Financing sustainable development: an African perspective

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Introduction

Sustainable finance is a hot topic for investors, banks and corporates around the world. It is an umbrella term for various financial instruments, including green bonds and loans, social loans and bonds and other sustainability linked financial instruments that refer to the incorporation of environmental, social and governance (ESG) considerations into the instrument's terms and conditions. Investors are looking to incorporate ESG practices across existing portfolios of assets to minimize their exposure to ESG risks, and increasingly shift capital from more traditional assets to assets that support sustainable development.

Climate change has become one of the key challenges. ESG issues related to a project and such project's exposure to climate change and its climate impact have been at the core of discussions in the financial community. The roots of green finance can be traced back to the 1970s. However, it received real traction in 2015 with the launch of the UN Sustainable Development Goals followed in 2016 by the Paris Agreement. In response to initiatives at national and supra-national levels, there is a growing investor demand for sustainability linked assets.

Developments at a governmental and industry level are supporting the inclusion of sustainability in financing and investment decisions. Individual financial institutions and investors also play a critical role. They can apply their experience and expertise and have a powerful tool, i.e., financing, to promote change, for example by blacklisting industries that contribute to climate change such as coal-fire power, agroindustry involved in deforestation, or industries or countries with human rights violations. In terms of positive action, they can support microfinance, renewable power, blended finance and other activities that promote sustainability.

This briefing focuses on Sub-Saharan Africa and discusses some legal aspects relating to sustainable finance, and trends and developments that are relevant for financing sustainable development in the region, such as South Africa's draft green finance taxonomy and the recently updated green and social bond and loan principles developed by the International Capital Market Association and the Loan Markets Association.

Legal framework

The regulatory framework for sustainable finance is currently most connected with climate change. For example, the Paris Climate Agreement of 22 April 2016 has strengthened the call to the financial community regarding their contribution to climate action. Its article 2(1) provides that it aims to strengthen the global response to the threat of climate change, in the context of sustainable development and efforts to eradicate poverty, including by (a) holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognizing that this would significantly reduce the risks and impacts of climate change; (b) increasing the ability to adapt to the adverse impacts of climate change and foster climate resilience and low greenhouse gas emissions development, in a manner that does not threaten food production; and (c) making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. It also obliges developed countries to provide financial resources to assist developing countries with respect to both their mitigation and adaptation goals under the agreement.

The UN Sustainable Development Goals (SDGs) were adopted by the United Nations in 2015 as a universal call to action to end poverty, protect the planet, and to ensure that by 2030 all people enjoy peace and prosperity. The 17 SDGs are integrated: they recognize that action in one area will affect outcomes in others, and that development must balance social, economic and environmental sustainability. The SDGs are therefore an important element of the sustainable finance objectives.

Also, more concrete measures have been and are being adopted to promote sustainable finance. An example is the European Union that has adopted various measures, such as the EU Regulation on Sustainability‐Related Disclosures in the Financial Services Sector, which requires certain financial service institutions, most notably those managing or marketing investment or pension funds and products in the EU, to disclose on various sustainability considerations to both potential investors and the general public. These disclosure requirements are, in general, aimed at increasing the incorporation of sustainability matters into regulated entities' decision-making.

Moreover, the EU prepared a framework for a taxonomy with six environmental objectives, being climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems. The Taxonomy Regulation was published on 22 June 2020 and entered into force on 12 July 2020. It provides for four conditions that an economic activity must meet in order to qualify as environmentally sustainable. It should (a) contribute substantially to one or more of the environmental objectives; (b) do not significantly harm any of the environmental objectives; (c) be carried out in compliance with the minimum safeguards laid down in the regulation; and (d) comply with technical screening criteria that have been established by the European Commission.

The EU Taxonomy Climate Delegate Act, set to apply from 1 January 2022, will introduce disclosure obligations on companies and financial market participants and includes a list of economic activities with performance criteria to assess the activities' contribution toward the objectives. It includes the first set of technical screening criteria to define which activities contribute substantially to two of the environmental objectives under the Taxonomy Regulation: climate change adaptation and climate change mitigation. Technical screening criteria for the other four objectives are still being developed.

