Prepared for:

European Bank for Reconstruction and Development

Carbon Market Services for Turkish Banks

Summary of a legal and regulatory review

Carbon Market Services for Turkish Banks

Summary of a legal and regulatory review

27 September 2013

Authors:

Mercedes Fernandez (Climate Focus)

Darragh Conway (Climate Focus)

Mortiz von Unger (Atlas Environmental Law Advisory)

Gediz Kaya (Gaia Carbon Finance)

Egbert Liese (Climate Focus)

Prepared for:

The European Bank for Reconstruction and Development

Climate Focus

Sarphatikade 13

1017 WV Amsterdam

The Netherlands

Gaia Carbon Finance

Halaskargazi Cd. Zafer Sk.

Manuel Apt. 11/4

Sisli Istanbul

Turkey

Triodos Facet

Utrechtseweg 84 B

3702 AD Zeist

The Netherlands

Content

1 Acknowledgements

This report is drafted as part of the Carbon Finance Consultant assignment for the Mid-size Sustainable Energy Financing Facility (MidSEFF). The principal is the European Bank for Reconstruction and Development (EBRD), and the assignment is funded by the Bank's Special Shareholder Fund (SSF) – see also www.turkishcarbonmarket.com and www.midseff.com.

The authors would like to express their gratitude to EBRD staff for valuable input and comments received, especially Jan-Willem van de Ven, Adonai Herrera-Martínez and Angela Delfino for their valuable comments.

2 Introduction

The EBRD is supporting Turkey on its low-carbon development path and the use of carbon markets as a means to reduce greenhouse gas emissions in a cost-effective manner. Through the Turkish Mid-size Sustainable Energy Financing Facility (MidSEFF), EBRD is providing close to EUR 1 billion in credit lines to finance mid-size investments in renewable energy, waste-to-energy and industrial energy efficiency. As part of MidSEFF, a dedicated carbon finance programme seeks to develop and promote carbon markets in Turkey.

Activities under the carbon market consultancy include support to Turkish banks in their endeavour to investment in energy efficiency and renewable energy leveraged by carbon market opportunities. Banks already finance renewable energy and energy efficiency projects and are in a comfortable position to act as the intermediary party between carbon project developers and the investors. Banks can support existing and new clients in:

– Exploring opportunities in the carbon market: Project developers are interested in investigating opportunities offered by the carbon markets and will look for ways to apply carbon financing. Banks can advise these clients on options and offer financing, securitisation and trading support

– Managing exposure to carbon risk: There are a considerable number of Turkish corporations active in the European market that is directly affected by the cap-and-trade legislation imposed by the EU-ETS. Banks can help clients understand, anticipate and manage exposure through advisory and trading.

However, one of the key questions that have arisen is whether and how Turkish banks can provide carbon market services under the current Turkish legal and regulatory framework. Generally activities of banks are strictly regulated to limit risk and over exposure to non-core activities. Therefore, in March 2013 a study by Hergüner Bilgen Özeke law firm entitled "Legal and regulatory review of carbon market services for banks in Turkey" (the "review") was finalised.

The review highlights questions for regulators to clarify. Several regulation options are possible and each determine the role banks can and cannot play. The results of this review offer an opportunity to discuss such developments, choices and the different approaches Turkish regulators might adopt in respect of the carbon services to be provided by banks in Turkey.

3 Purpose and objective

This review summary is based on a legal review prepared by Hergüner Bilgen Özeke law firm entitled "Legal and regulatory review of carbon market services for banks in Turkey" (the "review"), which was prepared as part of the MidSEFF carbon finance consultancy assignment financed by the European Bank for Reconstruction and Development. The purpose of the review is to assess current and future scenarios for:

(i) the legal classification of rights to greenhouse gas emissions or emission reductions ("emission allowances") under Turkish law;
(ii) the rules applicable to their ownership and transfer; and
(iii) the permissibility for banks to provide carbon market services.

Further, this review summary points out several regulatory gaps that Turkish decision-makers could consider in order to provide legal certainty to Turkish carbon market players.

