



FINANCING A SUSTAINABLE ECONOMY

Technical Paper 2021



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA





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LIST OF ACRONYMS

ASISA	Association for Savings and Investment South Africa
BASA	Banking Association South Africa
BATSETA	Council of Retirement Funds of South Africa
CISCA	Collective Investment Schemes Control Act 45 of 2002
COFI	Conduct of Financial Institutions Bill (public comment period closed 1 April 2019)
CRISA	(Voluntary) Code for Responsible Investing in SA
DEFF	Department of Environment, Forestry and Fisheries
E&S / ESG	Environmental and Social, when appropriate Governance is added and abbreviated ESG
ESRM	Environmental and Social Risk Management
FMA	Financial Markets Act 19 of 2012
FSB	Financial Stability Board, an international body that monitors and makes recommendations about the global financial system
FSB	Financial Services Board (South Africa) dissolved in 2018 replaced with the FSCA
FSCA	Financial Sector Conduct Authority
FUM	Funds under management
IPCC	UN Intergovernmental Panel on Climate Change
IFC	International Finance Corporation
JSE	Johannesburg Stock Exchange
JSE SRI	Socially Responsible Investment Index
King IV	King Code of Corporate Governance
LTI Act	Long term Insurance Act No. 52 of 1998
NDP	National Development Plan
NGFS	Network for Greening the Financial System
ORSA	Own Risk and Solvency Assessment
PA	Prudential Authority
PAIA	Public Accountants and Auditors Act No. of 1951
PE/VC	Private Equity/Venture Capital
PFA	Pension Funds Act No. 24 of 1956 as amended
PRI or UNPRI	Principles for Responsible Investment or United Nations Principles for Responsible Investing
Reg. 28	Regulation 28 of the Pension Funds Act
REIPPP	Renewable Energy Independent Power Producers Procurement Programme
SAIA	South African Insurance Association
SAVCA	Southern Africa Venture Capital Association
SDGs	Global Sustainable Development Goals
SSE	Sustainable Stock Exchange Initiative
STI Act	Short-term Insurance Act No 53 or 1998
TCFD	FSB's Task Force on Climate-related Financial Disclosures
UNEP FI	United Nations Environment Programme Finance Initiative

1. EXECUTIVE SUMMARY

“Together with all the nations of the world, we are confronted by the most devastating changes in global climate in human history. The extreme weather conditions associated with the warming of the atmosphere threaten our economy, they threaten our lives and the livelihoods of our people, and – unless we act now – will threaten our very existence.”

June 2019 State of the Nation address, President Cyril Ramaphosa

1.1 CLIMATE CHANGE IN SOUTH AFRICA

Climate change is a measurable global reality and along with other developing countries, where the impact is more pronounced due to the perceived lack of financial resilience, South Africa is especially vulnerable to its impacts.

South Africa is experiencing significant effects of climate change particularly as a result of increased temperatures and water variability. The observed rate of warming has been 2°C per century or even higher – more than twice the global rate of temperature increase for the western parts and the northeast (DEA 2017a, 72). There is evidence that extreme weather events in South Africa are increasing, with heat wave conditions found to be more likely, dry spell durations lengthening slightly and rainfall intensity increasing. Climate zones across the country are already shifting, ecosystems and landscapes are being degraded, veld fires are becoming more frequent, and overused natural terrestrial and marine systems are under stress (DEA 2017a).

The National Climate Change Adaptation Strategy, May 2019

The western and interior parts of South Africa are expected to become drier on average, with temperatures rising significantly above the threshold global average of 2 degrees Celsius (2°C) at which the risk of climate destabilisation is extremely high. The eastern areas are expected to experience more rain in shorter events. Extreme weather events, such as droughts and floods are likely to occur more frequently.¹ While climate change could be seen as an environmental or green challenge, it is already and will have profound economic and social impacts on rural and resource-based communities as well as cities, which must meet the needs of growing populations in less predictable circumstances. Climate change is thus also a social development issue, as it exacerbates inequalities and vulnerabilities of communities. South Africa has an energy intense economy and is a significant contributor to global carbon emissions. It has made commitments, which have been ratified by parliament, to contribute to reducing carbon dioxide equivalent emissions. South Africa is a signatory to the United Nations Framework Convention on Climate Change (UNFCCC) and has affirmed its commitment to making a fair contribution to global efforts to address climate change by submitting its Nationally Determined Contribution (NDC) and ratifying the Paris Agreement in November 2016.

The impacts of climate change on the global and South African financial sector are potentially significant if not effectively mitigated and appropriate adaptation activities undertaken. Climate-related risks for financial institutions can be classified as (see Figure 1):

- Physical risks from extreme weather – directly affecting financial institutions’ own operations or assets that they finance through damage, business disruption or default risks;
- Transition risks – resulting from disruptive technologies, changing regulation, consumer or market preferences;
- Liability and disclosure risks – resulting from loss and damages, rising insurance costs, director’s liability and disclosure failures.

¹ South Africa’s Intended Nationally Determined Contributions submitted to UNFCCC (<https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/South%20Africa%20First/South%20Africa.pdf>)

1. EXECUTIVE SUMMARY - CONTINUED

The mandate of the National Treasury, is to ensure transparency, accountability and sound financial controls in the management of public finances. This includes financial stability to protect the South African economy and its citizens from major external shocks to the financial system, building resilience through solvency and effective risk management. Financial stability, a mandate National Treasury shares with the South African Reserve Bank, requires building a greater understanding of the environmental, social and governance risk exposure facing the financial sector. Sustainable finance seeks to encourage the reallocation of capital to have a more positive impact and the raising of new and dedicated funds to finance the transition to a climate resilient and lower carbon economy.