South Africa, for example, is currently working on the development of a green finance taxonomy, and governance framework, as discussed in more detail below, and a benchmark climate risk scenario for use in stress tests by the financial sector. It also intends to promote sector capacity and competency for good climate risk governance, management and disclosure across the sector and the implementing arms of government.

A number of central banks, including the South African Reserve Bank, the Central Bank of West African States, the Central Bank of Seychelles and the Central Bank of Mauritius, have set up the Network for Greening the Financial System in order to help strengthening the global response required to meet the goals of the Paris Agreement and to enhance the role of the financial system to manage risks and to mobilize capital for green and low-carbon investments in the broader context of environmentally sustainable development.

Several NGOs and industry organisations have also developed rules and guidelines that promote or apply to sustainable finance. For example, the World Wildlife Fund has developed Sustainable Financial Regulations which should help central banks and financial regulators create a greener financial system. The International Capital Markets Association and the Loan Markets Association have developed policies and guidelines that attempt to harmonise the characteristics of sustainable financial instruments, and which will be discussed in more detail below. European development finance institutions, united in the European Development Finance Institute, have adopted the Principles for Responsible Financing of Sustainable Development that apply to their financing activities. Various internationally operating companies have, as part of the CFO Taskforce for the SDGs, developed the CFO Principles on Integrated SDG Investments and Finance, whose goal it is to engage the global CFO community to align corporate investments and finance with the SDGs. The Financial Stability Board has established a special task force that prepared a report with recommendations on climate-related financial disclosures. Many large corporates have created their own green finance framework, often based on the guidelines of these industry organisations.

The move towards sustainable financing has also resulted in many NGOs, committees, task forces and commercial enterprises, often based in Europe or the USA, reporting and advising on sustainable finance in Africa. Often these initiatives are funded by international organisations, governments, charities and industry organisations. There is a plethora of reports, principles, guidelines and recommendations that address sustainable finance, and it is often difficult to see the wood for the trees. Although a considerable number of them focus on Africa, it is not always clear to what extent they considered input from the African continent itself. It is therefore important that African governments, regulators, and public and private organisations develop their own initiatives and action plans, based on their concerns and priorities for sustainable development.

Developments in Sub-Saharan Africa

Sub-Saharan Africa has an interesting position in the context of sustainable financing. Many countries in the region are developing countries which, pursuant to the Paris Agreement, should therefore be provided by developed countries with financial resources to assist them with respect to mitigation of the consequences of climate change and adaptation to its adverse impact. Development finance institutions are regular financiers of infrastructure and other economic activities in these countries. They are subject to sustainability principles that determine the projects and activities that they can finance. Equally, banks and investors in, for example, Europe and North America, are subject to increased scrutiny as to the sustainability of the purposes for which their funding is being used. This implies that, even although the projects themselves may not be subject to sustainability criteria in the countries where they take place, the funding of these projects by foreign banks or investors may require these projects to be compliant with the sustainability rules and principles to which such banks and investors are subject. Moreover, parties to the Paris Agreement, which include virtually all Sub-Saharan African countries, have themselves obligations towards meeting its climate goals.

There are various Africa based initiatives regarding sustainable finance. For example, the African Ministerial Conference for the Environment, alongside international institutions, has recently put forward the African Green Stimulus Programme, in partnership with the UN Environment Programme. In March 2021, FSD Africa signed a co-operation agreement with the Committee of Southern African Development Community Stock Exchanges (CoSSE). The FSD Africa-CoSSE partnership programme will support the SADC's 16 member countries and both private and public sectors to issue green bonds, creating a favourable ecosystem and improving knowledge and capacity for sustainable investments. The programme will also help SADC countries develop listing guidelines and regulations for green bonds, build a pipeline of potential green bonds issuers, tap the countries' institutional investment community for investment into green bonds, train stakeholders on climate finance and support the adoption of climate-related financial reporting and disclosure.