4 Carbon Market Services for Turkish Banks

Many banks around the world have been active in providing carbon market services to a wide range of clients. The carbon market services identified for this assignment represents those that are regarded as the most attractive for regulated Turkish banks. Some of these services are already being successfully offered by numerous international banks operating in foreign markets. These include:

(i) Origination and project finance. The evolving domestic carbon market creates demand for capital necessary to get new emission reduction projects off the ground. This presents banks with opportunities to broaden the client base and increase the investment portfolio. Banks seeking direct involvement with the development of emission reduction projects can build expertise within their project finance teams to:

- identify GHG emission reduction opportunities suitable for carbon finance
- facilitate preparation and sale of the carbon asset
- provide financial support through project finance

(ii) Centre of competence. A considerable number of Turkish companies are already exposed to emission reduction legislation abroad. Furthermore, the number of businesses affected will grow as the EU ETS expands its reach (i.e. aviation sector) and enters the third phase (started 2013), and regional and domestic emission offset markets continue to evolve. These companies need to understand both the risks and opportunities presented by the carbon markets. Banks can build internal capacity to assist clients in:

- Managing risk: managing direct or indirect exposure to legislation
- Exploring opportunities: exploring domestic and international carbon markets

There is a wide range of advisory themes that banks can take on board, including:

- advising on carbon liabilities and risks
- structuring carbon credit transactions
- advising on incorporating carbon finance
- advising on new market opportunities
- preparing bankable agreements for sale of carbon credits with prospective buyers and sellers
- advising on the different carbon standards available

(iii) Emissions trading: Banks are a leading player in providing liquidity for traded assets. A growing domestic carbon market creates opportunities for banks to facilitate transactions between buyers and sellers, opening up possibilities to build new relationships and establish new clients. Furthermore, access to balance sheet capital gives banks the option to engage in trading for own gain. The main three types of trading services include:

- Client trading: Buying and selling activities of carbon assets on behalf of corporate clients directly affected by emissions trading
- Proprietary trading: Commitment of own capital for trading for direct gain
- Brokering: Facilitating transactions between sellers and buyers.

(iv) Offering green credit cards. The retail business is a key profit centre of Turkish banks, and domestic credit card use is one of the highest in the world. With each bank offering multiple credit cards to customers, the competition is stiff. Marketing a green credit card that enable carbon offsetting of purchases to clients that value responsible shopping or travelling presents banks with the possibility to introduce a new product on the market and access new customers, while improving the general image and reputation in this competitive market place.

5 Introduction to Turkish legal system and hierarchy of norms

Legal instruments in Turkey follow a hierarchy, under which lower-level instruments are subordinate to (and therefore must comply with) higher-level instruments. Aside from the constitution and treaties, laws enacted by parliament ("primary legislation") have precedence, and as such any lower instruments such as regulations or communiqués which are incompatible with such laws will not be valid.

6 Applicability of existing laws to emission allowances

Basic Turkish property law consists of two pieces of primary legislation, specifically the Turkish Code of Obligations (the "TCO") and the Turkish Civil Code (the "TCC"). These are the default laws applicable to ownership and trade in property. Unless other legislation can be deemed to apply to ownership and trade of emission allowances, this is the body of law that will apply. The review assesses several sets of rules to determine whether they may apply.

(i) Specific legislation on emission allowances

While the Environment Law and several non-binding texts refer directly to emissions trading, these references are general and do not provide any concrete rules on emission allowance.

Direct laws regulating emission allowance are limited to the Regulation on Greenhouse Gas Emissions Monitoring (the "Emissions Regulation") and the Communiqué for Registration of Greenhouse Gas Emission Reducing Projects (the "Registry Communiqué"). Neither of these instruments directly seeks to regulate ownership or trade of emission allowances. It is also worth noting that the Registry Communiqué provides that registration with the Turkish Emissions Registry is voluntary, does not provide a comprehensive framework for trading and has not been widely used in practice

(ii) Capital Markets Law

The Capital Markets Law governs financial instruments, securities and derivatives ("capital markets instruments"). Its regulatory scope is similar to the EU Markets in Financial Instruments Directive (the "MiFID"). If emission allowances were considered to be a form of capital markets instrument, they would then be regulated by the Capital Markets Law. In this case, the Capital Markets Board ("CMB") could set rules for their ownership and trade, and trade would be required to take place on the Istanbul Stock Exchange (Borsa Istanbul A.Ş.).

The Capital Markets Law only regulates instruments specified in the law itself (limited to derivatives and securities) or officially recognised by the CMB. In addition to capital markets instruments, the CMB may adopt rules for the trade of "other contracts, papers and values" that it may specify a phrase broad enough to include emission allowances. Therefore, the CMB has the authority to adopt rules for ownership and trade of emission allowances. However, since it has not yet done so, emission allowances are not currently regulated by the Capital Markets Law.