*The financial services sector is at the heart of the South African economy and touches the life of each and every citizen. Financial services allow people to make daily economic transactions, save and preserve wealth to meet future aspirations and retirement needs, and insure against personal disaster. . . At the level of the macroeconomy, the financial sector enables economic growth, job creation, the building of vital infrastructure and **sustainable development for South Africa** and her people. However, the global financial crisis highlighted the immense costs of a poorly regulated financial services sector. . . The financial sector needs to do more to support the real economy. The sector has a vital role to play in the ongoing transformation of our society, and our desire to bring a better life to all of our people.²*

1.2 FINANCIAL IMPLICATIONS

Globally, climate change is recognised as a real and potentially destabilising threat to economies and the well-being of people, particularly the most vulnerable. Recognition is growing about the urgent need to make a ‘just transition’ to a low carbon and climate resilient economy and society as well as achieve the Sustainable Development Goals (SDGs) to improve the lives of growing populations. As indicated in South Africa’s National Climate Change Response Policy (NCCRP), responding to climate change is a costly exercise that requires a collective response. There is also, however, global recognition of the potential to create new jobs and strengthen human development initiatives by addressing climate-related risks, hence the “build back better” and ‘green new deals’ being advanced in many economies. The NCCRP also acknowledges the role financial institutions play as development partners and, in the allocation and transfer of capital in the economy. This paper focusses on the financial sector from a financial stability mandate of National Treasury. This paper is an essential first step but is not a climate finance strategy or resource mobilisation plan. Department of Environmental Affairs, Forestry and Fisheries are leading on the development of a national climate finance response support needs strategy.

Long-term economic, environmental and social risks are linked. Environmental disasters such as floods or droughts or the destruction of built and ecological³ infrastructure inevitably cause economic, social and health stresses – particularly for those who are not insured or under insured and have no savings or financial resilience. Economic transition poses additional threats to jobs and communities if the opportunities for greening the economy are not actively pursued.

The South African national greenhouse gas (GHG) inventory highlights that electricity generation from fossil fuels combustion accounts for 80% of emissions with electricity sector emissions responsible for approximately 45% of the fossil fuel combustion emissions. It follows, therefore, that to address climate-related risks in the country it will be essential to reduce electricity-related emissions. This will require significant new resources, blending state and private capital and access to financial markets through additional instruments.

Addressing other environmental and social development issues, such as access to and protection of water resources, wetlands and biodiversity, and increasing access to sanitation and infrastructure will also require additional resources. Sustainable finance therefore

² National Treasury Red Book 2011: A safer financial sector to serve South Africa better

³ Ecological infrastructure refers to naturally functioning ecosystems that deliver valuable services to people, such as fresh water, climate regulation, soil formation and disaster risk reduction. It is the nature-based equivalent of built infrastructure.

will play a pivotal role in enabling environmentally appropriate social development and create new economic opportunities in the green economy.

The scale and reach of this problem is multifaceted and requires financial resources, structural and socio-economic reforms. This paper highlights the need for South Africa to mobilise the financial resources now to address this challenge, both for the benefit of its citizens and to meet its global obligations. This paper focuses on climate risk as a manageable starting point. Sustainable finance is essential for balanced and inclusive growth, based on the identification and mitigation of risks as well as the search for economic opportunities that are socially, environmentally and economically beneficial. It encompasses both the concepts of green and socially focused finance.

The Intergovernmental Panel on Climate Change (IPCC), the OECD and others have estimated that trillions of new dollars will be needed a year, up to 2030, for investments in energy, transport, water and telecommunications infrastructure to sustain growth and mitigate climate effects. An additional USD 600bn a year would likely be needed to make these investments compatible with holding average global warming to 2°C. While similar figures for South Africa are not readily available, the Climate Policy Initiative⁴ has estimated the South African economic transition risks at an aggregated R2tn (of which 60% has already been incurred).⁵ A further R362bn (USD25bn) may result from infrastructure investments currently being contemplated that may not be economically viable in a low-carbon transition. Many of the transition risks identified result from transitions in the global economy and cannot be prevented by any national government, but require rapid adaptation by all players public and private.

In 2017, the Task Force on Climate-related Financial Disclosures (TCFD),⁶ published recommendations to increase understanding of the financial risks related to climate change. It recommended to the G20 that for financial disclosure, global warming scenarios should be used to model the potential risks to companies and economic systems. Systematic and credible disclosure is needed to enable improved pricing and risk distribution and the identification of economic opportunities associated with climate risk mitigation and adaptation.

1.3 TREASURY APPROACH

Addressing both climate change and South Africa's development agenda will require the reallocation of capital, the mobilisation of new financial resources and the strategic realignment of existing resources (public and private and blended finance options) over the short, medium and long term. Government has recognised the need for a just transition⁷ and various government agencies and departments, including Treasury and the National Planning Commission, are working to understand what is needed and stimulate the creation of new jobs. By mobilising private sector funding of new and more sustainable projects, such as through the Renewable Energy Independent Power Producer Programme (REIPPP), Treasury facilitates the shifting of green infrastructure investment off the national balance sheet into the private sector.⁸

Treasury is seeking to protect the economy and unlock economic opportunities that will enhance the country's ability to adapt to the rapidly changing climate and realise socio-economic benefits from the transition to a lower carbon, greener economy and build resilience to create a safer financial sector to better serve South Africa. It is pursuing initiatives to ensure all financial institutions embed and improve their capability for identifying, managing and disclosing the environmental and social risks in their portfolios through strengthening the regulatory framework and encouraging the uptake of leading practice.

4 **Climate Policy Initiative:** <https://climatepolicyinitiative.org>

5 (USD125bn at January 2019 exchange rates).

6 Established by the Financial Stability Board at the request of the G20 finance ministers and central banks

7 Just transition accommodates the needs of workers and communities, which may be negatively affected through the loss of jobs or activities as a result of a move to a lower carbon economy.

8 Eskom power purchase agreements are an exception.

1. EXECUTIVE SUMMARY - CONTINUED

In addition, climate change planning is becoming part of the budget process and fiscal risks monitoring by Treasury. Economic modelling work is being undertaken and Treasury is working towards climate classification and tagging in the budget to enable tracking of climate-related expenditure. Treasury capital appraisal guidelines which are under review will incorporate climate resilience. Fiscal allocations to support ecologically sustainable development through the Department of Environmental Affairs, Forestry and Fisheries are complemented with funding for public transport, clean energy and energy efficiency, water conservation and demand management.

At an intergovernmental level, the Treasury approach is to integrate climate responsiveness into provincial and municipal planning. This includes ensuring climate change responsive budgeting through guidelines for provincial medium-term expenditure frameworks (MTEF) and built environment performance plans (BEPPs) for metropolitan municipalities. Through a progressive integration and system reform, provinces and municipalities can create an intergovernmental project pipeline.

