CLIFFORD CHANCE

GREEN SHOOTS: SUSTAINABLE CAPITAL MARKETS IN THE MIDDLE EAST

– THOUGHT LEADERSHIP

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The development of sustainable finance continues to evolve across the Middle East – a region more readily associated with conventional energy resources such as oil and gas.

Governments around the world continue to focus on climate policies and transition targets and the spotlight remains on green bonds and sustainable finance. Increasingly, however, the 'S' and 'G' facets of ESG (environmental, social and governance) finance are gaining momentum. The COVID-19 pandemic highlighted glaring disparities, such as income inequality, between populations and has precipitated a host of issuances with the proceeds earmarked for social purposes. In a report published in February 2021, Moody's anticipates global debt capital markets issuances of US$375 billion in green bonds, US$150 billion in social bonds and US$125 billion in sustainability bonds in 2021 – i.e., ESG issuances of approximately US$650 billion compared with US$491 billion in 2020.

In the Middle East, despite a legacy of substantial reliance on fossil fuels, governments are actively seeking to develop their economies and businesses in a sustainable manner. For example, the United Arab Emirates includes developing a "Sustainable Environment and Infrastructure" amongst its Vision 2021 National Agenda goals, with an emphasis on "improving the quality of air, preserving water resources, increasing the contribution of clean energy and implementing green growth plans", while the Kingdom of Saudi Arabia has included sustainability objectives as part of its National Transformation Programme (one of 13 programmes developed with the intention of achieving the Kingdom's Vision 2030). With regional corporates also aligning their ESG policies with international standards such as the United Nations Sustainable Development Goals and the Paris Agreement, the political and social mandate is clear.

ESG Issuances in the Middle East

To date, ESG issuances in the region have been in the form of senior, unsecured conventional bonds and sukuk. As is the case with an ESG conventional bond, the defining feature of an ESG sukuk is that the issuance proceeds must be used for environmental, social and/or governance purposes, while the key distinction is that the issuance will assume a *Shari'a*-compliant structure rather than a conventional issuance structure. Depending on the nature of the issuance in question, the use of proceeds may be for a specific project or operation; it is also common for the proceeds to be used for unspecified present or future projects in compliance with certain criteria set out in the offering document. Often, an additional consideration (albeit not a precondition) for ESG sukuk vis-à-vis conventional issuances would be the ESG-compliant nature of the underlying assets which form part of the sukuk portfolio.

The first Middle East green bond was issued by a financial institution, First Abu Dhabi Bank (FAB), in 2017. With no new ESG issuance for the following two years, the region lacked further development in sustainable finance until 2019, which saw the launch of a number of green sukuk and bond issuances by key regional issuers such as Majid Al Futtaim (MAF) and The Islamic Development Bank (IsDB) (as well as further green bond issuances by FAB). This momentum continued into 2020, with green sukuk and bond issuances by Saudi Electricity Company, Qatar National Bank (QNB) and the Arab Republic of Egypt as well as the Etihad Airways (Etihad) transition sukuk. For further details, see pages 4-5.

What Next for Middle East ESG Capital Markets?

The Middle East region has yet to witness significant volumes of ESG issuances, although we expect a number of trends to emerge in this space in the near future, including:

