The Role of green Islamic sukuk to the promotion of sustainable development objectives .

Mr. CHIKH TOUHAMI Brahim

University of Blida 02. Algeria.

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Abstract

It is necessary to find permanent financing alternatives to finance development. In this context, Islamic instruments, including green Islamic sukuk, are among the most important financing tools for their ability and readiness to deal efficiently with economic fluctuations and crises and to finance sustainable productive projects with a view to achieving sustainable development.

Based on this, the problem of the study can be formulated as follows: What are the green sukuk? How can they promote sustainable development objectives?

Introduction

The introduction by the international community of the concept of a green economy as a way to confront many global crises, whether financial, food or climatic crises. The aim of pursuing a green economy and achieving sustainable development is to promote the integration of the economic, social and environmental pillars of development. Which is always seeking to find innovative financial instruments, formulate practical solutions to financing and development problems, find green environmental financial products that finance environmental investments, and stimulate green markets.

One of the most important financial engineering product is Islamic Sukuk, which is considered one of the most important financial instruments that have been able to strengthen their position in the international financial markets, especially after the crisis of 2008. They were considered a financial solution and a legitimate alternative to traditional debt instruments.

Islamic sukuk investing in environmentally sustainable projects, renewable energy and climate change initiatives – so-called green sukuk – have become increasingly popular in the recent past as part of socially responsible or impact investment strategies of countries and companies alike.

Problematic

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Islamic sukuk, are among the most important financing tools for their ability and readiness to deal efficiently with economic fluctuations and crises and to finance sustainable productive projects with a view to achieving sustainable development.

Based on this, the problem of the study can be formulated as follows: What are the green sukuk? How can they promote sustainable development objectives?

1- The concept of Islamic sukuk

sukuk are potential financing instruments for contributing to a country's economic growth through real sector development initiatives. Sukuk plural; singular sak are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI') as "certificates of equal value representing undivided shares (in ownership of) tangible assets, usufruct, and services or (in the ownership of) the assets of particular projects or special investment activity[1].

There are two types of Sukuk, asset based and asset backed. Under the asset based Sukuk, the Sukuk holders have beneficial ownership in the asset. The Sukuk holders have recourse to the originator if there is a shortfall in payments. The beneficial ownership is a legal term where specific property rights, such as its use and title belongs to a

[1]- report of Accounting and Auditing Organisation for Islamic Financial Accounting and Auditing Organisation for Islamic Financial,2008, p : 307

person even though legal title of the property belongs to another person. A common example of beneficial owner is the owner of funds held by a nominee bank or for stocks held in the name of brokerage firm.

Under asset backed Sukuk, the Sukuk holders owned the asset and as a result do not have recourse to the asset but to the originator if there is a shortfall in payment.[1]

Table 1 : demonstrates the fundamental differences between 'asset based' and 'asset backed' Sukuk.

No right over assets	Recourse to assets
Risk with originator	Risk with assets
Assets are used as security interest	Securitization
Sukuk holders are creditors	Assets are ownership interest
. Assets remain on originator's book	Sukuk holders are owners
In case of sales of assets, investors receive their face value, all excess goes to the originator	Financial and legal due diligence are detailed because investors are paid from the asset's cash flow and redemption
Recourse to originator	Recourse to assets

[1] Tahmoures A. Afshar, Compare and Contrast Sukuk (Islamic Bonds) with Conventional Bonds, Are they Compatible?, The Journal of Global Business Management, Volume :09, Number :01, 2013, p : 45

Source : Tahmoures A. Afshar, Compare and Contrast Sukuk (Islamic Bonds) with Conventional Bonds, Are they Compatible?, The Journal of Global Business Management, Volume :09, Number :01, 2013, p : 46.

1-1- Types of sukuk

Since sukuk can be structured in numerous ways, proper classification of sukuk is crucially important for issuers to determine the aim of sukuk structures, as well as the nature of sukuk structures.

Hybrid/pooled certificates

The underlying pool of assets can comprise of istisna, murabahah as well as ijarah. Indeed, having a portfolio of different classes of assets allows for greater mobilisation of funds. Murabahah and istisna assets can comprise a portfolio of funds. However, at least 51% of the pool must be made up of ijarah assets. Due to the fact the murabahah and istisna receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return.

