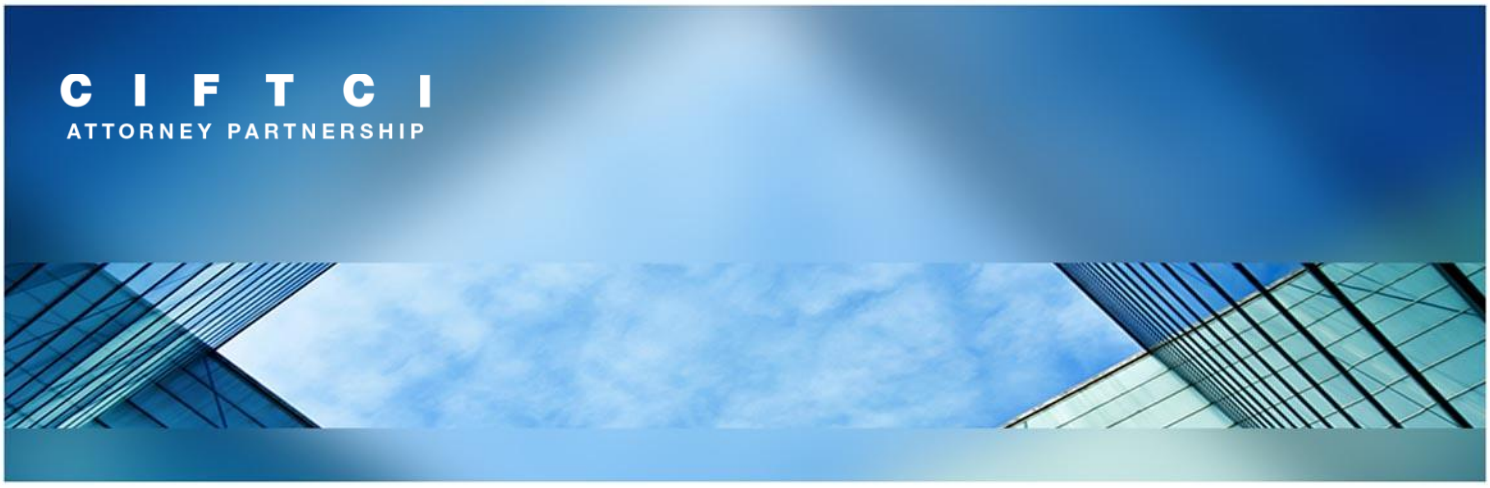

SUSTAINABLE FINANCE IN THE SPOTLIGHT: TURKEY JOINS THE REST OF THE G20 BY RATIFYING THE PARIS AGREEMENT

Turkey's transition to a more eco-friendly country gained momentum earlier this year with Turkey's release of a landmark Green Deal Action Plan in July. Yesterday, following the UN General Assembly that took place at the end of September which focused on, *inter alia*, climate change, Turkey has joined the rest of G20 by ratifying the Paris Agreement.[1]

In order to mark this long-anticipated milestone, we have prepared a brief summary of sustainable finance products and an overview of the global and Turkish markets in which they have been launched.

Introduction

Today, governments and companies alike face greater scrutiny in their adoption of sustainable and socially responsible policies, due toa combination of factors, including scarcity of resources, environmental concerns related to pollution and climate change, and a greater awareness of social equality and diversity issues.

The global momentum propelling the growth of responsible business is mainly driven by reputational risks for corporations due to legal and regulatory requirements adopted by governments, failure to meet which could diminish their value, as well as the empowerment of consumers by the rise of social media. Businesses and consumers now expect a greater degree of transparency from their partners and service providers, and innovative start-ups are successfully capitalising on this demand by prioritising socially conscious policies in their marketing and branding to differentiate themselves from competitors and legacy businesses. On this basis, corporations are no longer solely fixated on the generation of profits and are gearing up to adopt business models with a clearly defined set of values for a more sustainable, equal, diverse, carbon-free and 'green' future.

Financial markets have responded with a wide range of financial products to meet this demand. While, historically, there has been substantial focus on 'green' financing products that raise funds for projects with tangible environmental benefits, investors are demanding a larger array of environmental, social and governance ("**ESG**") credentials as part of their commitment to responsible investing. Investor demand, economic necessity and competitive pressures have resulted in the rapid growth of the sustainable debt market, which is defined as bonds and loans raised for projects with environmental and social purposes. With transactions becoming increasingly sophisticated, we are seeing a proliferation of new products with a 'green' theme.

