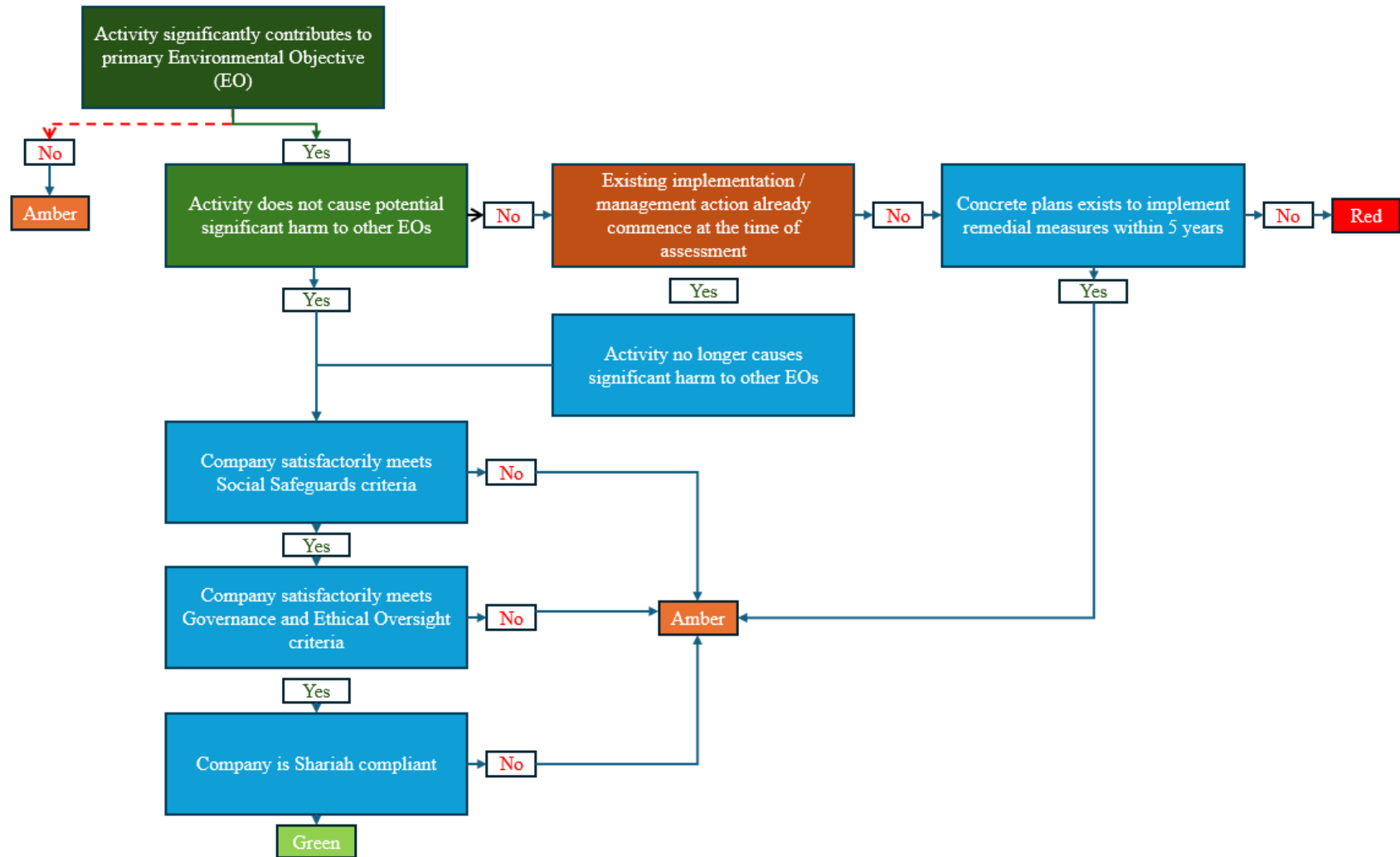


Figure 4: ESG-i Decision Tree
Source: Authors' own





CONCLUSION

This paper presents a foundational framework for developing a faith-aligned sustainable finance taxonomy that is both grounded in Islamic ethical principles and attuned to the operational realities of micro, small, and medium enterprises (MSMEs). By adapting the ESG-i Framework originally designed as a post-investment impact assessment tool into a classification logic suitable for ex-ante decision-making, the model bridges a critical gap in Islamic sustainable finance. Drawing from established taxonomies such as the EU Taxonomy, ASEAN Taxonomy, and Malaysia's Climate Change and Principle-based Taxonomy (CCPT), this proposed model integrates the principle of Maqasid al-Shariah, with its emphasis on stewardship (*amanah*), public welfare (*maslahah*), and harm avoidance (*la darar*), into the fabric of environmental and social assessments.

