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ESG Sukuk: The role of the sovereign in the evolution of the Middle East sukuk market

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8-10 minutes

Rizwan Kanji's practice focuses on debt capital markets, finance and securitisations using both conventional and Islamic finance structures. Rizwan has advised on a number of ESG transactions, particularly integrating ESG and Islamic-compliant financing instruments within in the Middle East. Rizwan has earned a reputation for advising on 'first of its kind' transactions. He advises investment banks, financial institutions, multilateral development banks, sovereign states, insurance companies and multinational regional corporations on high-profile transactions across the Middle East.

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OPINION

Environmental, social and governance (ESG) principles have become increasingly relevant and important, globally and in the Middle East specifically. Whilst the modern formulation of Sukuk has existed for decades, the markets have recently witnessed the growth of innovative Shariah-compliant financing structures that align with ESG principles. As Shariah-compliant assets have significant potential to also be ESG-compliant (due to, for example, both investment approaches prohibiting investing in certain products and services), green or sustainable Sukuk (where the proceeds of the issuance are used exclusively for the funding of eligible sustainability projects or to finance investments in renewable energy or other environmental assets) appear to be a natural next step in the evolution of the Sukuk market in the Middle East. By adding a sustainability facet to a Sukuk offering, issuers are able to appeal to a broader range of potential investors - most notably, ESG-minded funds and socially responsible investors beyond the traditional Sukuk fixed-income investor space.

In line with trends in the global markets, Shariah-compliant investors are increasingly conscious of the ESG implications of their investments. Whilst there have been relatively few sustainable or green Sukuk issuances in the region, awareness of and sensitivities to ESG factors are undoubtedly rising, with sustainability driving the strategic narrative of various sovereigns in the Middle East more than ever before.

The Role of Sovereign

In the absence of certain of the incentives that appeal to ESG investors in other jurisdictions (such as beneficial regulatory and tax treatment), the sovereign may have a pivotal role to play in paving the way for ESG and Islamic-compliant financing instruments in the Middle East. Sovereign issuances can not only set a benchmark for corporates and financial institutions but can help attract a wider pool of international ESG investors to the region. In 2020, the Government of Indonesia issued $2.5 billion Sukuk in three tranches, one of which was a green Sukuk, following its landmark $1.25 billion green Sukuk issuance in 2018. Indonesia's $2.5 billion issuance had strong demand with an order size of $16.66 billion and oversubscription of almost 6.7 times above the Government of Indonesia's target. More recently, in April 2021, Malaysia issued the first $800 million U.S. dollar sustainability Sukuk – an issuance which was oversubscribed by 6.4 times. The appetite and interest for ESG or sustainability-linked Sukuk is certainly rising in the Middle East.

A number of Middle East governments have announced ambitious energy targets (such as Saudi Vision 2030) which will require significant capital investment – green or sustainable Sukuk, which appeal to the region's traditional Islamic investors and the broader pool of international ESG investors, neatly align with energy-related policy objectives and further provide a unique source of diversified capital.

This month, the UAE announced its historic Net Zero 2050 Strategic Initiative, under which the country would aim to achieve net-zero carbon emissions by 2050. This announcement serves as the first net-zero carbon commitment by a Gulf Cooperation Council ("**GCC**") state and evidences the UAE's dedication to contributing to global sustainability efforts; as the first GCC state to make such a commitment, it is possible other states in the GCC may be encouraged to follow in the UAE's footsteps. It is anticipated that the UAE will invest approximately $165 billion in clean energy by 2050. As sovereign entities seek to grapple with and address the economic disruptions caused by the global pandemic, all the while adhering to energy commitments, the synergy between ESG and Islamic finance offers sovereign entities a unique opportunity to tap into a diversified, and to a certain extend restricted, source of capital.

As awareness and understanding of ESG in the region grows, there is increased interest in the role ESG can play in Islamic finance transactions. Although demand and pricing considerations will be key factors in the development of ESG in the Middle East Sukuk markets, there is certainly a growing level of interest and recent issuances have demonstrated the unique rewards available when introducing a sustainability component to a Sukuk offering.

Unique opportunities

There is a global shift towards corporate reporting on sustainability as sovereign states increasingly acknowledge the importance of recognising the impact of their actions on the environment. The requirement for allocation and impact reporting in a sustainable Sukuk issuance thereby aligns with the desire to be transparent about the social impact of policy decision and is not unduly burdensome in light of the already changing shift to enhanced corporate reporting. A number of Islamic banks in the region have not only already advised upon and issued sustainable and green Sukuk, but have also established a track record of investing responsibly and promoting asset classes that align with such values.

The ability of issuers to retrospectively rely on certain existing projects in the sustainability sphere – instead of having to earmark future projects in which the Sukuk proceeds would have to be invested – somewhat erodes the burden on issuers to source new projects or allocate new purposes for the proceeds of an issuance. Moreover, a broad range of international frameworks and principles (including the International Capital Market Association (ICMA) Green Bond Principles 2021 and the Loan Market Association (LMA) Social Loan Principles) have been established to assist and guide issuers in their sustainability efforts. The lack of a market consensus as to what constitutes green, social or sustainable projects affords issuers a broad mandate to identify eligible sustainable projects, which can, for example, include projects in the renewable energy sphere, employment generation and access to essential services.

The successful coalescence of ESG principles and principles of Shariah in green or sustainable Sukuk can offer unique opportunities and rewards for sovereign entities, corporates and financial institutions in the Middle East. Although a natural next step in the evolution of the Sukuk markets, the innovative structuring and potential added layer of complexity to traditional Sukuk issuances requires the advice of experienced legal counsel to help navigate these issues.

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