[1] Please note that Turkey ratified the Paris Agreement with the following declaration: "*The Republic of Turkey, on the basis of "equity, common but differentiated responsibilities and respective capabilities" as clearly and accurately recognised under the United Nations Framework Convention on Climate Change of 9 May 1992 and the Paris Agreement, and by recalling decisions 26/CP.7, 1/CP.16, 2/CP.17, 1/CP.18 and 21/CP.20 adopted by the Conference of the Parties to the Convention, declares that she will implement the Paris Agreement as a developing country and in the scope of her nationally determined contribution statements, provided that the Agreement and its mechanisms do not prejudice her right to economic and social development*."

WHAT ARE SUSTAINABLE FINANCE PRODUCTS?

Green Loans and Sustainability-linked Loans

Green loans provide a simple and traditional 'use of proceeds' approach, where the borrower is required to use the loan proceeds directly for specific green or sustainable purposes, whereas sustainability-linked loans ("**SLLs**") do not consider the 'use of proceeds' as a determinant in their approach. Instead, SLLs aim to facilitate ESG growth by enabling lenders to incentivise the sustainability performance of the borrower based on compliance with certain green or sustainability performance targets ("**SPTs**"). A key driver for many companies in entering into an SLL is to preserve flexibility, and to continue to use the loan proceeds for general corporate or other purposes (which may or may not be ESG-related) whilst still being able to have a positive ESG impact. The borrower of an SLL should clearly communicate to its lenders its sustainability objectives, as set out in the borrower's wider corporate social responsibility strategy, and how these align with its proposed SPTs.

Both products have developed rapidly over the past few years.

Sustainability-linked Bonds

As market demand for green financing has grown to a point that cannot be solely borne by the lending market, financial regulators have started to adopt innovative policy measures to unlock capital markets solutions for financing green and sustainable investments. Given the growing depth and liquidity of fixed income markets in many countries, capital markets are expected to have a central role in meeting this demand. Indeed, the sustainability bond market saw strong growth in the year 2020, with total issuances of USD68.7 billion despite the challenges presented by the COVID-19 pandemic.

Much like SLLs, sustainability-linked bonds ("SLBs") are performance-based instruments, and this, their financial and/or structural characteristics can vary dependent on whether the issuer achieves predefined sustainability objectives. This is measured through certain key performance indicators ("KPIs") that measure the overall progress in achieving the SPTs. In an effort to clarify the KPI mechanism, the Sustainability-linked Bond Principles, published by the International Capital Market Association (ICMA), set out voluntary guidelines with five core components: (i) selection of KPIs, (ii) calibration of SPTs, (iii) bond characteristics, (iv) reporting and (v) verification of each SPT.

Green Bonds

In order to qualify for the green bond market, the proceeds of the issue, or an amount equal to such proceeds, must be allocated only to the financing of 'green' projects. This is generally fine when the issuer is an SPV or project company, but there are controversial views in the bond market with respect to the issuance of green bonds by companies with carbon-heavy businesses. For some, any engagement with sustainability is good; what matters is the issuer's transition towards a low carbon strategy, as a green bond does not give investors express contractual rights in relation to the green elements of the bond. We believe that investors should make their own decisions on the environmental suitability of the bond, based on the information on the green bond and green bond framework provided by the issuer in the prospectus.

RECENT DEVELOPMENTS IN THE WORLD AND TURKEY

Renewables Energy Sector

According to the International Energy Agency's ("IEA") Global Energy Assessment report for 2021, global carbon emissions are estimated to reach 33 billion tons. Compared with 2020, global carbon emissions this year will increase by 5%, or 1.5 billion tons, recording the second largest rise in recorded history. This increase will also be the largest annual increase in global emissions since 2010. As a result of the efforts in economic recovery in the aftermath of COVID-19, a reported 4.6% growth in coal and natural gas consumption is expected due to increased energy demand.

That said, electricity generation from renewable resources is also expected to increase by 8% this year, which accounts for more than half of the growth in global electricity supply. In 2021, renewable energy sources will account for approximately 30% of global electricity generation, which will be the highest rate on record. The biggest increase in electricity generation from renewable energy in 2021 is expected to be seen in China, the USA, the European Union and India.