The above-mentioned two types of sukuk would partially represent the strength of the issuer's balance sheet.[1]

Pure Ijarah Sukuk

This certificate is issued on stand-alone assets identified on the balance sheet. The assets can be parcels of land to be leased or leased equipment such as aircrafts and ships. The rental rates of returns on

1 - Abul Hassan, Islamic Features of a Sukuk, from : https://kantakji.com/media/7732/f128.pdf

these sukuks can be both fixed and floating, depending on the particular originator.

Variable rate redeemable certificate

This type of sukuk can be called alternative sukuk due to its seniority to issuer's equity, their redeeming nature and their relative stable rate as compared to dividend payouts. The return on these sukuk is benchmarked to market references.[1]

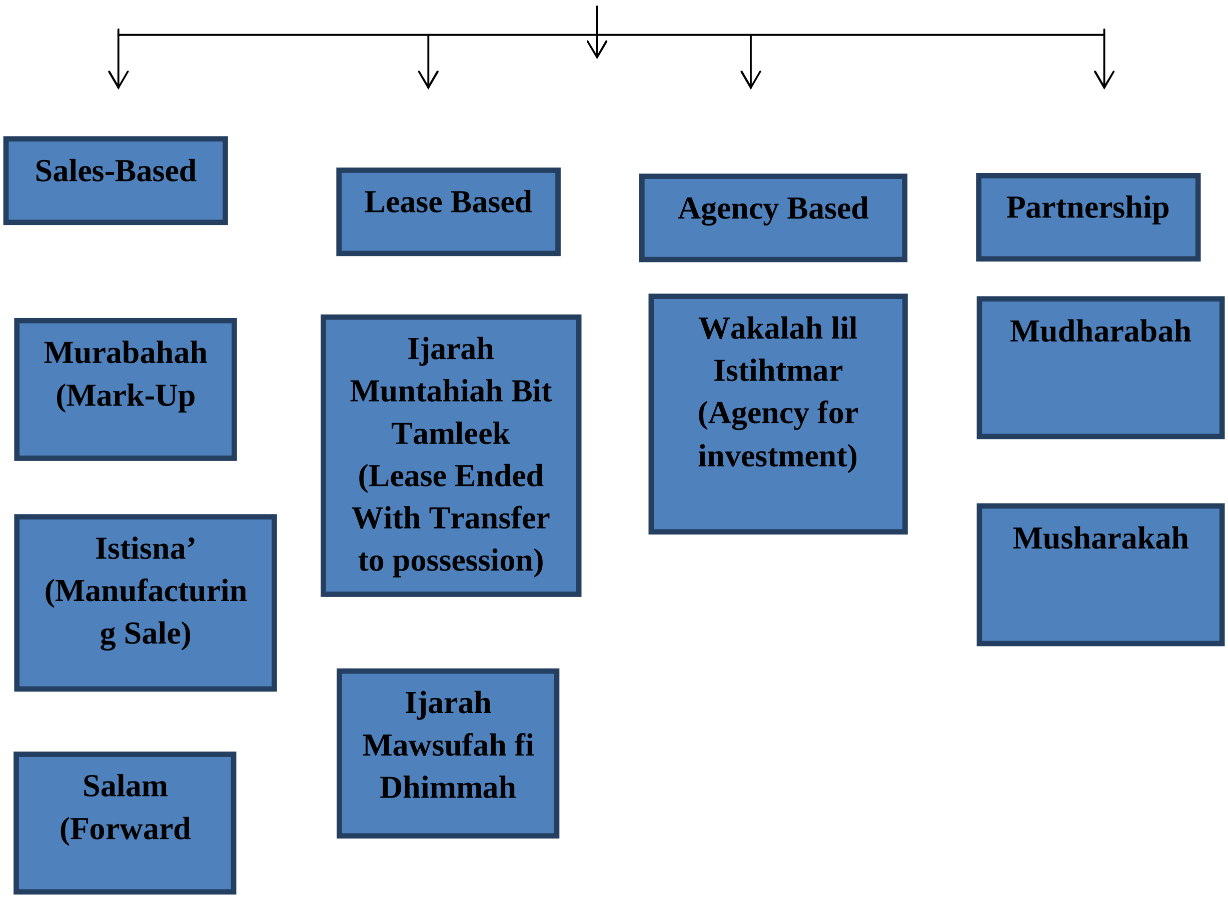
Zero-coupon non-tradable Sukuk

Another possible sukuk structure can be created where the assets to be mobilised do not exist yet. Consequently, the objective of the fund mobilisation would be to create more assets through istisna. However, certificates of this nature would not readily be tradable because of Shariah restrictions. The primary asset pools to be generated would be of a nature warranted by istisna and instalment purchase/sale contracts that would create debt obligations. The certificate on these debt arrangements can be termed as fixed-rate zero-coupon sukuk.[2]