The taxonomy's structure is intentionally simple, accessible, and aligned with the needs of Islamic MSMEs, who are often excluded from mainstream sustainable finance due to technical barriers and misaligned frameworks. By using qualitative guiding questions and a clear tiered logic; Green, Amber, Red, the model provides an intuitive pathway for businesses and financial institutions to screen, classify, and improve activities in line with both sustainability and Shariah standards. The inclusion of a DNSH/*Al-Darar* screening mechanism and essential ethical criteria (Social Safeguards, Governance, and Shariah Compliance) ensures that the framework upholds integrity while remaining adaptable to the capabilities of smaller enterprises.

Importantly, this taxonomy does not seek to replace existing tools but to complement and contextualise them within a faith-based framework. It offers a replicable model that can support Islamic financial institutions in advancing climate-aligned financing without compromising on religious or ethical mandates. In doing so, it also contributes to the broader discourse on ethical finance by showing that faith-based principles can reinforce, rather than conflict with, global sustainability goals.

Future work should focus on piloting the ESG-i taxonomy across selected institutions and sectors to evaluate its usability and effectiveness in real-world financing decisions. In parallel, aligning this taxonomy with national halal-linked development strategies and capacity-building efforts could help mainstream faith-aligned sustainability approaches, particularly in countries where Islamic finance plays a central role in economic development. Ultimately, the ESG-i taxonomy offers a strategic opportunity to embed values-driven decision-making into the architecture of sustainable finance, enabling a more inclusive, ethical, and resilient financial eco-system.

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APPENDICES





Appendix A: Benchmarking Conventional and Principle-Based Taxonomies for ESG-i Design

No.	Framework	Target Users	Pillars / Objectives	Classification Logic	Level of Technicality	Enforcement	Current Use	Potential for Adaptation
1.	EU Taxonomy	Financial market participants in the EU Large companies EU and Member States for setting public measures, standards, or labels for green financial products	Six Environmental Objectives: 1. Climate change mitigation 2. Climate change adaptation 3. Sustainable use and protection of water and marine resources 4. Transition to a circular economy 5. Pollution prevention and control 6. Protection and restoration of biodiversity and ecosystems	An activity is considered Taxonomy-aligned if it: <ul style="list-style-type: none"> Substantially contributes to one EO Does no significant harm (DNSH) to the others Meets minimum social safeguards Classification relies on detailed technical screening criteria tied to NACE sectors	Very high Requires extensive documentation and impact verification	Mandatory for large financial institutions under the EU Taxonomy Regulation	Widely applied by listed companies in the EU Financial institutions report Taxonomy-aligned loans and investments EU funds disclose alignment	Too technical for direct MSME application However, the underlying principles can be mapped to a simplified ESG-i framework





No.	Framework	Target Users	Pillars / Objectives	Classification Logic	Level of Technicality	Enforcement	Current Use	Potential for Adaptation
2.	ASEAN Taxonomy	ASEAN Member States (AMS), inclusive of diverse development levels Users include companies, investors, and governments	Four Environmental Objectives: 1. Climate change mitigation 2. Climate change adaptation 3. Protection of healthy ecosystems and biodiversity 4. Resource resilience and circular economy Three Essential Criteria (v2.0): EC1: DNSH EC2: Remedial measures EC3: Social aspects (e.g. human rights, labour)	Two-tiered framework: Foundation Framework (FF) – qualitative, sector-agnostic decision trees with Green-FF, Amber-FF, Red-FF classifications Plus Standard (PS) – detailed Technical Screening Criteria for selected sectors (e.g., energy, CCUS)	Moderate Simpler than EU Taxonomy, but still requires technical understanding	Voluntary Designed for progressive adoption across AMS	Version 2.0 (2023) introduced TSC for the energy sector AMS are adopting elements in national taxonomies (e.g. Malaysia)	FF's qualitative logic can be adapted to ESG-i Supports a faith-aligned, MSME-friendly approach





No.	Framework	Target Users	Pillars / Objectives	Classification Logic	Level of Technicality	Enforcement	Current Use	Potential for Adaptation
3.	Climate Change Principle-based Taxonomy (CCPT)	Financial institutions regulated by Bank Negara Malaysia Also relevant for capital market players, analysts, and intermediaries	Five Guiding Principles: 1. Climate change mitigation 2. Climate change adaptation 3. Do no significant harm 4. Remedial measures 5. Prohibited activities	Classification tiers: C1 (aligned) to C5b (requires significant remediation) GP1–GP2: Activity-level GP3–GP4: Entity-level (risk management, transition plans)	Moderately low Principle-based, nurturing approach tailored to Malaysia’s development context	Mandatory for Malaysian financial institutions from [effective date to be inserted]	Piloted by CCPT Implementation Group under JC3 SC1 Now adopted across Malaysian financial institutions	CCPT’s guiding principles and tiered logic align well with ESG-i Feasible to adapt for MSME-level screening in Islamic finance
4.	ESG-i Framework	MSMEs seeking to manage sustainability risks and opportunities Islamic banks and impact investors funding MSMEs	Based on four pillars: 1. Planet 2. People 3. Profit 4. Principle (Shariah compliance and ethical values) Emphasises Islamic principles and localised relevance	28 qualitative questions weighted by pillar: Planet (30%), People (30%), Profit (20%), Principle (20%) Scores normalised and aggregated	Very low Designed to be MSME-friendly and easy to understand Qualitative, with minimal technical or documentation burden	Voluntary	Piloted with 31 MSMEs across diverse sectors in Malaysia	High potential to evolve into a full taxonomy