Accelerating the implementation of the 2015 Paris Climate Agreement requires clear financing strategies that work to mobilise resources from both public and private sectors. Treasury is working with local and international partners to leverage climate change funding. The Department of Agriculture and Treasury are working closely with the local insurance industry on an agricultural insurance product. This Sustainable Finance technical paper thus contributes and aligns to other Treasury efforts, and makes recommendations on a process to establish minimum practice and standards with regard to climate change and emerging environmental and social risks including by local banking, insurance, pensions, collective investments, private equity and capital markets participants.

1.4 OBJECTIVES

This paper aims to:

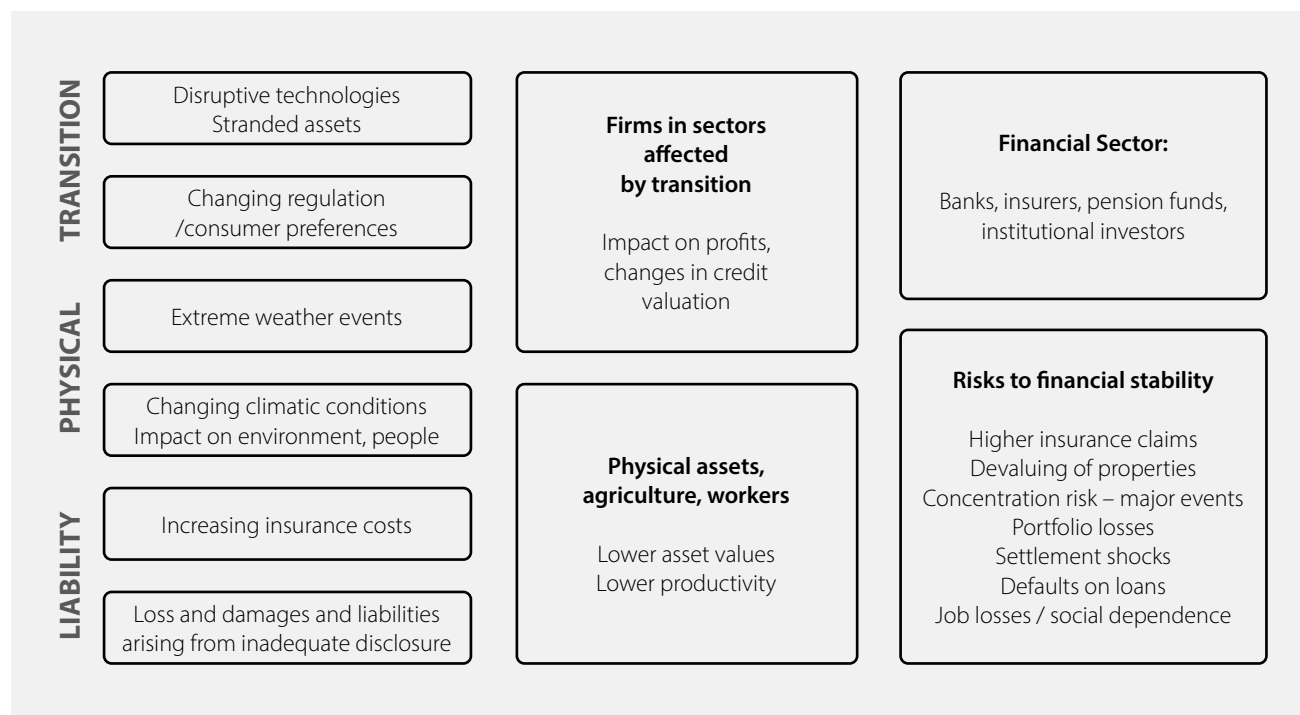
- Define sustainable finance for all parts of the South African financial sector including banking, retirement funds, insurance, asset management and capital markets.
- Take stock of the global and national financial sector policy, regulatory and industry actions taken to date in dealing with environmental and social (E&S) risks and opportunities.⁹
- Identify market barriers to sustainable finance and the implementation of E&S risk management best practices.
- Identify gaps in the existing regulatory framework and recommend actions required of regulators, financial institutions and industry associations.

This paper sets out the research and resultant recommendations of a process to establish minimum practice and standards with regard to climate change and emerging environmental and social risks. It looks at the approach of international financial regulators and the work of local financial institutions.

It is clear that there is a need for greater policy coherence for the sector, regulatory guidance and oversight. There is also real urgency to rapidly increase local financial sector capability to respond to the prevailing social and environmental challenges, which will increasingly have a major impact on our economic resilience and national well-being. Climate change, for example, was traditionally viewed as an environmental issue however it is also a social and economic issue as it will profoundly affect vulnerable individuals as well as the country's ability to grow the economy, create jobs and ensure food security. Figure 1 highlights the risks to economic stability resulting from climate change.

⁹ International frameworks increasingly require financial institutions to integrate E&S considerations in lending decisions to avoid or mitigate financial losses, reputational risk, or harm to the environment and communities. E&S risks should include climate change risks, but current frameworks do not always provide guidance for meaningful assessment of climate-related risks. Corporate Governance has grown in importance in recent years and has been added to the integrated concept of E&S risk management. Sustainable Finance is used here as an overarching definition that incorporates these various concepts.

Figure 1: Financial risks from climate change and potential impact



1.5 RECOMMENDATIONS

The following general recommendations are common to all financial services industries. They are necessary to facilitate unlocking access to sustainable finance and the allocation of capital to support a development-focused and climate-resilient economy. The recommendations were identified by key regulatory and industry stakeholders in the dialogue¹⁰ which preceded this paper, as well as local and international research. Recommendations specific to industry sectors are included at the end of each section.

a) **Adopt the following definition of sustainable finance in South Africa:**

“Sustainable finance contributes to the delivery of the sustainable development goals, a just transition to a low carbon and climate resilient economy and financial stability. Sustainable finance encompasses financial models, services, products, markets and ethical practices to deliver resilience and long-term value in each of the economic, environmental, social and governance aspects.

This is achieved by the financial sector by:

- Evaluating portfolio as well as transaction-level environmental and social risk exposure and opportunities, using science-based methodologies and best practice norms;
- Linking these to products, activities and capital allocations.”

¹⁰ In June 2016 Treasury, with the support of the IFC, established a dialogue between regulators and industry bodies to build a common understanding of the capability for and extent of incorporating environmental and social risks and mitigatory actions into the daily lending, insurance and investment practices of financial institutions. The group identified the need for greater coherence in the regulatory framework and the need to build capacity.