Turkey's use of biofuels has considerably reduced reliance on hydrocarbon products (such as coal, fuel oil and natural gas) in the country, and significant progress in the renewable energy sector has already been made. However, despite the progress in renewable energy front, the carbon intensity of Turkish economy is still increasing, and the renewable energy industry needs support and time to become cost-effective and competitive with hydrocarbons.

In Europe, there has been a focus among traditional oil & gas companies on transitioning into renewables as they seek to position themselves in the energy markets of the future, and so develop long-term corporate strategies accordingly. Similarly, installed capacity of renewable energy in Turkey grew in the past decade with increasing support from the government, principally through the YEKDEM (feed-in tariff) mechanism. With the amendments and optimisations in energy market legislation, YEKDEM has made available tempting prices against the declining market clearing price in the Turkish day-ahead market, which has increased interest amongst market participants. The Energy Market Regulatory Authority (*Enerji Piyasası Düzenleme Kurumu*) further seeks to enhance the competitive environment in the market by means of the recent amendments to the energy market legislation, which aim to conform with global market-making principles. On 30 January 2021, the Presidency of Turkey published a decree on YEKDEM setting out the new feed-in tariff applicable to those renewable energy power plants that become operational in Turkey between 1 July 2021 and 21 December 2025 (inclusive). The new YEKDEM scheme shifts the currency of previously US Dollar (USD) denominated feed-in tariff and domestic components incentive premia payments to Turkish Lira (TRY), whilst still capping the price indexed to USD.

The total installed capacity of renewable energy generation in Turkey has exceeded 97,000 MW, and this year it is expected that the total capacity will exceed 100,000 MW. The share of renewable resources in the country's electricity generation, which was 25.4% in 2011, has increased, to 43.9% in 2019 and 42.4% in 2020. Renewable resources constituted 98% of the installed capacity Turkey commissioned in the first three months of 2021. In 2020, Turkey rose to 12th place in the world, and 5th within Europe, in terms of renewable installed power. Meanwhile, the share of private sector investment in installed power infrastructure has experienced a threefold increase in the past 20 years; today, the share of the public sector in electricity generation is around 15-20% annually. We expect the appetite for renewables to increase in terms of the demand for infrastructure and energy projects in Turkey supported by privatisations as the world takes sustainable energy goals more seriously.

Sustainability Developments

During the recent Leaders' Summit on Climate hosted by the U.S., the UK announced a landmark target to reduce emissions by 78% from 1990 levels by 2035, Canada announced a 40-45% reduction from 2005 levels by 2030, and Japan promised a 46% cut from 2013 levels, also by 2030. China, too, made some strides in allaying fears on its dominant use of coal in agreeing to "phase down" coal consumption in the five-year period towards 2025.

Similarly, the European Commission has recently adopted a comprehensive package of measures to help improve the flow of money towards sustainable activities across the European Union. These measures include the Delegated Act in connection with the EU Taxonomy, and a new Corporate Sustainability Reporting Directive revising the existing rules introduced by the Non-Financial Reporting Directive to strengthen sustainability reporting as part of financial reporting.

Also, the 26th UN Climate Change Conference of the Parties (COP26) will bring states together in November 2021 to accelerate actions under the Paris Agreement and the UN Framework Convention on Climate Change. The Paris Agreement was signed in 2015 by 195 states in order to combat climate change and reduce its impacts. After prolonged debate, Turkey finally ratified the Paris Agreement on 7 October 2021.

On the other hand, Sustainable Development Goals ("SDGs") were also adopted by all UN member states in 2015 as a universal call to action to end poverty, combat climate change and ensure that all people enjoy peace and prosperity by 2030 (the "2030 Agenda"). With an established commitment to contribute to a sustainable world, Turkey has linked these SDGs with its national development plans and sectoral strategies. It has made significant progress in putting into operation the 2030 Agenda through comprehensive policy-making and providing support in respect of economic growth and environmental protection, the interconnectedness of which shape its medium and long-term development aims. Turkey has set the pace in terms of ESG policy-making and offers an enabling environment for institutionalising sustainability efforts. However, reports on the 2030 Agenda show that Turkey still faces challenges in terms of implementation and accountability.