- A wider pool of issuers – businesses in the region (including financial institutions, sovereign wealth funds and GREs, and corporates) are primed to adopt sustainable financing strategies as a result of shareholder activism, investor engagement and political mandates. Many frequent entrants into the capital markets in the region may well determine that their businesses lend themselves to sustainable development strategies – for example, real estate developers may seek to construct more energy and resource-efficient buildings while transport and logistics corporates may wish to use advancements in renewable energy sources and more energy-efficient technologies. Indeed, a number of other regional issuers have already, or are in the process of, establishing sustainable financing frameworks. For example, following DP World Limited's execution of a green loan in 2018, where the loan pricing was linked to DP World's carbon emission intensity and therefore incentivised the company to reduce its greenhouse gas emissions, the company (which is one of the largest and most geographically diversified logistics, marine and inland container terminal operators in the world) established its Sustainable Development Financing Framework for financing or refinancing eligible projects which fall within the "Green/Social/ Sustainability Bond Principles" promulgated by the International Capital Market Association.
- Varied structures – ESG issuances in the region have predominantly been by way of senior, unsecured ("vanilla") green bonds and sukuks. As the market develops, we may see different structures being used in line with other markets around the globe. For example, through "green" regulatory capital transactions (where the regulatory capital "credit" is used for ESG purposes), ESG securitisations (where the underlying cashflows emanate from ESG activities/projects), and structures which incorporate step-ups/step-downs for ESG (non) compliance (as means of rewarding "good" behaviour). As such structures emerge on the conventional side, sukuk structures will evolve in tandem ensuring that principal and profit payments are asset-based and *Shari'a*-compliant – for instance, in the case of a transition sukuk, where a step-down is triggered in case of non-satisfaction of the emission target.
- Social/Governance focused issuances – thus far, only IsDB and Etihad have issued sustainability/transition sukuk in the region. However, businesses are progressively more focused on such concerns and, in our view, it is only a matter of time before we see such further issuances in the region.
- Reporting standards – as ESG financing develops and gains momentum in the region, it is likely that regional regulators may promulgate guidance in respect of ESG issuances, including ongoing reporting in order to manage the risk of "greenwashing", and issuers may therefore need to comply with more prescriptive requirements. This may impact the management/compliance cost to issuers but, equally, may also result in more transparent and standardised ESG-compliance reporting for investors and, therefore, increased investor appetite for regional ESG issuances. For example, the Dubai Financial Services Authority published its own Green Bond Best Practice Guidelines in August 2018 to offer infrastructure and guidance in relation to green issuances in the capital markets. Since 2020, the

United Arab Emirates Securities and Commodities Authority requires that public joint stock companies listed on the Abu Dhabi Securities Exchange or the Dubai Financial Market should comply with certain ESG disclosure standards. These were further clarified in January 2021 and include the preparation of sustainability reports which must be submitted annually to the United Arab Emirates Securities and Commodities Authority within a prescribed period of time.

Ultimately, however, ESG issuances cannot be detached from commercial considerations – namely, diversification of the issuer's investor base, liquidity, and cost of funds (including any "greeniums" offered by investors resulting in lower borrowing costs). Despite a lack of ESG-focused funds/investors in the region vis-à-vis other markets such as the U.S. and Europe, a positive development in this regard is portfolio managers' awareness of including sustainable assets as part of a diversified portfolio, and managed funds becoming increasingly decisive in their desire to invest in sustainable assets. From a commercial perspective, particularly where an issuer has an existing credit curve of conventional bonds and/or sukuk, a key consideration in the decision to issue a ESG bond/sukuk will be pricing in line with the existing credit curve. This is particularly the case when the establishment by the issuer of a ESG framework is taken into consideration, together with the management infrastructure involved in that process. Although the prognosis remains positive for ESG debt capital markets, that pricing outcome will remain a key determinant of the speed at which issuers across the region embrace sustainable funding in the capital markets.

The table below sets out the principal ESG issuances in the Middle East region to-date:

Issuer	Issuance	ESG Characteristics
FAB – the largest bank in UAE and the second largest bank in GCC by total assets	US$587 million 3.00% Notes issued on 30 March 2017 (first ESG issuance in the region)	Green bonds issued pursuant to FAB's EMTN Programme. Proceeds to be used in accordance with FAB's Green Bond Framework (eligible project categories include renewable energy, energy efficiency, pollution prevention and control, sustainable management of living natural resources, terrestrial and aquatic bio-diversity conservation, clean transportation, sustainable water management, climate change adaptation, and eco-efficient products)
MAF – one of the largest developers and operators of shopping malls and hypermarkets in MENA region	US$600 million Sukuk issued on 14 May 2019 (world's first benchmark corporate green sukuk and the first green sukuk by a regional corporate)	Green sukuk issued pursuant to MAF's Sukuk Programme. Proceeds to be used in accordance with MAF's Green Finance Framework (eligible project categories include green buildings, renewable energy, sustainable water management, and energy efficiency)
FAB	US$50 million Floating Rate Notes issued on 3 September 2019	Green bonds issued pursuant to FAB's EMTN Programme. Proceeds to be used in accordance with FAB's Green Bond Framework (as set out above)
FAB	US$20 million Floating Rate Notes issued on 26 September 2019	Green bonds issued pursuant to FAB's EMTN Programme. Proceeds to be used in accordance with FAB's Green Bond Framework (as set out above)
MAF	US$600 million Sukuk issued on 30 October 2019	Green sukuk issued pursuant to MAF's Sukuk Programme. Proceeds to be used in accordance with MAF's Green Finance Framework (as set out above)