1. EXECUTIVE SUMMARY - CONTINUED

- b) Regulators and industry to co-develop or adopt technical guidance, standards and norms for use across all financial sectors in identifying, monitoring and reporting and mitigating their environmental and social (E&S) risks, including climate-related risks, at portfolio and transaction level. These should include E&S risk management frameworks, the use of science-based methodologies,¹¹ and the incorporation of the recommendations of the TCFD.
- c) Develop a benchmark climate risk scenario for use in stress tests by the sector.
- d) Develop or adopt a taxonomy¹² for green, social and sustainable finance initiatives, consistent with international developments, to build credibility, foster investment and enable effective monitoring and disclosure of performance.
- e) Include disclosure of progress in environmental and social risk management, including climate risks, in supervision activities carried out by the Prudential Authority and Financial Services Conduct Authority. Incorporate voluntary codes of principles, or acknowledged benchmarks for good practice, into regulatory regimes.
- f) Work with Institute of Directors, trustees, professional and industry associations and academic institutes to build governing body capacity and “fit-for-purpose” skills necessary for the identification and management of long-term risks and sustainability challenges.
- g) Build capacity across the sector and in the implementing arms of government – particularly local government – to ensure E&S risks are addressed within local infrastructure and development planning, capital raising and insurance planning.
- h) Finalise an action plan to give effect to the recommendations, using a technical working group to be comprised of regulators and industry representatives.

¹¹ Science-based methodologies, such as the 2° initiative, ensure that companies are making a fair contribution to the actions needed.

¹² Report by the EU Technical Expert Group on sustainable finance: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf

2. INTRODUCTION

2.1 AIMS AND OBJECTIVES

This National Treasury technical paper defines Sustainable Finance for the South African context and articulates a shared vision for its implementation. It recommends future actions to promote the achievement of a more sustainable economy and industry actions for identifying, understanding and acting on environmental and social (E&S) risks that impact on the safety, soundness and stability of the financial sector. The initial focus is on climate risk management approaches as a key dimension of financial stability. The primary audience is financial institutions, their regulators and stakeholders. Climate- risk in its narrow form refers to climate change and greenhouse gas emissions, but can take into consideration wider environmental factors and associated risks. Managing and disclosing climate risk is identified as the area of urgent demand for the financial sector, building on the international standards, such as those of the Financial Stability Board's Task force on Climate-related Financial Disclosure. Treasury acknowledge that the scope of sustainable finance is broad and evolving, and whilst starting with climate-risk our sustainable finance approach is to allow for flexibility to broaden this work over time to beyond climate and environmental factors to incorporate social and governance matters and the interrelationship between these factors. The approaches to climate risk should establish a foundation for how to treat other environmental and social risks and build a more circular economy.

It has been estimated that the cost of the global economic transition to a low-carbon economy could be trillions of dollars. Transitioning South Africa to a cleaner economy will be both fiscally and economically expensive. It will also have a social cost as well as opportunities. The country's transition risk has been estimated at R2tn¹³ because of the significant exposure to a global low-carbon transition through exports, thermal coal and related infrastructure, power generation and synthetic fuel production. Managing the transition does provide some means of mitigating the risk and finding upside opportunities. Mobilising the finance sector to invest in the necessary transition will require all participants in the financial services industry to contribute by screening for and disclosing E&S risks, financing new technologies and working in concert towards a more sustainable national economy.

Developing this technical paper, as a response to these risks, is in line with key international trends as evidenced by the European Union's (EU) High-level Expert Group on Sustainable Finance¹⁴ and the G20, in which South Africa participates, in their 2018 Action Plan and Leadership Declaration¹⁵ as well as the work of other international governmental organisations seeking to mobilise the funding to deliver the Sustainable Development Goals (SDGs) and mitigate or adapt to climate change. The Reserve Bank has in 2019 joined the Network for Greening the Financial System, a voluntary network of central bankers.

The objectives of this paper are to:

- Define sustainable finance for all parts of the South African financial sector including banking, retirement funds, insurance, asset management and capital markets.
- Take stock of the global and national financial sector policy, regulatory and industry actions taken to date in dealing with E&S risks and opportunities.¹⁶
- Identify market barriers to sustainable finance and the implementation of E&S risk management best practices.
- Identify gaps in the existing regulatory framework and recommend actions required of regulators, financial institutions and industry associations.

¹³ USD 125 billion at the January 2019 exchange rate: Climate Policy Initiative, 2019, with DBSA

¹⁴ https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en

¹⁵ <http://www.g20.utoronto.ca/2018/2018-leaders-declaration.html>

¹⁶ International frameworks increasingly require financial institutions to integrate E&S considerations in lending decisions to avoid or mitigate financial losses, reputational risk, or harm to the environment and communities. E&S risks include climate change risks. Corporate governance has grown in importance in recent years and has been added to the integrated concept of E&S risk management. Sustainable finance is used here as an overarching definition that incorporates these various concepts.

2. INTRODUCTION - CONTINUED

- Stimulate the pursuit of more sustainable opportunities and resource mobilisation – including new and blended finance.
- Enhance financial stability through better understanding of E&S factors, including the concept of a just transition.
- Make recommendations for implementing sustainable finance in South Africa through regulatory and industry actions.

2.2 APPROACH

This paper was developed by a sustainable finance working group led by the Treasury, following round table discussions starting in 2016 involving some 50 stakeholders. The working group was supported by the International Finance Corporation (IFC) and Swiss donor funding. The working group consisted of representatives from the following organisations:

- South African Reserve Bank
- Financial Sector Conduct Authority (FSCA)
- Prudential Authority (PA)
- Department of Environment Affairs (DEA)
- The South African Insurance Association (SAIA)
- The Banking Association of South Africa (BASA)
- The Association for Saving and Investment South Africa (ASISA)
- The Johannesburg Stock Exchange (JSE)
- Batseta – Council for Retirement Funds

The working group set out to better understand the extent of the financial sector's vulnerability to E&S risks and the governance approaches needed to effectively identify, quantify and manage these risks within South Africa's financial institutions and regulatory activities. Since the release of the draft paper in May 2020, the working group has been revived, chaired by National Treasury Financial Sector Policy unit and under the secretariat of BASA. This working group has been expanded to include the Department of Planning, Monitoring and Evaluation (DPME), local development finance institutions's (DFIs) and the Southern Africa Venture Capital Association (SAVCA). This working group is referred to as the Climate Risk Steering Committee and has mandated a further 5 sub- working groups to take forward the key recommendations general to financial institutions. Other recommendations, specific to each sector, should be taken up by the relevant associations. These are technical working groups, and broader stakeholder consultations will be undertaken when technical reports have been compiled. Documents are publically available via the website: <http://sustainablefinanceinitiative.org.za/> and as the other working groups develop draft documents and reports, these will be uploaded.