In 2017, Turkey signed, in line with the global SDGs, the Declaration on Sustainable Finance as part of the United Nations Global Compact, which aims to integrate environmental and social risk analysis in banking activities and market strategies. To date, eight Turkish banks, whose asset value represents almost 40% of the Turkish banking sector, have signed the Declaration on Sustainable Finance. The signatory parties have been implementing sustainability benchmarks in their credit facility policies and diversifying the green products they provide to customers, ranging from individuals to big corporations.

Most recently, on 3 May 2021, Istanbul Metropolitan Municipality signed a memorandum of understanding with the European Bank for Reconstruction and Development (EBRD) which oversees Istanbul's participation in the EBRD's flagship "Green

Cities" urban sustainability programme. Following Ankara and Izmir, Istanbul will be the 47th city to take part in the EBRD's Green Cities urban sustainability programme.

Sustainable Finance in Turkey

Following an increase of USD500 billion in 2020 alone, the volume of the global sustainable debt market has already passed USD1.5 trillion so far this year. As an emerging economy, Turkey's sustainable debt market volume is a total of USD4.2 billion, of which USD3 billion is comprised of bonds, while the remaining USD1.2 billion is made up of loans.

The most common forms of sustainable finance in Turkey have been green credit lines and loans made available by International Financial Institutions ("IFIs"). In the current market, the two major players are EBRD and the World Bank. The EBRD has recently provided financing to renewable energy and resource efficiency investments of private sector enterprises in Turkey, while the World Bank has provided on-lending facilities for the promotion of women's participation in the labour force and encouraging a women-friendly working environment with the aim of attaining for women inclusive access to finance. This year has also marked Turkey's first-ever corporate green bond issuance in international markets. In this inaugural deal, our firm has advised Arçelik Global, a leading consumer durables and electronics manufacturer and Europe’s second largest white goods company by market share (based on volumes), in connection with its issuance of EUR 350 million 3.0% green bonds due 2026.

The regulatory framework for ESG initiatives is newly developing in Turkey. Recently, in order to introduce ESG principles to publicly listed companies, the Capital Markets Board (the "CMB") amended the Corporate Governance Communiqué and published the Sustainability Principles Compliance Framework. Although the steps envisaged thereunder are intended to be of advisory nature only, and will be followed by companies on a voluntary basis, the companies would still be required to report annually on their compliance with the ESG step-plan. In July 2021, the "Green Deal Action Plan" was published by the Ministry of Trade for the purposes of setting out the action items needed to align Turkey's business environment and regulatory framework with the European Green Deal and the UN's Sustainable Development Goals, in accordance with the Turkey's Foreign Direct Investment Strategy for the years 2021-2023.

Despite these new developments, there are still substantial financing risks in the transition Turkey is making towards the implementation of sustainability principles. Further regulatory changes will require engagement from all stakeholders, to facilitate the appropriate amendments to existing policies and processes (particularly in relation to disclosure and reporting mandates on ESG-driven risks, as well as financial risks). As sustainable finance initiatives further develop and introduce new products and business models, additional human and technical resources will be needed to adapt to these new market principles. It may also be challenging to define corporate duty in a way that promotes this individualised risk-based approach while creating certainty for businesses from day one that its approach meets the expectations of financial adequacy and profitability.

Boosting sustainability in the financial market requires the determination of all stakeholders in a mutually beneficial environment. In this regard, ESG prosperity is a matter of properly identifying, addressing and managing the risks each stakeholder has, including the risks borrowers assume in their business and the risks relating to the businesses of such borrowers in which banks and financial institutions invest.

OUTLOOK

The growth in sustainable financing has been a marked high note in a challenging market. In the first quarter of 2021, sustainable debt deals of USD280 billion were executed globally of which around two thirds were bonds and one third were loans. This market has more than doubled since 2018. Regionally, Europe is the biggest market, with most of the bonds and loans originating from Europe. Europe's success story is no surprise, as the EU seems to have unreservedly adopted a consciousness which is distinguished in its establishing pioneering legislation and, simultaneously, keeping pace with global trends at the domestic level.

With government and corporate attention focused on both ESG initiatives and sustainable investing, it is a matter of "when" and not "if" the sustainable finance market in Turkey will have to overcome issues relating to environmental and social accountability. Sustainable finance products serve as an attempt by investors to reward debtors for positive environmental practices, which need to be further supplemented by government-backed financial support schemes and a forward-looking regulatory environment.

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