Appendix B: Environmental Objectives (EO) – Activity-Level Guiding Questions (Source: Author’s own, adapted from the Enhance ESG-i Framework)

No	Environmental Objectives	Guiding Questions for the Specific Activity
1	Environmental Stewardship	<ul style="list-style-type: none"> ● Does the activity incorporate environmentally responsible practices (e.g., energy-efficient equipment, reduced paper or plastic use, office/resource greening)? ● Will the implementation of this activity improve the overall environmental footprint of the business process? ● Are any policies or behavioural nudges introduced through this activity to promote sustainable consumption or procurement?
2	Air and Climate	<ul style="list-style-type: none"> ● Will this activity reduce or avoid greenhouse gas (GHG) emissions? ● Does the activity involve the use of renewable energy (e.g., solar panels, biogas)? ● Does the activity minimise reliance on fossil fuels or reduce employee commuting through digitalisation or logistics improvements? ● Does this activity avoid locking in high-emission technologies or practices?
3	Water Management	<ul style="list-style-type: none"> ● Does this activity involve any water efficiency improvements (e.g., low-flow systems, water reuse)?- Will water usage be monitored, recorded, or reduced as part of this activity? ● Does the activity contribute to sustainable water use in high-stress or vulnerable watersheds?- Are water reduction targets or conservation strategies part of the activity implementation?





4	Waste Management	<ul style="list-style-type: none">● Will this activity reduce the amount of waste sent to landfill or ocean?● Does the activity involve recycling, upcycling, or reusing materials?● Is the activity designed to eliminate single-use products or packaging?- Does the activity generate circular value (e.g., waste from one process is input for another)?
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Appendix C: Do No Significant Harm / Al-Darar Assessment (Source: Author's own)

Harm Area	Guiding Questions
Environmental Pollution	Does the activity result in hazardous waste, emissions, or pollutants that could damage air, water, or soil quality?
Biodiversity and Ecosystems	Will the activity negatively affect biodiversity, deforestation, or natural ecosystems? Are there mitigation plans in place?
Resource Depletion	Does the activity over-extract or misuse finite natural resources (e.g. water, minerals)? Can the input be substituted with more sustainable options?
Social Harm	Does the activity risk displacing or disadvantaging communities? Is there a plan to consult and compensate affected people fairly?
Moral/Ethical Harm	Is there a reputational or moral risk associated with the activity under Islamic principles—even if legally permissible?





Appendix D: Essential Criterion 1: Social Safeguards (People Pillar) Source: Author's own, adapted from the Enhance ESG-i Framework)

Social Safeguard Area	Guiding Questions
Labour Rights	<ul style="list-style-type: none"> - Are fair wages, safe conditions, and decent working hours ensured? - Are anti-discrimination and anti-child/forced labour policies in place?
Employee Well-being and Growth	<ul style="list-style-type: none"> - Does the company support skills development or personal growth of employees? - Are mental health or well-being initiatives offered?
Community Engagement	<ul style="list-style-type: none"> - Does the company support community-based projects or social causes? - Are underserved or vulnerable communities engaged or supported?
Integration into Strategy	<ul style="list-style-type: none"> - Are social impacts of business decisions assessed and monitored? - Are these considerations reflected in company planning and culture?





Appendix E: Essential Criterion 2: Governance and Ethical Oversight (Principle Pillar)
 (Source: Author's own, adapted from the Enhance ESG-i Framework))

Governance & Ethics Area	Guiding Questions
Commitment to Positive Impact	<ul style="list-style-type: none"> - How often is environmental/social impact considered in decision-making? - Is it viewed as a strategic priority?
Board Oversight	<ul style="list-style-type: none"> - Does the company have an active board providing strategic and operational guidance? - Are meetings held regularly and outcomes documented?
Internal Policies	<ul style="list-style-type: none"> - Are internal SOPs and policies formally documented and regularly updated? - Are these communicated clearly within the organisation?
Legal Compliance	<ul style="list-style-type: none"> - How is compliance with national/local regulations monitored? - Is there a system or person in charge of compliance oversight?
Ethical Decision-Making	<ul style="list-style-type: none"> - Are business ethics integrated into company culture and operations? - Are mechanisms in place to review, monitor, and improve ethical standards?





Appendix F: Essential Criterion 3: Shariah Compliance (Principle Pillar)

<p>Shari'ah Compliance</p>	<ul style="list-style-type: none">- Does the company's business model avoid prohibited (haram) activities?- Are financial transactions free from riba, gharar, and other non-compliant elements?
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