At a country level, South Africa was the first African country to issue a green bond in 2012 and is a leading issuer of green bonds on the continent. The Johannesburg Stock Exchange has on its main board a sustainability segment for listing of debt instruments which are used for raising listed debt where the proceeds are ring-fenced for activities directed at sustainable development. These include green bonds, social bonds and sustainability bonds. It also operates the TSE/JSE Responsible Investment Index. It was already mentioned that South Africa is developing its own green finance taxonomy and governance framework.

In Namibia, the Bank of Windhoek issued a three-year green bond in December 2018 which is the first and for now the only Namibian issue. Kenya has in cooperation with the Nairobi Stock Exchange developed the Kenya Green Bond Programme. A Kenyan corporate entity, Acorn Projects Limited, issued in September 2019 a green bond to finance green and environmentally friendly buildings for students in Nairobi.

Nigeria issued in December 2017 the first African certified sovereign green bond. A second sovereign green bond was issued in 2019. The Nigerian Access Bank Plc became the first financial institution to issue a certified corporate green bond in Africa in 2019. The Nigerian Stock Exchange maintains the NGX Sustainable Bond Market. It signed in 2019 a Memorandum of Understanding with the Luxembourg Stock Exchange to cooperate in promoting cross-listing and trading of green bonds in Nigeria and Luxembourg. Seychelles was the first country to issue a sovereign blue bond in October 2018. Its proceeds pay for marine protection, fisheries management and other projects to protect the ocean economy.

South Africa's draft green finance taxonomy

It is important that also African countries themselves create a regulatory framework for sustainable finance. An important step in this direction was taken on 7 June 2021 when in South Africa a working group of financial sector regulatory agencies and industry associations published a draft Green Finance Taxonomy for South Africa (Taxonomy) for consultation. The six objectives of the Taxonomy are, like its EU counterpart, climate change mitigation, climate change adaptation, sustainable use of water and marine resources, sustainable resource use and circularity, pollution prevention, and ecosystem protection and restoration. The Taxonomy is divided into three main sections: (a) a matrix providing high-level view of eligible activities under each sector, (b) a catalogue indicating basic attributes of the activities identified in the matrix and maps the environmental objectives of each activity, and (c) technical screening criteria, giving in-depth information on the attributes and requirements for each eligible activity, including principles, metrics, and thresholds. The current technical screening criteria focuses on climate change mitigation and climate change adaptation. Technical screening criteria related to the other taxonomy objectives have not been developed yet.

The purpose of the Taxonomy is to:

- help the financial sector with clarity and certainty in selecting green investments in line with international best practice and South Africa's national policies and priorities;
- reduce financial sector risks through enhanced management of environmental and social performance;
- reduce the costs associated with labelling and issuing green financial instruments;
- unlock climate-friendly investment opportunities;
- support regulatory and supervision oversight of the financial sector; and
- provide a basis for regulators to align or reference green financial products.

Its target audience includes policy makers and government agencies, financial market participants and asset owners and project developers. The Taxonomy recognises two distinct types of substantial contribution that can be considered Taxonomy-aligned. Firstly, activities that make a substantial contribution based on their own performance: For example, an economic activity being performed in a way that is environmentally sustainable. Secondly, enabling activities, i.e., activities that, by provision of their products or services, enable a substantial contribution to be made in other activities, for example, an economic activity that manufactures a component that improves the environmental performance of another activity. The areas and sectors covered in the Taxonomy are agriculture, forestry and fisheries, industry, energy, water and waste, transportation, construction, ICT and enabling activities, such as non-life insurance.

Sustainable finance instruments

Several public and private issuers in Africa have already issued green and blue bonds. The taxonomies developed by the EU, South Africa and other countries will create clearer fand more objective criteria for determining whether instruments can be considered "sustainable". Two important industry organizations for the financial markets, the International Capital Markets Association (ICMA) and the Loan Market Association (LMA) have developed global market standards for sustainable finance instruments. ICMA updated in June 2021 its green and social bond principles and its sustainable bond guidelines. Last year, it also published sustainability-linked bond principles. LMA has similar instruments in place and updated in June 2021 its sustainability-linked loan principles. It has also established green and social loan principles. The contents of the principles prepared by LMA and ICMA are aligned.