And There are many types of Sukuk are depending on the Islamic mode of financing used in their structuring. The AAOIFI identified the eligible Sukuk as follows:

1 - Jhordy Kashoogie Nazar, Regulatory and financial implications of Sukuk's legal challenges for sustainable Sukuk development, bloomsbury Qatar foundation journals, Qatar, 2015, p : 137.
2 - Abul Hassan, Islamic Features of a Sukuk, op.cit.

Sukuk based on Shariah contracts



Source: Mohd Nazri bin Chik, Guidelines for Islamic Bonds, Islamic Banking Operations and Regulatory Framework Workshop Organized by Centre for Banking Studies, Central Bank of Sri Lanka 24 – 26 January 2012 Colombo – Sri Lanka, p 10.

1-2-the benefits of islamic Sukuk

The basic concept behind issuing Islamic Sukuk, however, is for the holders of the Sukuk to share in the profits of large enterprises or in their revenues. If Sukuk are issued on this basis they will play a major role in the development of the Islamic banking business and thereby contribute significantly to the achievement of the noble objectives sought by the Shariah. Among the benefits of Sukuk are the following:

A- Sukuk are among the best ways of financing large enterprises that are beyond the ability of a single party to finance.

B- Sukuk provide an ideal means for investors seeking to deploy streams of capital and who require, at the same time, the ability to liquidate their positions with ease whenever the need should arise. This is because it is envisioned that a secondary market for the trading of Sukuk will develop. Thus, whenever investors require cash from their investments, or from a part of the same, it will be possible for them to sell their Sukuk holdings, or a part thereof, and receive their value from their original investment plus earnings, if the enterprise is profitable, in cash.

C- Sukuk represent an excellent way of managing liquidity for banks and Islamic financial institutions. When these are in need of disposing of excess liquidity they may purchase Sukuk; and when they are in need of liquidity, they may sell their Sukuk into the secondary market.

D- Sukuk are a means for the equitable distribution of wealth as they allow all investors to benefit from the true profits resulting from the enterprise in equal shares. In this way, wealth may circulate on a broad scale without remaining the exclusive domain of a handful of wealthy persons.2 This is clearly among the most important of all the higher purposes sought by an Islamic economic system.[1]

2- The concept of green Islamic sukuk

There has been a growing interest in the past few years towarads socially responsible invesment (SRI) sukuk or green sukuk. A number of sukuk in this class has been issued in the global market to finance environmental-friendly projects.

The growing trend toward SRI sukuk or green sukuk is mainly due to the natural progression of sukuk market, the growing awareness of investors toward ethically and socially responsible investment and the stricter capital requirements for the bank to finance infrastructural projects.

2-1- Definition of green Sukuk

Green Sukuk are Shari'ah compliant investments in renewable energy and other environmental assets. Proceeds are used to preserve the environment and Natural resources, conserve the use of energy,

[1] - Muhammad Taqi Usmani, Sukuk and their Contemporary Applications, Shariah Committee, Without publication year,p : 02.

promote Renewable technologies and reduce greenhouse gas emissions.[1]

2-2- Motivation for reliance on green Islamic sukuk.

- Increased number of investors interested in environmentally sustainable investments;
- The strong growth witnessed by Islamic sukuk markets;
- Reluctance of banks to finance the infrastructure's projects due to stringent capital requirements.

2-3- Principles and advantages of Islamic green sukuk

- Green sukuk have the potential to further expand this market and also help bridge the gap between conventional and Islamic world money;

- Sukuk should be attractive to traditional investors if they generate reasonable returns that are risk-adjusted and properly marketed;

- sukuk that meet these criteria and provide financing for an environmentally sustainable project can be particularly attractive to investors who pay special attention to the environment for two main reasons:

- Sukuk provides investors with a high degree of confidence that their funds will be used to a certain extent and in compliance with the

[1] - Mohammad Mahbubi Ali and Shahino Mah Abdullah, green sukuk : present state and futur outlook, http://www.iais.org.my/e/attach/2017/20NOV2017.

principles of Islamic Shari'a, the mobilized funds through Sukuk issance will be directed to investing in known assets and projects;

- Sukuk, which is often similar to traditional fixed income securities, can help close the fixed income gap for investors in environmental activities.