(iii) Commodity Exchanges Law

The Commodity Exchanges law provides a legal framework for trade in physically storable and endurable commodities. This definition excludes intangible assets and rights. Since emission allowances are intangible assets, they are therefore not regulated by the Commodity Exchanges Law. It is worth noting, however, that this does not necessarily imply that emission allowances cannot be classified as a commodity, a question which is not addressed by Turkish law.

Given that the above laws do not apply to emission allowances, the basic property law set out in the TCO and TCC will apply. The review concludes that, though some language ambivalences in the law create uncertainty in the matter, it is likely that under property law emission allowances are classified as "movable property". In addition, contracts for the sale of emission allowances are likely to be deemed "non-typical contracts", though this does not substantially change the rules governing them.

Under the rules of Turkish property law, parties are free to choose the terms of contracts for the sale of emission allowances. Unless otherwise agreed, contracts are enforceable by either party, and a failure by the seller to transfer an emission allowance that has been paid for can result in the courts forcing the seller to make the transfer or, where the allowance is located in a Turkish registry, requiring the relevant authorities to transfer the emission allowance to the buyer's account.

Turkish property law is ambiguous as to when transfer of ownership is completed. Where a contract is signed and transfer of title to an emission allowance in the registry has been completed, this is likely to be sufficient. Uncertainty may arise where, for example, the seller becomes bankrupt before title is transferred in the registry. In this case, if transfer is deemed not to have been completed then the emission allowance will be treated as a debt owed to the buyer, payment of which will depend on its ranking with other debts, in accordance with applicable bankruptcy law.

The parties to a contract for the sale of emission allowances may choose that the contract be governed by the law of a country other than Turkey so long as the contract contains a "foreign element" and does not violate "public order" principles. Neither of these terms is specifically defined in the law. Courts consider a foreign element to include factors such as nationality and residency of the parties, place of service and performance of the contract undertakings. The public order concept, for its part, is narrowly defined, and will generally only apply to sales contracts in relatively extreme circumstances.

7 Expected legislative developments

Legislative developments currently underway in Turkey may potentially have a major impact on the regulation of emission allowances, while under current law several other means of regulation are also possible.

In the first place, the Parliament is currently debating a draft Electricity Market Law "EML" which proposes to give the Energy Market Regulatory Authority ("EMRA"), in consultation with the Ministry of Energy, the specific authority to regulate emission allowances. This would include regulating issues such as the rules of transfer, the moment transfer is effected and the registry under which it must be logged. In addition, the draft EML creates a new entity, the Energy Exchange Management Corporation ("EPIAS"), which will be in charge of day-to-day management of energy exchanges, including an emission allowance exchange.

It is notable that the draft EML specifies certain types of energy contracts as capital markets instruments, but does not classify emission allowances as such. Therefore, emission allowances will not be regulated as capital markets instruments under the draft EML.

While EMRA will be granted the authority to regulate emission allowances under the draft EML, it remains possible that this authority is also partly vested in the CMB. Aside from the authority deriving from the right to adopt rules for "other contracts, papers and values", as described above, under the Capital Markets Law the CMB has the authority to regulate "energy products", a term that may include emission allowances.

Given this potential dual authority, the future situation remains uncertain, and several regulation scenarios arise:

(i) Current scenario: No new laws or regulations are adopted and ownership and trade of emission allowances remains governed under the general rules of property law.

(ii) CMB Stand-alone Regulation Scenario: The draft EML is not enacted and the CMB, considering emission allowances to be an "energy product", acts alone to adopt rules to regulate them as either a form of capital markets instrument or as a stand-alone type of instrument to be traded on Borsa Istanbul A.Ş (this scenario is not deemed likely, given the express intention of the legislator to have emission allowances regulated under the EML). It should be considered in any case that the provision of the Capital Markets Law allowing regulation on this matter (Art 67(2)(b)) states the CMB should act in consultation with EMRA. This means that any attempt by the CMB to apply capital markets legislation to emission allowances necessarily implies consultation with EMRA.

(iii) EMRA Stand-alone Regulation Scenario: The draft EML is enacted, and EMRA acts alone to regulate emission allowances, to be traded under an emission trading exchange governed by EPIAS.