Issuer	Issuance	ESG Characteristics
IsDB – a multilateral development bank which was founded for the purpose of fostering economic development and social progress in its member countries in accordance with the principles of *Shari'a*	EUR1 billion Sukuk issued on 4 December 2019 (first AAA-rated green sukuk in the global capital markets)	Green sukuk issued pursuant to IsDB's Sukuk Programme. Proceeds to be used in accordance with IsDB's Sustainable Finance Framework for the purposes of financing or refinancing green projects (eligible project categories include renewable energy, clean transportation, energy efficiency, pollution prevention and control, environmentally sustainable management of natural living resources and land use, and sustainable water and wastewater management)
IsDB	US$1.5 billion Sukuk issued on 25 June 2020 (first COVID-19 response sukuk and the first AAA-rated sustainability sukuk in the global capital markets)	Sustainability sukuk issued pursuant to IsDB's Sukuk Programme. Proceeds to be used in accordance with IsDB's Sustainable Finance Framework for the purposes of financing or refinancing social projects (with a focus on "access to essential services" and "SME financing and employment generation" categories to assist its Member Countries in tackling the aftermath of the COVID-19 pandemic)
Saudi Electricity – Saudi Arabia's electric energy company responsible for generation, transmission and distribution of power in the Kingdom	US$1.3 billion Sukuk on 17 September 2020 (first green issuance out of Saudi)	Green standalone sukuk (dual-tranche). Proceeds to be used to finance or refinance eligible green projects (eligible project categories include energy efficiency (including procurement and installation of "smart meters") and renewable energy (including capex for construction/operation of the transmission and/or distribution infrastructure for connecting renewable energy sources to the grid))
Qatar National Bank – largest bank in Qatar by total assets and one of the fastest growing banks in GCC	US$600 million 1.625% Notes issued on 22 September 2020 (first green bond issuance out of Qatar and second green issuance by a commercial bank in GCC (first being FAB's issuance in 2017))	Green bonds issued under QNB's MTN Programme. Proceeds to be used in accordance with QNB's Green, Social and Sustainability Bond Framework to finance or refinance a green loan portfolio consisting of project-specific loans as well as corporate loans to "pure play" companies (including for green buildings, renewable energy, clean transportation, energy efficiency, environmentally sustainable management of living natural resources and land, sustainable water and wastewater management, and pollution prevention control)
Arab Republic of Egypt	US$750 million 5.250% Notes issued on 6 October 2020 (first sovereign green bond issuance in MENA region)	Green standalone bonds. Proceeds to be used to finance or refinance in accordance with Egypt's Green Financing Framework eligible green projects (eligible project categories include clean transportation, renewable energy, pollution prevention and control, climate change adaptation, energy efficiency, and sustainable water and wastewater management)
Etihad – national airlines of the UAE	US$600 million Sukuk issued on 3 November 2020 (world's first transition sukuk and the first sustainability-linked financing in global aviation)	Transition sukuk issued under Etihad's Sukuk Programme. Proceeds to be used in accordance with Etihad's Transition Finance Framework (linked to Etihad's carbon reduction targets – a commitment to net zero carbon emissions by 2050, a 50% reduction in net emissions by 2035, and a 20% reduction in emissions intensity in its passenger fleet by 2025)
IsDB	US$2.5 billion Sukuk issued on 31 March 2021 (second AAA-rated sustainability sukuk in the global capital markets and IsDB's largest US$ issuance)	Sustainability sukuk issued pursuant to IsDB's Sukuk Programme. Proceeds to be used in accordance with IsDB's Sustainable Finance Framework for the purposes of financing or refinancing green and social development projects

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