Before discussing these principles in more detail, it is perhaps good to recall that there are basically three types of sustainability linked instruments:

- Activity based financial instruments such as green bonds and loans, social bonds and loans and blue bonds are used to raise money to finance or refinance projects or activities that, for example, support a net-zero emissions economy and protect the environment or promote social or financial inclusion.
- Behaviour-based instruments such as sustainability-linked bonds and loans do not have a specific use of proceeds, rather they contain sustainability goals with the borrower or issuer tying corporate sustainability to financing needs. Sustainable targets could include greenhouse gas emission reduction goals or a quota for diversity in the workplace.
- Transition instruments focus on bringing financial resources to activities that are hard to be categorized as green, but still play a role in the environmental transition. The idea is that borrowers use the proceeds towards energy efficiency projects, resource efficiency, gas transmission network retrofits, carbon/emission reduction and other projects that support the energy transition.

The principles and guidelines prepared by ICMA and LMA do not contain provisions that prescribe in detail the terms of, for example, green loans or bonds, but provide certain general guidelines which the parties involved in the origination of such bonds and loans should take into account, in particular to ensure that bonds or loans that are not labelled as green, social or sustainability linked without proper reason or justification (so called greenwashing). They do therefore not replace the earlier mentioned taxonomies but focus more on the process for determining whether bonds or loans meet the relevant characteristics to be consider green, social or sustainability linked. Neither LMA nor ICMA have developed principles or guidelines for transition financial instruments.

The four core components that are to be considered in the context of green or social bonds and loans are:

- The use of proceeds: are they used for green or social projects?
- The process for project evaluation and selection: does the project meet the relevant sustainability criteria and how was it selected by the borrower or issuer?
- Management of the loan or bond proceeds: they should be tracked in an appropriate manner to maintain transparency.
- Reporting: borrowers and issuers should make and keep readily available up to date information on the use of proceeds.

The approach in relation to sustainability linked instrument is different. The borrower's or issuer's sustainability performance is measured using predefined sustainability performance targets (SPTs), as determined by predefined key performance indicators (KPIs), which may comprise or include external ratings or equivalent metrics, and which measure improvements in the borrower's or issuer's sustainability profile. The core components here are:

- The selection of the KPIs: they should be relevant, core and material to the borrower's or issuer's overall business, and of high strategic significance to its current and/or future operations, measurable or quantifiable on a consistent methodological basis and able to be benchmarked.

- The calibration of SPTs; they should be ambitious, i.e., represent a material improvement in the respective KPIs, where possible be compared to a benchmark or an external reference, be consistent with the borrower's or issuer's overall sustainability strategy and be determined on a predefined timeline.
- The loan or bond characteristics: an economic outcome, such as the applicable margin, is linked to whether or not the selected predefined SPTs are met.
- Reporting: borrowers and issuers should provide their funders with up-to-date information sufficient to allow them to monitor the performance of the SPTs and to determine that the SPTs remain ambitious and relevant to the borrower's or issuer's business.
- Verification: borrowers and issuers must obtain independent and external verification of the borrower's or issuer's performance level against each SPT for each KPI at least once a year.

Conclusion

Given the global reach of the ICMA and LMA principles, it can be expected that they will also apply to loans and bonds with African borrowers or issuers with foreign investors. Also, the EU Taxonomy is expected to become a golden standard (already evidenced by the fact that it provided a source of inspiration for the South African draft taxonomy). Moreover, to the extent that projects and activities in Africa are funded through green or social bonds or loans by issuers and borrowers located elsewhere, the principles and the taxonomies developed by the EU may impact on the project or the activities in the sense that they need to meet the relevant criteria set out in these principles and taxonomies. Although the ICMA and LMA principles themselves have a more procedural character, African countries and institutions should carefully consider whether the adoption of standards developed in other continents for determining whether a project or activity can qualify as "sustainable" is in all circumstances appropriate and complies with their own views and policies in respect of sustainable development.

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