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Green Bonds & Islamic Finance

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Green Finance

Green Bonds are a specific sub-set of bonds used for clean energy projects, the vast majority of which are in the area of renewable energy and energy efficiency. Green Bond deals can include other types of bonds which, while not formally labelled Green Bonds, are issued by renewable energy companies or for the construction and operation of green assets. As the market develops many of these 'other' types of bonds may enter the Green Bond market.

Brief Overview of Green Bonds[1]

Green Bonds raise funds for new and existing projects with environmental benefits. They are similar to mainstream bonds with the difference residing essentially in a defined use of proceeds for specific 'green' projects. From a credit perspective, Green Bonds are indistinguishable from other bonds. Operationally, Green Bonds largely function as conventional debt instruments. They are risk-weighted and credit rated in the usual way, based on the creditworthiness of the issuer, and they are generally listed, traded and regulated in the same way as other bonds in the international bond markets. Issuers and the dealers/managers expect pricing and transaction costs to be similar to an issuer's regular bond.

However, there are a number of advantages to issuing a Green Bond as opposed to a regular corporate bond. From the issuer's perspective, a Green Bond: (i) results in the diversification of its investor pool (e.g., greater numbers of asset managers and insurance or pension funds); and (ii) contributes to 'green' investor relations and corporate social responsibility initiatives (something that dovetails with Islamic principles directly). From a dealer/manager's perspective, Green Bonds can be marketed as premium products to their clients as many investors seek to meet sustainability guidelines or criteria in their investment strategies. Green Bonds are an increasingly popular mechanism to meet these commitments.

The Green Bond Principles[2]

The Green Bond Principles ("GBP") were launched in 2014[3] in order to develop parameters for creating the Green Bonds instrument. The GBP are voluntary guidelines that recommend transparency and disclosure and promote integrity in the development of the Green Bond market by clarifying the approach for issuance of a Green Bond. The GBP: (i) provide issuers guidance on the key components involved in launching a Green Bond; (ii) aid investors by ensuring availability of information necessary to evaluate the environmental impact of their Green Bond investments; and (iii) assist dealers/managers by moving the market towards standard disclosure which will facilitate transactions.

As there is no standard definition of what constitutes a 'Green Bond', the 'Use of Proceeds' section of a typical Green Bond Prospectus plays a key role in equipping investors in their assessment of whether a given bond is 'green' enough for them. This is reflected in the GBP through the disclosure of use of proceeds. The GBP are not, however, prescriptive as to the form such disclosure should take. As a practical matter this means that an issuer will designate a 'green' use of proceeds in the prospectus or other issuing documentation and then provide summarised information about the 'green' uses, reporting and second party opinions (if any).

1 A more detailed discussion and Green Bond may be found in "Recent Developments in Green Bonds" (August 2016) at http://www.whitecase.com/publications/alert/recent-developments-green-bonds

2 See the latest GBP at http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-bonds/

3 The Green Bond Principles were updated in 2016.

Typically in a basic Green Bond, the use of proceeds, reporting and second party opinions do not form part of the terms and conditions of the Green Bond and do not create specific contractual obligations. However, they typically form part of the disclosure documents or are referred to in the disclosure documents.

The GBP provide a minimum standard of process guidelines that recommend transparency and disclosure in the Green Bond market. As a result, the environmental undertakings of Green Bonds issuers are only partially reflected in transaction documentation. A microcosm has developed around the GBP in support of the Green Bond market that involves opinion providers, certifiers and assurers (including accountancy firms, ESG analysts and academics). Some markets and jurisdictions have begun to integrate elements of the voluntary GBP guidelines into domestic Green Bond regulations and mandatory market criteria. In jurisdictions such as China and India that have or seek to develop mandatory regimes, the GBP are the minimum starting point to which additional mandatory requirements are added. For example, the National Association of Financial Market Institutional Investors ("NAFMII")[4] in China takes a more active role in setting out: (i) rules for listing Green Bonds; and (ii) the catalogue of Green Bond sectors and projects which define 'green' for that market.

Types of Green Bonds

The GBP identify four types of Green Bonds (additional types may emerge as the market develops):

Green Use of Proceeds Bond – a standard debt obligation for which the proceeds are moved to a segregated account or otherwise tracked by the issuer and attested to by a formal internal process that will be linked to the issuer's lending and investment operations for projects. The vast majority of Green Bonds currently fall within this category.

Green Use of Proceeds Revenue Bond – a debt obligation in which the credit exposure in the bond is linked to the pledged cash flows of the revenue streams, fees, taxes etc., and the proceeds of the bond are used to fund related or unrelated 'green' project(s) such as a utility provider issuing a bond backed by fees on electricity bills.

Green Project Bond – this is a project bond for a single or multiple Green Project(s) for which the investor has direct exposure to the risk of the project(s) with or without potential recourse to the issuer.

Green Securitised Bond – a bond collateralised by one or more specific projects, including covered bonds, ABS, and other structures. The first source of repayment is generally the cash flows of the assets. This type of bond covers, for example, asset-backed securitisations of rooftop solar PV.

