

## **GREEN SUKUK: CHALLENGES AND POTENTIAL**

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### **ABSTRACT**

The world is witnessing a trend right now. This trend is pertinent to all things related to the environment and its sustainability. The idea of saving the environment arises from the fact that current and projected impacts of climate change are affecting populations around the globe- and not in a favourable manner. And it is time to take action. Leveraging untapped financial resources and introducing ingenious methods of financing projects that aim to reverse the impact of climate change are the first steps towards combatting it. Green sukuk is one such innovative investment instrument belonging to the band of Islamic Finance, that enables investors to invest in projects that aim to achieve economic, social and environmental goals in a manner that abides by the Shariah or the Islamic jurisprudence. The green sukuk is just breaking out of its inception stage and garnering more and more debate and scrutiny which gives rise to a lot of discussion regarding its potential as a green financing instrument and this potential can only be accomplished if the green sukuk can take on the challenges it encounters on its way to glory.

**Keywords:** Bonds, Climate Change, Environment, Green Sukuk, Islamic Finance.

### **1. INTRODUCTION**

In this particular day and age, there is a lot of talk associated with saving the only planet that houses life as we know, within itself. There has been significant evidence that our planet is suffering, in the form of increased global temperature, shrinking ice caps, warming oceans and rise in extreme events that has caused our generation to wake up and take notice. (Nicholas Stern, Lecture, & Stern, 2013)

Conferences on climate change like the Paris Agreement (2015) and Bonn Climate Change Conference (2018) by the United Nations are bringing countries of the world together on deciding a solution to tackle this phenomenon. Collaborative decisions with regard to climate change matters are being made to legally bind developing nations to work towards reducing the

global greenhouse gas emissions. With a plethora of preventive actions being planned and executed all around the world, there remains a question lurking within the shadows of such a big initiative. How will we fund this sustainability plan of ours?

Financial estimates that are required to mitigate that effects arising due to change in climatic conditions range from about US\$200bn to US\$1,000bn a year and government resources by themselves will prove to be insufficient. This makes private financing options, a lucrative source of funding to prevent/reverse climate change and its effects. (N. Stern, 2006).

According to various estimates, infrastructural investments of over USD 2.5 trillion annually is needed to combat rising temperature.(World Energy Investment Outlook Special Report, International Energy Agency, 2014). There would be more benefit if alternative financing options are in conformity with sustainable development principles, especially given the current scenario of climate change.

## **2. LITERATURE REVIEW**

Ever since the awareness of climate change began to turn significant, the world of commerce was quick to churn out the concept of Socially Responsible Investing and subsequently, the financing options for it.

Socially Responsible Investment is an investment approach that incorporates ESG (environmental, social and governance) factors in the investment process and is closely related to investments made for the environment and its preservation. It looks beyond improvement of just GDP and may power generations to come. The concept was introduced way back in the 1980s but it only developed by definition in the last two decades.(Iqbal, 2013)

Today, we refer to one of such financing options as the issuance of a green bond. Green bonds are a form of bond instruments whose proceeds are solely intended to be applied to finance or refinance green projects of the present and future. (ICMA, 2018) Green Projects are considered to be include projects that address an environmental issue. Green Bonds are refined to aid projects that reinforce sustainable growth and integrity of the environment. Also what began as a market is rapidly transforming into a supply driven exercise. (Ross, 2015) This exercise forms a part of Socially Responsible investment where money is invested not only for financial gain, but also to cause a social benefit.