2-4- why are green ‘Sukuk’ a good fit for sustainable development?

For one, to finance sustainable infrastructure through green Sukuk can further broaden this market as well as help bridge the gap between conventional and Islamic financial worlds. Both environmentally sustainable investors and Sukuk investors aim to use their money in manners that comply with certain values and beliefs. Green Sukuk funding and environmentally sustainable infrastructure projects, such as the construction of renewable or clean energy projects, could appeal to both Sukuk investors and conventional environment-focused investors, as Sukuk by design are structured based on a specific pool of assets.

A closer look reveals that there is a need for infrastructure globally that could require up to hundreds of billions of U.S. dollars a year in additional financing; this is a real opportunity for green Sukuk where we find key and potential Islamic finance markets are primarily young and growing populations. However, this opportunity has not yet been tapped in to; 2016 was no different to previous years where we saw limited activity in the Islamic finance regions’ infrastructure bond financing, let alone Islamic finance and Sukuk.[1]

3- MARKET OPPORTUNITIES

ln the conventional capital markets, environment-focused bonds have begun to appear in recent years. The World Bank, for example has issued since 2008 a type of bonds called ‘World Bank Green Bonds’. Rather than funding all of the activities of the World Bank, the proceeds of World Bank Green Bonds only go to support certain projects that meet pre-determined criteria for low carbon development. These bonds have been very well-received by environmentally sustainable investors, and the structure has become a model for other supra-national, corporate and sub-sovereign issuers. “Green” sukuk have the potential to further broaden this market as well as to help to bridge the gap between the conventional and financial worlds.

Sukuk, which are most similar to a conventional fixed income securitie could help fill the fixed income supply gap for environmental investors to the extent the proceeds of a sukuk are earmarked for a particular environmentally beneficial purpose.

Muslim communities across the globe have already begun to take environmen- tally friendly steps through the development of “eco-mosques” and carbon- conscious local communities. In addition to

1 - Bashar Al Natoor, Why Green Sukuk Could be a Growth Driver for Islamic Finance, Of the site : https://medium.com/fitch-blog/why-green-sukuk-could-be-a-growth-driver-for-islamic-finance, Date of entry :20/08/2018.

local activism in various Muslim communities around the world, Muslim-majority countries have started to improve renewable or "green" energy projects. In late 2012, Australian solar companies Solar Guys International and Mitabu raised $100 million (the first tranche of $500 million) for a 50-megawatt photovoltaic project in Indonesia by way of sukuk. The project, which was fully funded under a Power Purchase Agreement (PPA) model, is the first phase of the Indonesian "One Solar Watt Per Person" program. This renewable energy project was reported to be funded by green sukuk, and likely was environmentally friendly. However, no reporter established that the project adhered to definite green criteria.

Market opportunities in traditional geographies of the sukuk investor base, particularly in renewable energy, are also starting to develop. Large-scale renewable energy projects span the wider Middle East and North Africa, particularly Morocco, Egypt, and Jordan.

Three initiatives that could benefit from green sukuk funding include the King Abdullah City for Atomic and Renewable Energy, the Abu Dhabi Vision 2030, and the Dubai Integrated Energy 2030 Strategy.[1]

[1] - UMAR F. MOGHUL AND SAMIR H.K. SAFAR-ALY, Green Sukuk: The Introduction of Islam's Environmental Ethics to Contemporary Islamic Finance, THE GEORGETOWN INT'L ENVTL. LAW REVIEW, vol :27, N° : 01, 2014, p : 49-50.

surveying the available financing models in the Middle East for sustainable infrastructure projects, Sukuk appears as a viable option to match the region's growth.

Three trends are discernible in the current global financial market:

1. Banks are reluctant to commit long-term capital to infrastructure finance due to stricter capital requirements;

2. An increasing number of investors are interested in environmentally sustainable investing, in other words, investing to promote activities that are seen as being positive for the environment;

3. The market for sukuk, the Islamic financial instrument most similar to a conventional bond is growing significantly.

While these three trends are distinct and not obviously related, taken together, they create a market opportunity for sukuk to be used as a tool to finance environmentally sustainable infrastructure projects.