Conceptually each of these categories of Green Bonds could be modified in structure and documentation to fit Sukuk requirements.

Green Bond Market

The Green Bond market accounted for US$800 million of issuance in 2007, but has expanded significantly every year since then. Moody's reported in February 2016 that Green Bond issuance for 2016 could exceed US$50 billion[5].

Notably, there has been a difference in the approach to the development of Green Bond markets in different jurisdictions – roughly split into markets which, for the time being, rely on a voluntary approach to criteria and reporting (e.g., the GBP, as used by many European Corporate Green Bond issuers and the set criteria that entities such as NAFMII in China require Green Bonds to meet. There is some market debate on the need for: (i) greater clarity on what a Green Bond is and what distinguishes it from regular bonds; (ii) independent certification; (iii) 'green' catalogues and definitions; and (iv) 'green' covenants and liabilities. While standardisation of disclosure will support credibility and provide criteria for independent validation in the Green Bond market, a balance has to be struck between enhancement and over-regulation. It is important nonetheless to be aware of regional differences in the developing Green Bond market.

4 http://www.nafmii.org.cn/english/

5 https://www.moodys.com/research/Moodys-Green-bond-issuance-could-exceed-50-billion-in-2016--PR_343234

Investor Appetite

Green Bonds

The initial demand in the Green Bond market was largely driven by environmentally and socially responsible investors and this segment of the market has continued to grow (e.g. dedicated Green Investment Funds are developing rapidly). However, the market has quickly become mainstream with institutional investors and Green Bonds are developing into their own asset class. With the growth in diversity of issuer type and structure, the investor base for the Green Bond product has expanded to include more pension funds, insurance companies, asset managers, and retail investors. For investors, Use of Proceeds Green Bonds are fixed income products that meet their underlying financial requirements but which also enable them to show support for initiatives they deem to be important global priorities.

We have noticed an increase in the demand for specific products, including both investment grade and high-yield corporate Green Bonds, bespoke structured deals such as project bonds and securitisations and nationally driven products (e.g. 'green' Pfrandbriefe, Schuldschein and 'green' Sukuk). There is increased commitment from emerging markets to develop robust Green Bond frameworks, for example in India, China and Mexico, and we are seeing prominent global stock exchanges dedicating separate platforms to Green Bonds.

For all categories of investors, providing certainty and transparency on the use of proceeds and investments are, and will continue to be, important requirements. Green Bonds are part of a wider trend toward increased focus on social and environmental responsibility among companies and financial institutions. This trend is strongly encouraged by governments, public and other regulatory authorities, NGOs and even the community at large.

Green Sukuk

Green Islamic finance instruments must have the benefit of a fatwa supporting a Scholar's opinion that the structure of the instruments are Shari'ah-compliant. The principal requirements are:

- the Islamic principle of cooperation (requiring all risks and profits to be shared amongst investors);
- the prohibition of interest or similar fees; and
- not to engage in forbidden industries (including alcohol, tobacco and gambling)

The most commonly used tradable Islamic finance instrument is the Sukuk. Green Sukuk are structured in the same manner as a traditional Sukuk, whilst typically enjoying the beneficial tax treatment of a Green Bond. There are other forms of Shari'ah compliant finance available, however the market expectation that the parallel to a Green Bond would be a Green Sukuk.

The focus on social and environmental responsibility is perhaps most clearly noticeable in the Islamic finance market, especially following the issuance of RM100 million Sustainable and Responsible Investment Sukuk by Khazanah Nasional Berhad ("KNB") (Malaysia's state-owned sovereign wealth fund), and two successful Sukuk issuances by the International Finance Facility for Immunisation Company ("IFFIm"). KNB used the proceeds from the issuance to fund schools to improve the accessibility of quality education in Malaysia, while the proceeds from the IFFIm issuance were donated to the Gavi Vaccine Alliance for immunisation programmes to strengthen health systems.

Markets where Islamic finance is strong are beginning to develop Green Islamic financing infrastructure. The Islamic Declaration on Climate Change[6] launched at the International Climate Change Symposium in August 2015 signalled the Islamic finance market's commitment to develop a market to finance climate-related initiatives. The Climate Bonds Initiative, the Clean Energy Business Council of the Middle East and North Africa and The Gulf Bond and Sukuk Association have formed a Green Sukuk working group which is developing best practices and guidance for the issuance of Sukuks for financing climate change investments and projects, such as renewable energy projects.