Parallel to the growth of SRI, there was another development in the cosmos of finance- the advent of Islamic Finance as an alternative form of finance to conventional finance by economies of the world. Its stability was well pronounced during the global crisis of 2007/08 after it was

able to combat shocks in a manner better than conventional finance could. (Lawal & Bank, 2016)

Islamic finance refers to financial instruments with frameworks and financial transactions that satisfy the sharia law against the payment of interest and engagement in gambling (Tabash & Dhankar, 2014). During the last two decades, the Islamic banking and finance has sensibly grown in international finance, documenting double digit growth rates per Annum both within and beyond Muslim economies ("World Islamic Banking Competitiveness Report 2016," 2016) Islamic finance maybe represented in the global financial markets as a modest portion but the sector has been witnessing rapid advancement. By, 2015 the Islamic Finance sector mhad surpassed US\$1.88 trillion in size and its banking assets had doubled in merely four years. (WB Group).

Islamic finance could be just what is required to deliver more infrastructure to emerging markets and developing economies. Hence it becomes a lucrative avenue for investors, especially when it comes to socially responsible investing. This is because Islam, the source of islamic finance, possesses certain inbuilt potentials or qualities that make it one of the most ethical investments there is. It prohibits transactions that involve interest, investment risks and rewards are shared between parties and certain investments are forbidden as they are considered prohibited. This ethical standpoint becomes imperative as financiers play a key role in promoting sustainable behaviour. (Georgetown Law Review) Moreover in the age of evolving markets, green bond markets can head the revolution of financial markets to accommodate the effects of climate change.

To enforce this idea, the Climate Bonds initiative along with , the Clean Energy Business Council of the Middle East and North Africa and The Gulf Bond& Sukuk Association established Green Sukuk Working Group. According to Climate Bonds Initiative, Green Sukuk are Shari'ah compliant bonds that generate returns to investors within the renewable energy sector or any other environmental assets. They comply with the Shariah regulations with regard to environmental conservation; an application of shariah compliant products in climate change solutions. In fact they correspond to the concept of green bonds in the conventional market.

According to World Bank Group, a sukuk sells a certificate, with proceeds used to purchase an asset that is mutually owned by both buyer and seller. A rising number of SRI investors accept sukuk as a development tool due to the ethical nature of Islamic Finance. (Wieckowska, 2013) What makes Green Sukuk an attractive investment opportunity is that it provides a high extent of credence that investor funds will be applied in green sukuk that comply with shariah law.

Thus, if the structure of a Sukuk is designed to generate funding for definite infrastructural ventures like a certain project in the renewable energy sector, there will be limited chances that

investors' money will be redirected for another purpose.

Secondly, the sukuk, which hold ample similarities with conventional fixed income securities can bridge the gap between income and supply for environmental investors to the extent the proceeds generated out of such Sukuk Are earmarked for specific environmental purposes.

It also brings together a new base of investors and the government by enabling the diversification of sources from where their fiscal funding originates. Also, external financing requirements and support to build reserves can be sourced through the proceeds from sukuk issued to foreign investors. (Bahari, Ahmad, Shahar, & Othman, 2016)

As such instruments and practices manifest themselves, they require backing from among conventional bankers and academics with important and recognized research to flourish (Warde, n.d.)

Green sukuk is a great way to bridge the gap between Islamic and conventional finance as we are at a brink of a new era in Islamic Finance driven by a global appetite for SRI investment that is promoted by The United Nations-supported Principles for Responsible Investment and The United Nations Sustainable Development Goals.

Unperturbed by a recent slowdown, the market for green sukuk continues to be augmented. Islamic Banks are devoting their resources into identifying areas that provide them with sustainable investment opportunities. One such area is socially responsible investments: green sukuk. Thus, Islamic finance principles and environment friendly instruments can be tailored to meet the need of the hour through the application of green sukuk. By combining environmental concerns and a traditional sukuk, issuers can derive benefit from both Islamic and conventional investors whose objective is to invest ethically.

This paper aims to discuss the challenges a green sukuk issuance might face as a relatively new instrument in the market and if it holds the potential to establish itself as a reliable investment option in the global financial markets in the context of SRI and establish itself at par with its conventional finance counterpart.

### **3. OBJECTIVES**

- i. To identify prospective challenges or hurdles faced by Green Sukuk.
- ii. To summarise future potential of Green Sukuk.