The need tor significant infrastructure spending is obvious in both developed as well as developing countries. From crumbling transportation infrastructure in the United States to inadequate power generation capacity in India, the evidence is clear that improving infrastructure is a global priority. At the same time, popular concern about climate change and the detrimental impact of increasing greenhouse gas emissions has made improving infrastructure in an environmentally sensitive manner a priority also.[1]

Banks, the traditional providers of debt finance for infrastructure projects have been pulling back from this type of lending due to regulatory changes that have decreased bank appetites for longer dated risk. Capital markets investors are in theory, well-placed to replace banks as the providers of debt finance for infrastructure, given that many projects offer relatively high yields with low correlation with other types of fixed income instruments.

However debt financing of infrastructure projects would be an entirely new and unfamiliar asset class tor most capital markets investors. As a result, intermediaries will need to engage in considerable marketing efforts to interest capital markets investors in infrastructure and the investments will need to be packaged in a manner that appeals to such investors.

One potential means of attracting capital markets investors' interest in infrastructure finance is to combine the two other trends described above — the expanding markets for both environmentally sustainable investing and sukuk. Although, to date these two markets have been geographically distinct – with environment-focused investors mainly found in Northern Europe, North America and Japan and sukuk

[1] - Michael Bennett, the Treasury Department of the World Bank, the State of Energy Report, 1st Edition, Dubai, 2014, https://www.sukuk.com/article/sukuk-financing-model-green-projects-2202/

investors concentrated primarily in the Arabian Gulf and Malaysia — the two markets do share a strong commonality.

Both environmentally sustainable investors and sukuk investors aim to use their money in a manner that conforms to their values and beliefs. Whereas traditionally finance has been solely driven by the effort to maximise risk-adjusted returns, these types of investors have added an additional qualitative objective for financial market activity— compatibility with the investor's ethics.

A sukuk in which the proceeds are used to fund a specific environmentally sustainable infrastructure project such as the construction of renewable energy generation facility, could appeal to both sukuk investors and conventional environment focused investors. Combining these two distinct investor bases would be a novel development for the capital markets.

While some conventional investors, mainly bank treasuries and hedge funds purchase sukuk, the vast majority of conventional investors [including virtually all environmentally sustainable investors] have no experience at all with these instruments. However, there is nothing intrinsic to sukuk that make them inappropriate for conventional investors. Although the structures and terminology will be unfamiliar at first sukuk should be attractive to conventional investors if they offer reasonable risk-adjusted returns and are properly marketed.[1]

[1] - op.cit

A sukuk that meets those criteria and provides funding for an environmentally sustainable project could be particularly attractive to environment-focused investors for two principal reasons. First, sukuk provide investors with a high degree of certainty that their money will be used for a specific purpose. In order to comply with the underlying Shari'ah principles, the funds raised through the issue of a sukuk must be applied to investment in identifiable assets or ventures. Therefore, if sukuk are structured to provide funds for a specified infrastructure project, such as a renewable energy project, there is little chance the investors' money will be diverted and used for another purpose.

Second, many more environment-focused investment products exist on the equity side of the capital markets than on the fixed income side. The reason for this lack of supply is that the majority of corporate and sovereign bonds are general unsecured obligations of the issuer, meaning the use of the proceeds of the bonds is not restricted to a particular purpose. Since most environmentally sustainable investors want to know precisely how their money will be used, bonds that are general obligations of an issuer have limited appeal unless all of the activities of the issuer meet the investor's environmental standards.[1]

The Abu Dhabi Vision 2030 would have non-oil sectors of the economy (including petrochemicals) make up 64% of the emirate's Gross Domestic Product ("GDP") by 2030.338 At the World Future Energy Summit in 2009, Abu Dhabi also announced a target of

[1] - op.cit

generating 7% of its energy capacity with renewable sources by 2020.339 In addition to its ambitious nuclear energy program,340 Abu Dhabi's energy mix is being met with a combination of solar and wind projects.341 International authorities such as the IMF, the World Bank and the U.N. Development Project have recommended the issuance of government bonds to effectuate these fiscal policies,342 an opportunity for sovereign green sukuk. Masdar, a subsidiary of Abu Dhabi's government-owned Mubadala Development Company (a catalyst for the economic diversification of Abu Dhabi), has commissioned renewable wind and solar energy projects and signed a Memorandum of Understanding with the U.K. Green Investment Bank[1].

