Green Sukuk: The race to be first

One of the largest barriers to large-scale clean energy deployment is access to capital and investment. Limiting temperature rise to 2° globally will require an additional US$44 trillion in clean energy investment between now and 2050, according to the International Energy Agency. Energy efficiency has stimulated even less investor appetite than clean energy projects, given the perceived complexities of measuring energy saved as opposed to energy generated. LEE IRVINE, MICHAEL GRIFFERTY and ALICE COWMAN discuss the role Islamic debt can play in encouraging the growth of the sector.



GREEN SUKUK

By Lee Irvine, Michael P Grifferty & Alice Cowman

A number of GCC governments, including those in Dubai and Saudi Arabia, have set clean energy targets, as well as ambitious energy efficiency targets. Compounding the difficulty of achieving these targets, the population of the GCC is expected to grow to over 53 million by 2020, a 30% increase over the population in 2000, making the GCC one of the fastest growing regions in the world. Such a population growth trajectory will create an unprecedented rise in demand for energy, water, transport, urban development and infrastructure. Substantial amounts of investment will be required in order to finance the clean energy and energy efficiency projects necessary to meet the needs of the future population.

Increasingly, investors in other parts of the world are looking to the capital markets as a low-cost alternative to fuel growth in these sectors through green bonds. Given the growth of the Islamic finance industry, a green Sukuk that funds these projects in compliance with Shariah law is the obvious next step. We have yet to see either a green bond or a green Sukuk issued in the GCC but increasingly, we see signs that this might change. Most recently, the Dubai Supreme Council of Energy (DSCE) announced its partnership with the World Bank to develop a green investment strategy incorporating Sukuk. If this strategy succeeds, governments in the GCC could play a key role in developing a green Sukuk market. Such a market could play a key role in financing the region's ambitious clean energy and infrastructure projects.

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Capital markets – Green bonds

Green bonds, which tie the proceeds of the bond to environmentally friendly investments, have been used to finance green projects since 2008, when the World Bank pioneered the first-ever green bond. Since then, the World Bank has raised US$6.4 billion in green bonds through 67 transactions in 17 currencies, funding a diverse range of projects from drinking water projects in Tunisia to the treatment of wastewater in China. The Climate Bonds Initiative, an independent body promoting green finance, expects the value of green bonds issued in 2014 will increase to approximately US$40 billion, almost four times the amount issued in 2013. Market participants expect the issuance of green bonds to exceed US$100 billion by the end of 2015. With the development of the first green-bond index earlier this year, the product is likely to become a mainstay in the fixed income market.

While historically international agencies have issued green bonds, the private sector has started to use green bonds to finance their green activities. During the

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first six months of 2014, it is estimated that companies issued half of all green bonds and in May 2014, GDF Suez launched the largest corporate green bond in the world — a huge EUR2.5 billion (US$3.5 billion) bond linked to 'renewable energy and energy efficiency projects. Government and government institutions have also been using green bonds to finance their infrastructure needs. For example, Massachusetts was the first state in the US to issue a green, tax-exempt, municipal bond, the proceeds of which were used to fund energy conservation projects, such as improving energy efficiency in state buildings and protecting open spaces. California followed, raising US$300 million through the issue of a green bond in September 2014 to fund a variety of clean energy projects.

Investors typically are attracted by the ability to easily integrate environmental initiatives into their investment portfolio, as well as the ability, in some cases, to offset the risks of their portfolio being exposed to climate change. Therefore not only public-sector investment funds, but increasingly asset managers and financial institutions are also buying these bonds. Investors representing over US$2 trillion in assets under management — including Zurich Insurance Group, Barclays and Aviva — issued an investor statement on green bonds and climate bonds in September 2014 committing to grow the global market in the financing of climate change solutions. Barclays announced plans to invest GBP1 billion (US$1.6 billion) in green bonds by next year. Zurich Insurance Group confirmed it plans to invest US$2 billion in green bonds. Two insurance industry associations, the International Cooperative and Mutual Insurance Federation and the International Insurance Society, have also stated their members would double climate investments to US$84 billion by the end of the 2015 and multiply their green investment tenfold by 2020.

Capital markets – Green Sukuk

While Islamic finance principles and environment-friendly products, such as green bonds, both emphasize the importance of ethical investing, and Sukuk can be tailored to finance green initiatives, Islamic finance has remained largely absent from the green financing sector.

The global Islamic finance industry has seen remarkable growth in the last few years, with annual Sukuk issuances increasing from less than US$32 billion in 2010 to an expected US$70 billion in 2014. Despite GCC countries with large infrastructure needs, such as Saudi Arabia and the UAE leading the way (ranking second and third for total Sukuk issuances in 2013), the growing Sukuk market has so far not tapped into the potential of green Sukuk.

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Green Sukuk could mobilize essential finance needed to fund the rising number of clean energy initiatives throughout the GCC. Tighter capital regulations, including the introduction of Basel III, are already placing strain on regional and European banks, which has led to rising costs of finance and an increasing reluctance by banks to engage in longer term lending.