2.3 ENVIRONMENTAL AND SOCIAL RISK MANAGEMENT IN A GLOBAL CONTEXT

Given the financial sector's enabling role in the real economy, it is imperative that the E&S risks posed by climate change, water and air pollution, degradation and resource depletion are assessed and managed at strategic as well as transaction level as they impact directly on quality of life for those most vulnerable citizens, on job creation and reduction of inequity. Public policies for the financial sector must be adapted.

Globally, the financial system is being reformed to address the lessons from the financial crisis and, in this context, form an integral part of the solution towards a more sustainable economy, consistent with mobilising public and private financial resources for the foreseeable future to address key sustainable development challenges. The Task Force on Climate-related Financial Disclosures (TCFD)¹⁷ final report

17 <https://www.fsb-tcfd.org/>

quotes the International Energy Agency 2015 special briefing to COP21 which estimated that the transition to a lower carbon economy, necessary to fight destabilising climate change, requires \$1 trillion of new finance every year from 2015 for the foreseeable future, requiring the combined global efforts of the public and private sectors. This is in addition to the money needed to address the global SDGs, which were agreed by the United Nations (UN) in 2015 as the most pressing development challenges. In South Africa, the National Development Plan (NDP) correlates closely to the SDGs.

Reorienting capital to more sustainable investments requires a comprehensive shift in how the financial system works. This is necessary if South Africa is to develop more sustainable economic growth, ensure the stability of the financial system and foster more transparency and long-termism in the economy. The transition will need to be properly managed in order to support economic growth, while transitioning away from a carbon-based economy.

Consensus is emerging on how financial sector policy makers and regulators can lead a coordinated response to these challenges. The following model, drawn from a variety of sources including the work of the European High-level Working Group and the United Nations Environment Programme Finance Initiative, describes the elements that constitute a robust national sustainable finance framework:

- **Enabling environment:** The voluntary and mandatory policy requirements include incorporation of ESG considerations, to promote sustainable finance at a market level.
- **Environmental and social risk management:** Policy, regulation, guidelines and management and disclosure systems at financial institutions, which guide and assess the integration of environmental and social risk into strategy, governance and management systems, and at strategic and transaction level. These support the foundational requirement for first doing no substantial harm.
- **Sustainable and green finance flows:** Initiatives, definitions, market instruments and monitoring in place to promote the flow of capital to green and socially inclusive investments.

2.4 CURRENT MEASURES TO INCORPORATE ENVIRONMENTAL AND SOCIAL RISK IN THE GLOBAL FINANCIAL SECTOR

Integrating environmental and social (E&S) factors into risk management systems is essential for strengthening the resilience of the financial system. Better disclosure of E&S performance – for example through stock market and securities' requirements in South Africa¹⁸ – is now seen as necessary to deliver market efficiency in capital allocation and the pricing of risk. It is essential that existing and new E&S risks in portfolios are identified and mitigated.

From 2015-2017, the G20 hosted a Green Finance Study Group, since renamed the Sustainable Finance Study Group, which has prioritised policy measures to improve environmental and social risk analysis in financial decision making. In parallel, the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD) published its final recommendations in 2017, which have been widely adopted and supported by governments and international industry actors.

Both of these bodies of work have resulted in new emphasis on the use of forward-looking scenario analysis in financial decision making. One of the key challenges now is that financial institutions need to expose their strategy, risk and regulatory affairs teams to new areas of knowledge (from drought risk to energy transition) in such a way that confidence can be built and new decisions made.

During the 24th meeting of the Conference of the Parties to the Climate Change Convention (COP24)¹⁹ the conference chairman reminded delegates that there is no trade-off between climate change and jobs, saying "the choice we are making is not between jobs

18 For example, JSE listing requirements which require King IV compliance.

19 The 24th meeting of the UN Framework Convention on Climate Change held in 2018

2. INTRODUCTION - CONTINUED

and the natural environment but whether we are going to keep both or none of them". It must, however, be based, on a *just transition*²⁰ that integrates both the environmental and the social dimensions into climate strategies.

2.5 SOUTH AFRICA'S CLIMATE CHANGE RESPONSE

Climate change is already a measurable reality and, along with other developing countries, South Africa is especially vulnerable to its impacts. The western and interior parts of South Africa are expected to become drier on average, with temperatures rising significantly above the threshold global average of 2 degrees Celsius at which the risk of climate destabilisation is extremely high. The eastern areas are expected to experience more rain in shorter events. Extreme weather events, such as droughts and floods are likely to occur more frequently.²¹ While climate change has traditionally been seen as an environmental or green challenge, it is an economic and social development challenge with impacts on health, labour and productivity. The socio-economic impacts will be on rural and resource-based communities as well as on cities which must meet the needs of growing populations in less predictable circumstances.

Climate change is a multifaceted challenge, requiring more resilient societies that can adapt to increased drought and water shortages, more unpredictable weather patterns, food and water insecurity, changes in disease trends, and physical threats to infrastructure. Improving ecosystem integrity and resultant water security is a critical component of climate change adaptation in the face of the warmer temperatures and more variable rainfall that are already part of the South African climate. The National Climate Change Response (NCCR) White Paper (2011) sets out South Africa's response to these challenges, highlighting the importance of well-functioning ecosystems in helping society to adapt to climate change as well as supporting opportunities for adaptation to contribute towards broader development goals. The National Development Plan: Vision 2020 (NDP) addresses both climate change mitigation and adaptation. The increasing physical impacts of climate change mean that it is an important E&S risk that financial institutions need to consider, both in their existing portfolios and in new financing and investment decisions. Furthermore, financial institutions, through the clients that they choose to transact with, can help mitigate climate change and build resilience to its impacts. This has been articulated by the Alliance for Financial Inclusion. This includes provision (ensure that financial services are provided to qualified beneficiaries), promotion (create incentives for the private sector to offer financial services to qualified beneficiaries), prevention (aim to avoid undesirable outcomes by lowering financial, social and environmental risks), protection (reduce financial risk by socialising potential losses through insurance or social payments). Without an accurate understanding of the E&S risks posed by climate change and adequate data, protecting existing assets or making strategic investments to promote more resilient societies will become increasingly difficult for financial institutions.

