Q&A with Harj Rai and Lee Irvine

Green Sukuk: Financing the Gulf Region’s Renewable Energy Infrastructure

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In this interview Latham & Watkins partner Harj Rai and associate Lee Irvine discuss how an issuance of green sukuk would allow Islamic investors, for the first time, access to ethical and socially responsible investments.

Rai has experience in bank finance, project and asset finance, Islamic financing (including sukuk issuances and securitizations), debt capital markets and general corporate matters relating to Saudi Arabia. Irvine advises financial institutions and public and private companies on all aspects of conventional debt capital markets, equity capital markets, Islamic finance and liability management.

What is a green bond?

A green bond is one that ties the bond issuance proceeds to environmentally friendly investments. While green bonds still form only a small part of the total fixed income market, it is a growing industry and the US$34 billion issued in 2014 is triple the amount issued in 2013. Market participants expect the issuance of green bonds to exceed US$100 billion by the end of 2015. While green bonds were first pioneered by the World Bank, they have now been successfully used in fundraising by entities as varied as the State of California, the Bank of America and Toyota.

Is it possible to fit this concept within an Islamic framework?

It is certainly possible to issue a Shari’a-compliant sukuk, with the proceeds tied to environmentally friendly investments. A green sukuk could be used for many of the same purposes as a green bond and, on a structuring level, the structuring of a green sukuk wouldn’t be much different from that of a conventional sukuk. The sukuk’s structure would largely depend on the assets that are available to support the sukuk and the project to be financed.

In the context of the remarkable growth seen in the global Islamic finance industry in recent years, with annual sukuk issuances increasing from less than US$32 billion in 2010 to an expected US$70 billion in 2014, and when you consider that a large proportion of such issuances are coming from government and government-related issuers, which have large renewable infrastructure funding requirements, it is almost surprising that the sukuk market has so far not really tapped into the potential of a green sukuk. A number of governments and affiliated bodies have, however, started recognizing the benefits of a green sukuk, and are, in some cases, working to ensure a stable and supportive framework for issuers and investors and, in other cases, considering issuances themselves.

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 Shari’a-compliant investments, these guidelines are anticipated to drive growth in the sector and provide much needed finance for such projects.

In the Gulf Cooperation Council (GCC) region, the Dubai Supreme Council of Energy has announced a partnership with the World Bank to develop a green investment strategy, which could incorporate sukuk. A number of corporate entities with large renewable energy funding requirements have also announced that they are considering a green sukuk, so we think it really is a matter of “when” and not “if” we see a green sukuk from the region.

What are the advantages of a green bond/sukuk?

Given the rising cost of bank lending, investors are increasingly turning to the capital markets to raise capital, with the
issuance of a bond/sukuk allowing issuers to raise significant sums of money over fairly long tenors. Investors are increasingly demanding socially responsible investment (SRI) opportunities and have expressed a strong appetite for green bonds. When we look at Islamic financing, by incorporating environmental requirements into a conventional sukuk, this could also help to facilitate broader participation in the sukuk market by conventional investors that are interested in investing ethically.

Public-sector investment funds, asset managers and financial institutions are increasingly buying green bonds and would potentially also be interested in a green sukuk, which could therefore attract new types of investors to the sukuk market. An issuance of green sukuk would also allow Islamic investors, for the first time, access to ethical and socially responsible investments. Press coverage continues to cover green bond issues favorably and issuance of green bonds/sukuk could also help promote a company’s corporate image and provide it with a chance to brand itself as forward thinking, innovative and sustainable.

What do you see as the future for the Green Sukuk market?

We think, looking forward, that substantial amounts of investment will be required in order to finance renewable energy projects, both in the GCC region and globally, and investors will increasingly look to the capital markets as a low-cost alternative to fund this investment through the issuance of green bonds and green sukuk. Given the preference amongst GCC sovereigns, sovereign-related entities and corporates to issue sukuk, we believe that a green sukuk has the potential to become integral to financing the region’s ambitious renewable energy and infrastructure projects and could help mobilize essential finance needed to fund the rising number of clean energy initiatives throughout the GCC.

What are some of the challenges to creating a sustainable Green Sukuk market?

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 and will be equally applicable to 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. The small secondary market for green bonds and the buy-and-hold nature of regional investors suggests that, when the green sukuk market does develop, it may suffer from liquidity constraints, although we expect that liquidity will improve as the market matures.

For More Information

For more information about the future of the green sukuk, download and read the Islamic Finance news article “Green Sukuk: The Race To Be First.”