Since the majority of clean energy projects in the region will rely on large, long-term infrastructure spending, a green Sukuk would be an ideal vehicle to support the development of low-carbon industries and further strengthen growth in regional Sukuk markets. A successful 30-year international Sukuk issuance by Saudi Electricity Company has already demonstrated the investor appetite for long-term Shariah compliant paper. Sukuk also could potentially fund shorter term energy efficiency projects, for which low cost funding has traditionally been harder to come by. By incorporating environmental requirements into a traditional Sukuk, issuers would be able to benefit from the synergy between Islamic and conventional investors who are looking to invest ethically. This will help to facilitate broader participation in the Sukuk market by conventional investors, who are already showing an increasing appetite for Islamic financial products. An issuance of green Sukuk would also allow Islamic investors access to a wider range of Shariah compliant investment products.

Recognizing the benefits of a green Sukuk, governments and their affiliated bodies are working to ensure a stable and supportive framework for issuers and investors. In August 2014, the Securities Commission Malaysia published guidelines for the issuance of sustainable and responsible investment Sukuk, as part of a highly anticipated expansion of the country's existing Sukuk framework. These guidelines are intended to allow Islamic institutions to capitalize on the growing demand for social and environmental focused investments. With Malaysia's strong regulatory framework and a growing demand for Shariah compliant investments, these guidelines are anticipated to drive growth in the sector and provide much needed finance for such projects.

As the Malaysian and Middle Eastern Sukuk markets have varying dynamics and characteristics, the development of a green Sukuk market in the Middle East will require more than a 'drag-and-drop' approach using the Malaysian standards. The UAE Securities and Commodities Authority's recent regulatory reforms for Sukuk mark a positive step in the development of a modern Sukuk regime, and could potentially be used as a building block for establishing a similar green Sukuk framework.

Challenges

Of course, a number of challenges

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to developing a green Sukuk market remain. The market for green instruments has yet to mature, which has led to a fragmentation of standards to certify green initiatives. Independent verification agencies such as the Climate Bonds Initiative have developed guidelines to help standardize green criteria, although each organization's standards vary slightly and the process is voluntary. This makes the due diligence process more difficult for investors, because of the difficulty of identifying and comparing the levels of environmental impact between projects. The GCC governments can play a role in coordinating a streamlined framework to encourage new issuers.

The small secondary market for green bonds and the buy-and-hold nature of regional investors suggests that, when the green Sukuk market develops, it may share similar liquidity constraints. As the market matures, liquidity will improve. Though, in the meantime, an emphasis on education and marketing of the Sukuk structure will help increase demand and liquidity in the green Sukuk market.

Private sector issuers within the MENA market may find that deal size is a deterrent for a corporate Sukuk issuance with currently planned projects simply not sizeable enough to justify Sukuk issuances, although this may change as North Africa and, particularly, Morocco and Egypt start to invest in clean energy.

As many environment-friendly projects involve a degree of new technology, green bonds and green Sukuk may also carry a higher risk profile. Political and economic uncertainty can magnify this risk. A number of governments have introduced tax incentives to encourage the support of green bonds. For example, the US introduced Clean Renewable Energy Bonds (CREB) and Qualified Energy Conservation Bonds (QECBs) both of which have tax benefits for US investors. The GCC governments, which can offer only a few tax incentives, may be able to mitigate some uncertainty by providing policy support, or offering government guarantees or risk-sharing incentives to improve investor uptake and confidence.

Watching the race

So who will be first? A corporation might be the most efficient vehicle to issue such

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Sukuk, as increasingly, companies are attracted to capital markets by favorable capital costs. In May 2014 the French multinational electric utility company GDF Suez announced its first green bond — a huge EUR2.5 billion (US$3.5 billion) issuance linked to clean energy and energy efficiency projects that fight climate change. The bond shares GDF Suez's credit rating of 'A1/A-'. Given the paucity of clean energy projects in the GCC, a corporate based in the GCC may not have had a large enough green energy project to justify a benchmark Sukuk issuance, although there are signs that this is changing. Saudi-based power and water project developer ACWA Power has confirmed that it is seeking financing for US$15 billion-worth of projects, almost half of which are in renewable energy and the company has stated that it would consider Sukuk as a financing option. However, the Dubai government has already indicated its intention to look to Sukuk to finance its clean energy and energy efficiency goals and given the emirate's experience, existing developed Sukuk program, as well as Sheikh Mohammed's intention to develop Dubai into the center of the Islamic finance economy, the DSCE may well pioneer the green Sukuk movement in the region.

With agencies such as the Climate Bonds Initiative working to develop a better understanding and awareness of the green bond market, and a global push for clearer certification criteria and public discussion, likely many of the potential challenges will be overcome as the green investment market develops. A green Sukuk market in the Middle East could become a groundbreaking development for the Islamic financial markets. One thing is certain, it is only a matter of time: and the race to the first green Sukuk has begun in the Middle East.

Latham and Watkins, the Clean Energy Business Council, The Gulf Sukuk and Bond Association, and the Climate Bonds Initiative are working together to increase awareness of the challenges and opportunities and promote the development of a green Sukuk market.

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