South Africa's parliament formally ratified the Paris Agreement on Climate Change in November 2016, thereby formally consenting to it. The country has set an ambitious target as part of its first nationally determined contributions (NDC): 42% below business as usual carbon output by 2025. The 2016 NDC requires that emissions peak in 2020 to 2025, plateau for a ten year period from 2025 to 2035 and declines from 2036 in the range of 398 to 614 megatonnes.

In June 2018, the then Department of Environment Affairs (DEA) tabled a Climate Change Bill²² to follow its earlier draft National Climate Change Response Paper. The Bill makes provision for, amongst other things, the identification and mapping of risks and 'vulnerabilities' across areas, ecosystems, communities and households and the setting and achievement of adaptation targets, and a just transition to a more sustainable economy. The Bill commits the South African government to:

- Effectively manage climate change impacts through interventions that build and sustain South Africa's social, economic and environmental resilience and emergency response capacity.
- Make a fair contribution to the global effort to stabilise atmospheric GHG concentrations at a level that avoids dangerous anthropogenic interference with the climate system within a timeframe that enables economic, social and environmental development to proceed in a sustainable manner.

20 Nick Robins, co-author of the report and Professor in Practice at the Grantham Research Institute, said: "For responsible investors, the just transition means integrating both the environmental and the social dimensions into their climate strategies. We've been impressed by how quickly investors have grasped the compelling case for action."

21 **National Climate Change Response White Paper**: https://www.environment.gov.za/sites/default/files/legislations/national_climatechange_response_whitepaper.pdf

22 **National Climate Change Bill published for comment in June 2018**: https://www.environment.gov.za/sites/default/files/legislations/climatechangebill2018_gn41689.pdf.

South Africa's commitments to reducing greenhouse gas emissions

South Africa's parliament formally ratified the Paris Agreement in November 2016 and endorsed the submission of its Nationally Determined Contribution (NDC). The government recognises climate change as a significant threat to the people of South Africa and to the economy and acknowledges that South Africa has been a major contributor of greenhouse gas emissions (GHG). It has therefore committed the country to an emissions peak in 2020 to 2025, a plateau for a ten year period from 2025 to 2035 and decline from 2036 onwards.

This means that by 2025 and 2030 South Africa's emissions must be in a range between 398 and 614 Mt CO₂-eq, as defined in national policy.

Meeting the commitments to the Paris Agreement will require sizable reductions in energy-related greenhouse gas (GHG) emissions by large emitting countries, including in developing economies, such as South Africa. The NDC noted carbon tax as an important component of our mitigation policy strategy to lower GHG emissions.

South Africa is the 11th biggest contributor globally to Greenhouse Gas Emissions because of its significant reliance on fossil fuels. Its emissions are above the G20 average. Some 45 percent of the 518 239 Gigagrams (Kilotonnes) of CO₂ equivalent gases emitted in the country result from electricity generation, as published in the 2014 South African National Greenhouse Gas Inventory, with the energy sector as a whole (including liquid fuels, manufacturing industry, construction and transport) accounting for more than 77%.

For South Africa to meet its objectives the financial sector must consider the roles it can play in reducing the economy's GHG emissions and building resilience. The Carbon Tax Act (No.15 of 2019),²³ came into effect on 1 June 2019. In terms of the Act large emitters are required to report greenhouse gas (GHG) emissions and pay a tax, subject to a number of sectoral adjustments and rebates. The Treasury is cognisant that abrupt climate policy measures and rapidly advancing low-carbon technology could lead to write-downs of loans to and investments in companies with carbon-intensive production processes or products with high GHG emissions. The Carbon Tax has been the subject of lengthy consultation and was signalled in several budget speeches and the country's Nationally Determined Contribution to the Paris Agreement. Regulations for the offset of carbon emissions by taxpayers were gazetted in November 2019²⁴. This is intended to drive financial institutions to consider the risks associated with climate change and promote an orderly and a just transition from high to low-carbon investments.

2.6 BARRIERS TO INVESTING IN A MORE SUSTAINABLE ECONOMY

Combined with the increased implementation of environmental and social risk management practices, there are USD 12tn in market opportunities²⁵ in addressing the sustainable development goals and climate change through food and agriculture, sustainable cities, energy and materials, health and well-being. There are also opportunities to blend public and private finance and to unlock and attract the sizeable investments being offered by international funds and asset owners globally in support of sustainable development. However, the needed finance is not being mobilised fast enough.

23 **Carbon Tax Act:** https://www.gov.za/sites/default/files/gcis_document/201905/4248323-5act15of2019carbontaxact.pdf

24 <http://www.treasury.gov.za/public%20comments/CarbonTaxAct2019/Gazetted%20Carbon%20Offset%20Regulations%2029%20Nov%202019.pdf>

25 **Business Commission on Sustainable Development, Better Business Better World Report Jan 2017:** <https://www.report.businesscomission.org/uploads/executive-summary.pdf>

2. INTRODUCTION - CONTINUED

In studies²⁶ published by the National Business Initiative (NBI) some years ago, several key barriers which impede the growth of green (or sustainable) finance in South Africa were identified, including:

- The need for an all-encompassing national policy for a greener economy, industrial policy and the structure of the financial system as the dominant local factors.
- Shortages of early stage funding, low availability of venture capital and a scarcity of private equity,
- A reliance on concessional loans from local or international banks (both commercial and development banks).

At that time, many projects with potentially high environmental returns were not commercially viable without direct financial support from government (i.e. capital subsidies or interest rate subsidies), as the payback periods for these projects were too long. Since then the price of renewable energy installed is now often cheaper than traditional power sources.

The NBI and the working group on sustainable finance, coordinated by Treasury, concluded that a clear sustainable finance strategy, consistent definitions and understanding of environmental and social risks linked to value creation is needed. This must be supportive of South Africa's climate change objectives, together with the necessary prioritisation of projects and the creation of a commercially viable and sustainable value proposition and more consistent definition of environmental and social risks and value creation..