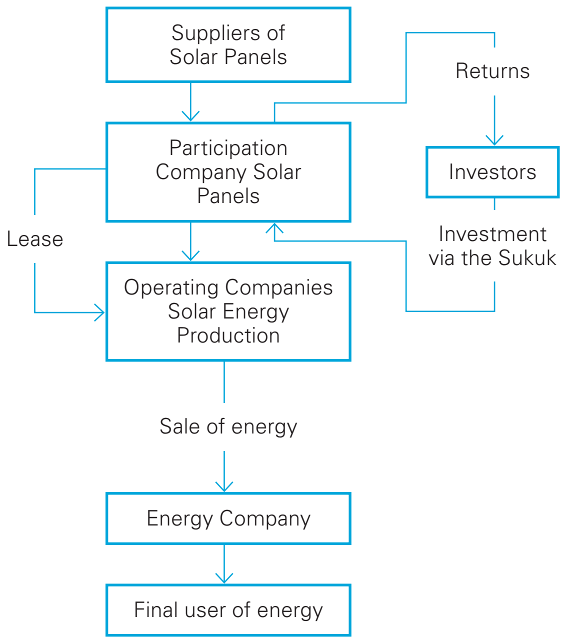
6 http://islamicclimatedeclaration.org/islamic-declaration-on-global-climate-change/

Following a wave of sovereign Shari'ah-compliant Sukuk issuances from countries outside the Islamic world, including the UK, Luxembourg and Hong Kong regional based Sukuk instruments will provide access to a wider pool of investors, many of whom are seeking to diversify their holdings beyond traditional asset classes. This increased appetite for Sukuk products combined with the need for financing for 'green' initiatives means that Green Sukuk have potential to bridge the gap between conventional and Islamic investors.

Structuring of Green Sukuk

By way of example, this is the structure chart for the Orasis[7] Green Sukuk:

- subscription in multiples of €5000
- investment guaranteed by EDF for 20 years
- annual income at a minimum number of 1% for an investment in a SEP (Société en Participation)
- yields are the interest (riba) on real property
- no taxes or CSG-CRDS on income



Due to its asset-based structure the Sukuk has often been advocated as a well suited financial instrument for investment in renewables projects.

Green Infrastructure Sukuk

We believe that there are significant opportunities to build on the increased focus on environmental responsibility in the Islamic finance market, notably in relation to green infrastructure.

The inaugural Global Infrastructure Forum took place earlier this year, with a focus on "enhancing multilateral collaborative mechanisms to improve infrastructure delivery globally". According to the World Bank, infrastructure plays a critical role in growth, competitiveness, job creation, and poverty alleviation, yet increasing access to basic infrastructure services remains a critical challenge in developing countries.

According to a recent McKinsey report[8] current infrastructure spending of US$2.5 trillion to US$3 trillion a year is only half the amount needed to meet the estimated US$6 trillion of average annual demand over the next 15 years. The report suggests that many countries are likely to scale up their investment in sustainable green infrastructure, as the way these countries build and operate the necessary infrastructure will be a major factor in whether they can deliver on their intended nationally determined contributions ("INDCs") made at COP21.

Although banks are the traditional providers of debt finance for infrastructure, there has been significant interest in introducing infrastructure Sukuk, with analysts at Fitch suggesting that Shari'ah-compliant products to finance the construction of major public investment works could eventually spur a big increase in the market[9]. A Sukuk product to fund a specific environmentally sustainable infrastructure project, such as the construction of renewable energy generation facility, could appeal to both conventional environment-focused 'green' investors and Sukuk investors.

Indeed, a green Sukuk product could be an appropriate channel for environmentally aware investors. In order to comply with underlying Shari'ah principles, funds raised through the issue of a Sukuk must be applied to investment in identifiable assets or ventures. If a Sukuk is structured to provide funds for a specified green infrastructure project, such as a renewable energy project, it may help to ensure that investors' money will not be diverted and used for another purpose.

7 http://cenf.univ-paris1.fr/fileadmin/Chaire_CENF/HC_-_Orasis_Sukuk_presentation_10-2012.pdf
8 http://www.mckinsey.com/industries/infrastructure/our-insights/voices-on-infrastructure-number-3
9 https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Infrastructure-Sukuk-Challenge?pr_id=982376

Investor Appetite for Green Sukuk

Sukuk and Green Bonds are two growing financial niches. Perhaps the question is whether the overlap of two relatively niche products can be sufficiently mainstream to find sufficient investor appetite, particularly in the Gulf region where innovative instruments have often been slow to take off.

The market for Green Sukuk is being driven by the following advantages over other capital markets instruments:

- holding Green Sukuk would allow investors to gain exposure to the renewable energy sector, particularly in the Middle East. With a rising global population and dwindling fossil fuel reserves renewable energy is poised to become an increasingly significant and profitable;
- Green Sukuk will allow investors to hedge against climate change in their investment portfolio;
- issuer's (particularly in the Middle East) may also wish to diversify their energy mix. Green Sukuk should allow sovereign to encourage investment in renewable energy sources. This is particularly relevant in light of the recent collapse in oil prices; and
- in the context of investment funds divesting funds from certain industries, such as tobacco and firearms; many large institutional investors have recognised the need to invest a proportion of funds into socially responsible and ethical investments. Green Sukuk offer the potential to combine profitable investing with the desire for an ethical portfolio.

As environmental standards align with capital markets and Islamic finance, momentum is gathering for Green Sukuk and other instruments for green Islamic finance. Governments, investors and issuers are becoming more engaged in the Green Sukuk dialogue, and this is essential to bring the Green Sukuk market to the fore. Green Sukuk could help supply the finance needed for many of the infrastructure and renewable projects in markets where Islamic finance is strong. Mobilising capital in this way has the added benefit of utilising Islamic finance mechanisms to address issues of sustainable development and climate change adaptation.

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