### **4. RESEARCH METHODOLOGY**

Descriptive research studies were undertaken for the purpose of devising this paper. In order to meet the objectives, research papers relating to the title were analysed in addition to intelligence collected from international institutions associated with climate/green bonds.

Observations were made based on this information in order to arrive at a conclusion with reference to the future of green sukuk.

## **5. CHALLENGES FACED BY GREEN SUKUK**

The year 2016 saw the World Bank Group Global Knowledge & Research Hub and the Technical Working Group from Central Bank Of Malaysia and the Securities Commission join hands in providing aegis to the Malaysia Green Finance Program. This program advocated the debut of the World's inaugural Green Sukuk on June 27, 2017.

Though the future prospects for green sukuk are apparent due to the expanding need for energy supply that requires energy financing and increasing investor awareness, there still remain a few challenges.

### Challenge 1:

The critical scholars hold the opinion that most Islamic financial instruments, if not all are only mere replications of their counterparts from conventional finance and due to this such products are labelled shariah compliant but are not so in the complete sense. They critic that the practice of sukuk simply replicating the practice of conventional bond in the market. (Bahari et al., 2016)

### Challenge 2:

Currently, the green label does not capture the varying "shades of green" of green bonds (i.e., some projects may produce more climate benefits than others). Rather, the green label merely signals that proceeds will create some environmental benefits, and the quality and quantity of such benefits remains uncertain at best.

This creates a risk of violating one of the principles of Islamic finance- to avoid transactions with gharar (uncertainty) as the outcome is not sufficiently quantifiable. (El-gamal, 2001). With green bonds, there always remains a risk of violating gharar as shades of greenness aren't defined because there exists no standard to do so.

### Challenge 3:

Proper regulatory frameworks can help Islamic institutions capitalize on the growing demand for

socially responsible investments but the current structure of guidelines seems to be insufficient. This is due to the fact that there is limited involvement of shariah scholars in developing a strong regulatory framework that can withstand the dynamics of a rapidly evolving green sukuk market.(Bahari et al., 2016)

Specifically, the World Bank identified the complementarity between Malaysia's SRI Sukuk Guidelines and Green Bond Principles to enable potential issuers to issue green sukuk in the absence of a nationally adopted green bond framework.

In addition the AAOFI need to introduce a precise tool for measurement or set of guidelines to conclude whether or not clear cut intention on the investors part must be laid out because there is an argument that intention of the investor is difficult to determine and that it maybe subjected to environmental and situational changes.

#### Challenge 4:

One of the contributory reasons behind the increasing acceptance of Islamic bonds- the sukuk , has been its sophisticated and flexible nature. (Taoual, 2016). Various types of sukuk are formulated to meet required obligations. Some of the most widely issued sukuks are al ijarah, al musharakah and al murabaha.

Unfortunately, this flexibility can also translate into complexity of sukuk structure in the market. In order to meet the specifications of a green bond and also simultaneously adhere to Islamic principles, the structure of green sukuk may involve a lot of complexity.This complexity of structure of sukuk is another impediment to the development of sukuk market.(Micheal Bennet & Zamil Iqbar, 2012)

#### Challenge 5:

Raising capital through Sukuk needs careful consideration and due diligence on the underlying asset which will be used to rise financed through Sukuk. It is best to start with a prudent businessplan and ascertain the viability of the asset. In terms of a green bond there is no tangible underlying asset. The progress of the projects for which money is being raised is what the returns are based on. (Hosen, 2017)

#### Challenge 6:

There are commonalities between sukuk and green bonds that can easily be channeled to tap the Islamic Capital Markets and maximize private sector financing for environmental projects. (The World Bank, n.d.) the secondary market for green sukuk is very small due to small number of

investors holding sukuk funds and other institutional investors which traditionally require robust secondary market for meeting the investors' liquidity expectations.