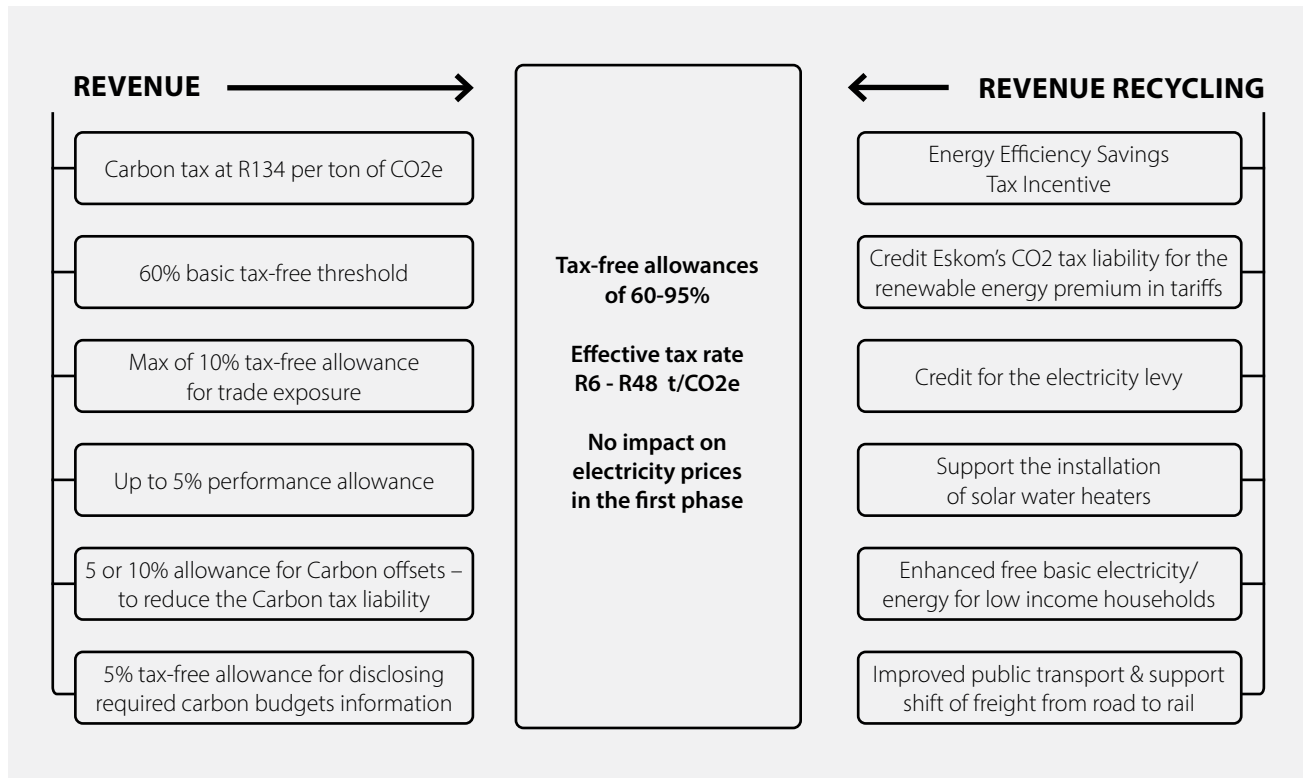
2.7 GOVERNMENT-LED INITIATIVES

A number of initiatives have been implemented to promote the greening of the South African economy, including, but not limited to:

- Putting a price on carbon, via the carbon tax (see Fig 2), and the publishing of offset regulations to enable reduction of those taxes through climate-positive investments
- The Renewable Energy Independent Power Producers Programme (see Fig 3,4,5)
- Accelerated depreciation allowances for machinery for renewable electricity generation and biofuels production
- R&D tax incentives including for green technologies (150% deduction)
- Tax incentives for biodiversity conservation
- Energy efficiency savings tax allowance
- Fiscal allocations, such as those to the Department of Environment Affairs, Forestry and Fisheries (DEFF), for risk mitigation and job creation projects such as Working for Water and Working on Fire
- Regulations for carbon offsetting under the Carbon Tax (Nov 2019)
- Motor vehicle emissions tax to promote the sale of vehicles with lower carbon emissions during their operating phase
- Incandescent globe taxes to stimulate the uptake of low energy light bulbs

²⁶ The National Business Initiative's papers on green economy and financing: Barriers to climate finance (2013); It's the economy, Stupid, (2015); Green Economy Finance project, (2016) <https://www.nbi.org.za/communications/reports/>

Figure 2: Structure of the 2019 carbon tax



LESSONS FROM THE RENEWABLE ENERGY INDEPENDENT POWER PRODUCERS PROGRAMME (REIPPP)

Private Investment in greening South Africa's economy

South Africa's programme to procure renewable energy from independent power producers has been used as a case study around the world. An Independent Power Producers (IPP) office, run independently but set up jointly by the Department of Energy and the National Treasury, oversees a competitive bidding process, to inject privately supplied renewable energy into South Africa's fossil fuel-heavy generating mix and at the same time addressing the significant socio-economic challenges the country faces.

To date, through the seven bid rounds, 112 projects capable of delivering 6,422 MW have been procured, spread across South Africa, and benefitting some of the poorest communities in the country in the Eastern Cape, Northern Cape, North West province and the Free State. As of March 2019, 64 projects with a 3,976MW capacity had been connected to the grid and had generated 36,699GWh of electricity, with 45% of the projects exceeding their projected capability. The rest of the projects are in progress, some nearing completion and other commencing construction in the 2018/2019 period.

2. INTRODUCTION - CONTINUED

During the significant electricity outages in 2018, which resulted from problems in Eskom’s coal-fired power stations, the renewable energy projects made a contribution to the supply of electricity. The Medupi power station project, which started in 2007, has been marked by cost overruns, time delays and design issues and is not yet delivering power from all its units. Its 4764 MW capacity has risen in costs from an estimated R80 billion in 2007, to an approved R145 billion. However, energy analysts are predicting a further R39 bn for flue gas desulphurization as well as approximately R50bn for capitalised interest to reach a projected final cost of R234bn*. Kusile, similarly has rising from R161bn (including flue gas desulphurization) to a projected R226 billion. South Africa has some of the world’s highest concentrations of sulfur dioxide and nitrogen dioxide emissions as a result of its coal-fired energy generation.