In July 2017, Malaysia, through Tadau Energy, issued the world's first green sukuk—RM250 million Sustainable Responsible Investment (SRI) sukuk—to finance the construction of an LSS project in Kudat, Sabah.

Quantum Solar, meanwhile, announced the world's largest green SRI sukuk issuance of RM 1 billion recently. The wholly owned special-purpose vehicle of Quantum Solar intends to raise money to fund a portfolio of three large-scale solar photovoltaic (PV) plants in Gurun, Kedah, Jasin in Melaka, and Merchang, Terengganu.

[1] - Umar F. Moghul and SAMIR H.K. SAFAR-ALY, Green Sukuk: The Introduction of Islam's Environmental Ethics to Contemporary Islamic Finance, op.cit, p : 51.

The projects are expected to create up to 3,000 jobs, generate electricity for up to 93,000 households and reduce carbon emissions by 210,000 tonnes annually.[1]

And Malaysia will issue more green sukuk to finance environmental-friendly infrastructure projects, in a move to bolster its position as the key driver in the green Islamic financial market.

More green sukuk is expected to be issued in Malaysia to support environmentally sustainable infrastructure projects and to strengthen the country's position as the main catalyst for Syariah-compliant green sukuk.

Certainly, the future of green sukuk in Malaysia is promising for a number of reasons :[2] Firstly, the government aspires, as envisioned in the 2014 Budget speech, to position Malaysia as the home for SRI as part of its ambition to make Malaysia a green technology hub by 2030 ;

Secondly, a substantial increase in the demand for both energy supply and energy financing in Malaysia has opened up room in which green sukuk can grow. The government has put in place a renewable energy generation target of 7,200 megawatts by 2020. Malaysia's Green Technology Master Plan also aims to boost the

[1] - More green sukuk for infra projects, http://www.constructionplusasia.com/green-sukuk-infra-projects/

[2] - Mohammad Mahbubi Ali, Malaysia's green sukuk, 2018, https://www.nst.com.my/opinion/columnists/2018/03/346085/malaysias-green-sukuk

growth of its green technology sector, with a targeted revenue of RM180 billion alongside the creation of 200,000 green jobs by 2030 ;

Thirdly, there is a growing awareness of SRI among both conventional and Muslim investors. Green sukuk facilitates and increases the broader participation of conventional investors in the sukuk market, especially those looking for more ethical and socially responsible investment opportunities. They help bridge the gap between sustainable investors and sukuk investors who aim to place their money in a scheme that complies with certain values.

Other positive factors include the design of sukuk, which is naturally supportive of green principles because it requires a specific pool of assets. Also, the progress of green sukuk is, and has evolved into, an indispensable part of the natural evolution of the global Islamic financial market.

4- Challenges of Green Sukuk

Notwithstanding the positive prospects for green sukuk, the future of green sukuk is hindered by a number of challenges and constrains. First, 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. Second, the absence of the standard and verification system for performance measurement of green bonds/sukuk. Third, green sukuk may expose to higher risk profile. This is because many environmental friendly projects involve a sophisticated degree of new technology due to construction and operation of green technologies. Fourth, the difficulty to assure investors that sukuk proceeds will be used for projects with economic value, while meeting accepted and credible green standards.[1]

Conclusion

The benefits to be gained by contemporary Islamic finance by way of a green sukuk are both qualitative and quantifiable. The latter includes improved market reputation by more obviously participating in widely recognized socially responsible behavior and earning a perception of greater authenticity from within.

Renewable energy projects are ideal candidates for financing via green Sukuk, because of the values they share in terms of social responsibility and protection of the environment but also in financial advantages and diversification of financing methods.

- Green Sukuk are the catalyst that would open more doors for Islamic Banking and Finance to develop and expand its horizons – limited not only to Islamic countries but also to the rest of the world ;
- The principles of islamic finance share substantial synergies with the concept of environment-friendly and sustainable development ;

[1] - SRI & GREEN SUKUK: CHALLENGES & PROSPECTS, http://www.mifc.com/index.php?ch=28&pg=72&ac=162&bb=uploadpdf

- The green sukuk has the potential to channel the growing global pool of shariah-compliant capital to fund renewable energy and climate change projects ;