As compared with green sukuk, only few were issued in the market. A great challenge faced when issuing a green sukuk is that the market for such an instrument is still in a nascent stage.(IFN Oman Report, 2016). Since these projects have previously been proven to be successful in the 1980s and 1990s (backed by governmental policy and direction), they will be used to sustain economic growth. (Hosen, 2017)

#### Challenge 7:

The higher risk profile associated with green sukuk may pose as a threat to it as environment oriented projects are associated with sophisticated technology due to operations that are green in nature.

#### Challenge 8:

Verification agencies such as CBI have created guidelines to help standardize green bond criteria and so has S&P. But there will tend to be slight variations amongst different verification agencies that shall create difficulty in due diligence process for investors because of difficulty of identifying and comparing the levels of environmental impact between projects.

Self-certification is not a solution either, given the rigorous and often expensive commitments behind green offerings. Investors, Issuers and banks must protect themselves from being misled or abused, Bauduin observes, "Green bonds need external validation to demonstrate effort and sincerity, to attest that their actions are compliant with their promises. (Ross, 2015)

## **6. FUTURE POTENTIAL OF GREEN SUKUK**

The concept of green bonds pairs up perfectly with that of Islamic finance on the basis that they both are fixated on utilizing money in accordance with morals and ethical stance of the investors. Likewise, both have been operating excessively within the boundaries of capital market, along the lines of equity than on fixed income investments. (Iqbal, 2013)

The notion of environmental stewardship, the protection of air, water and land, and the ecosystems that depend on them are intrinsic to Shari'ah principles- again an adept example of how the fundamentals green bonds and Islamic finance match with each other.

Additionally, the structure of an asset based sukuk and a green bond are complimentary to each other as it provides investors with a high degree of certainty that the funds raised are only used



for the designated purpose. Such clarity in intent will draw more substantial investment in the market, as per studies conducted by World Bank Group.

March 2018 saw the Indonesian Government, through the Ministry Of Finance issue the first sovereign green sukuk which hit a whopping \$1.25 billion. This issuance of 5 years has both conventional and Islamic investors signifying that this investment is not confined to just the muslim investor population. It seems to be equally lucrative to anyone outside the community whose main intent is to contribute to economic, social and environmental benefit. This green sukuk also witnesses an over issuance that clearly signals that the market for SRI investments is gaining momentum.

As the green sukuk has gained added recognition through issuances by governments, investors and corporates, the United Nations Development Program has released a set of services that are devised to strengthen the bond market. They are:

- Defining and measuring sustainability
- Assessing eligibility for green finance
- Demonstrating impact

These services make the green sukuk a more transparent and therefore a more reliable avenue of investment. The UNDP has worked hand in hand with the World Bank in Indonesia to ensure the application of post impact reporting so that the investors are aware for what purpose their money is being utilized for.

The involvement of influential entities such as governments and the United Nations in development of the green sukuk signifies the potential that lies in the financing instrument which they want to derive the maximum benefit out of and they are working in order to do the same.

As the green sukuk market is still very much in the inception stage, it is bound to see manifold improvements as time progresses. To start off with, it would be favourable to all green sukuk stakeholders if the green sukuk market embraces a standard system of reporting that defines the all features of a green sukuk in an explicit manner. This is because there still exists ambiguity concerning what really defines a green sukuk- a sizeable hindrance in its development.

Furthermore, the main focus should now be on garnering more attention towards the existence of the green sukuk and its underlying principles. With so many attributes to its name, the green sukuk also has an implied competence to attract investors from a wide range of backgrounds. It serves the ever advancing purpose of investors looking for an investment avenue that is ethical, socially responsible and also conforming to the religious beliefs of those who require it.



## **7. CONCLUSION**

Today's green sukuk market is still in its infancy, but there seems to lie ahead, a fruitful future for it. Therefore, the green sukuk, a product of convergence of both these approaches along with the influence of an ethical standpoint, will have a good appeal in the worlds capital markets. This demand will increase even more so given the heightened awareness of climate change in the current era.

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