(iv) CMB and EMRA Joint Regulation Scenario: The draft EML is enacted and the CMB considers emission allowances an energy product. CMB, EMRA and the Ministry of Energy therefore jointly prepare secondary legislation regulating emission trading. EPIAS will manage the emission trading exchange as a sub-exchange operating under Borsa Istanbul A.Ş.

8 Eligibility of banks to provide services with respect to emission allowance

Under the Turkish Banking Law, banks may only provide such services as are covered by their respective licenses. Licenses may cover any of the activities listed under the Banking Law, or other activities that are approved by the Banking Regulation and Supervision Agency (the "BRSA"). Trading in emission allowances is not listed under the law and has thus far not been approved by the BRSA.

The following table assesses the permissibility of banks carrying out certain services related to emission allowances under the various scenarios outlined above.

Service	Description	Permissibility			
		Current scenario	CMB Stand-alone scenario	EMRA Stand-alone scenario	CMB/EMRA Joint Scenario
Origination and Project Finance	Screening for potential projects; structuring financing; development of project; performing standard project financing procedures.	Service can be provided.	Service can be provided, subject to limitations that may be imposed by CMB.	Service can be provided, subject to limitations that may be imposed by EMRA.	Service can be provided, subject to limitations that may be imposed by CMB/EMRA.
Emissions Trading and Brokerage	Acquisition and sale of emission allowances and/or derivative instruments on own or clients' account; identifying parties' sale opportunities to monetize assets; hedging.	Application to the BRSB required for either (i) amending banking license to allow for include emissions trading; or (ii) confirmation by the BRSB that emission trading does not require amendment of banking license.	Permitted for banks with license to trade capital markets instruments, subject to any limitations that may be imposed by CMB.	Same as under the Current Situation, subject to limitations that may be imposed by EMRA.	Same as under CMB Stand-alone Scenario, subject to limitations that may be imposed by CMB and EMRA.
Services Provided as Centre of Competence	Providing consultancy services to clients on carbon market developments; training of internal personnel on sector-specific transactions.	Service can be provided. However, deposit banks are prohibited except in certain one-off cases and in context of performance of intermediation services.	Service can be provided, subject to limitations of deposit banks under Current Scenario and any further limitations imposed by CMB; CMB approval required for capital market investment consultancy.	Same as under the Current Situation, subject to limitations that may be imposed by EMRA	Same as CMB Stand-alone Scenario, subject to limitations that may be imposed by CMB and EMRA.
Green Credit Card	Issuance of credit cards by Banks on which a certain transaction charge is applied at each purchase transferred to accounts owned by registered allowance originators or beneficiaries of emission allowance derivatives.	Service can be provided.	Service can be provided, subject to any limitations that may be imposed by CMB.	Service can be provided, subject to limitations that may be imposed by EMRA.	Service can be provided, subject to limitations that may be imposed by CMB/EMRA.

9 Areas for further analysis

The review makes clear that the issue of regulation of emission allowances remains in flux. Several scenarios for regulation remain open and, as can be seen from the analysis of the permissibility of certain banking services under each scenario, future regulatory changes will have significant consequences. Though not directly addressed in the report, a number of important issues can be identified that would benefit from further investigation before further decisions are made.

(i) Benefits and drawbacks of different forms of classification: Whether emission allowances are classified as a capital market instrument, commodity or other form of property has significant consequences, affecting the applicable rules on, amongst others, transfer, taxes and market oversight. Assessing the benefits, drawbacks and practical implications of each, including experience from other jurisdictions (EU, Australia, Brazil, California, South Korea), can help ensure the best solution is reached.

(ii) Registry issues: Given that the current registry system is voluntary and little used, expansion of emission trading in Turkey raises the question of whether a more comprehensive registry system could be advantageous. Such a system could potentially regulate trading, market governance and management of accounts.

(iii) Future alignment with EU framework: If Turkey in the future becomes a member of the EU, it will become necessary to align its legal framework for emission trading with the EU framework. Given that the EU is currently moving toward regulating emissions trading under financial markets law, it will be important to consider the compatibility of different scenarios with future alignment with this law.

(iv) Options for governance and market oversight: While the classification of emission allowances will to some extent determine the rules on governance and market oversight, additional or more specific rules may be appropriate for ensuring the success of the Turkish emissions market. Assessing options and the implications of different options can help design a system suitable for Turkey that ensures effective governance and environmental integrity in the market.