The REIPPP programme attracted R202bn in new private investment, R42bn of this from foreign sources. It has thus far created 40,134 job years, of which some 90% went to South African citizens, 82% in the construction phase and 7,115 jobs in the operational phase.

Figure 3: Lessons learnt from the Renewable Energy Independent Power Producers Programme

WHAT THE REIPPP HAS ACHIEVED SO FAR:
6,422 MW of electricity has been procured from 112 IPPs in seven bid rounds
3,976 MW of electricity generation capacity from 64 IPP projects has been connected to the national grid; 62 projects have been operational for more than a year; 45% of the projects have exceeded their energy delivery projections
35,669GWh of energy has been generated by renewable energy sources
The REIPPP has attracted investment (equity and debt) valued at R209.7bn , of which R41.8bn is foreign investment (updated to financial close data)
The REIPPP has created 40 134 job years for South African citizens
36.2Mton CO₂ emissions reduced
42.8 million kiloliters of water saved in relation to fossil fuel power generation from inception to March 2019
R860.1 million spent to March 2019 on socio-economic development (R81.1 million in the reporting quarter); R276 million spent to March 2019 on enterprise development (R26.5 million in the reporting quarter)

Source March 2019 Quarterly Report IPP Programme: <https://www.ipp-projects.co.za>

Table 1: Summary of Status of Independent Power Producers

INDEPENDENT POWER PRODUCER PROJECTS						
	Projects			Megawatts		
	Online	Nearly complete	Building starts 2018/2019	Online	Nearly complete	Building starts 2018/2019
Solar PV	33	-	12	1501	-	813
Wind	21	-	12	1988	-	1367
Solar Thermal	5	2	1	300	200	100
Hydro	2	-	1	14.3	-	4.5
Biogas	-	-	1	-	-	62
Landfill Gas	1	-	-	18	-	-
Total	62	2	27	3800	200	2346

Source: March 2019 Quarterly Report IPP Programme: <https://www.ipp-projects.co.za>

The call for Independent Power Producers (IPPs) capable of delivering renewable energy to the national grid, took place in a number of tranches, or bid windows with price caps. These took place over a number of years and each had certain specifics that were required either in terms of technology (e.g. wind, solar, hydro or a combination thereof) or size of the power output. Over the different windows the prices fell dramatically as illustrated in red below, which show the falling prices with each round. This was a factor of economies of scale internationally, as investment in these technologies grew as well as greater local capability and reduced perceptions of risk impacted pricing.

The one bid window which is not included in the table is the call for independently produced coal-fired power as that has not been successfully concluded. There are legal challenges based on water usage, pollution and climate change impact as well as banks and other financiers' reluctance to fund new coal-fired energy generation.

Table 2: Trend in renewable energy prices over REIPPP bid rounds relative to Eskom's new coal projects Medupi and Kusile

AVERAGE WEIGHTED COST IN R/KWH FOR RENEWABLE ENERGY PROJECTS, AND THE LATEST COAL-FIRED POWER STATIONS, MEDUPI AND KUSILE					
2.79	-34%				
	1.83	-20%		1.76	1.98
		1.47	-38%		
			0.92		
Bid window 1	Bid window 2	Bid window 3	Bid window 4	Medupi (NT discount rate; real post-tax discount rate: 8.2%)	Kusile (NT discount rate; real post-tax discount rate: 8.2%)

Source: IPP Quarterly report March 2019 for Bid windows 1-4 (as at April 2018): Medupi and Kusile, Meridian Economics (figures adjusted for inflation to provide comparable numbers). The levelised costs of electricity for Medupi and Kusile are considered to be conservative in the light of new information regarding unauthorized expenditure and rectification costs for design, execution and construction problems.

3. DEFINING SUSTAINABLE FINANCE

Sustainable finance is a widely used but frequently poorly understood concept. The following definition is proposed for the purposes of South African policy making:

“Sustainable finance contributes to the delivery of the sustainable development goals, and a just transition to a low carbon and climate resilient economy and financial stability. Sustainable finance encompasses financial models, services, products, markets and ethical practices to deliver resilience and long-term value in each of the economic, environmental, social and governance aspects.

This is achieved when the financial sector: Evaluates portfolio and transaction-level environmental and social risk exposure and opportunities, using science-based methodologies and best practice norms; discloses and mitigates these risks and links these to products, activities and capital allocations.

Sustainable finance should therefore comprise the collective set of actions, processes, policy, regulations, goods and services that actors in the financial service sector give effect to in the enablement of the global Sustainable Development Goals or the closely-correlated National Development Plan 2030 (NDP)²⁷, with consideration for the short, medium and long-term interests of South African citizens. In line with global definitions, Sustainable Finance incorporates climate finance, green finance, and social finance.

3.1 SCOPE OF SUSTAINABLE FINANCE

As an emerging global practice and trend, the scope of sustainable finance is still evolving according to priorities and activities identified in different national and financial sector contexts. In the EU, for example, the High-level Expert Group²⁸ appointed by the Commission proposed that sustainable finance is based on two imperatives. The first is to improve the contribution of finance to sustainable and inclusive growth, in particular funding society's long-term needs for innovation and infrastructure and accelerating the shift to a low-carbon and resource-efficient economy. The second is to strengthen financial stability and asset pricing, notably by improving the assessment and management of long-term material risks and intangible drivers of value creation – including those related to ESG factors.

In short, sustainable finance means ‘better development’ and ‘better finance’ – development that is sustainable in each of its economic, social and environmental dimensions, and a financial system that is focused on the longer term as well as material ESG factors. Mobilising capital for a sustainable economy requires action on two fronts: the first is shifting the current capital allocation from an unsustainable pathway to a sustainable one; the second is filling the investment gap to ensure that objectives are achieved on time.

To draw a manageable boundary for implementation of the recommendations, this document recognises both the broad and inclusive scope of the term sustainable finance, as well as some of the immediate priority topics within sustainable finance that are shaping implementation and innovation.

The broad and inclusive scope of the term sustainable finance covers the following:

- Risk management and business opportunities related to E&S performance, and in particular climate change and associated economic impacts and challenges.
- It is applicable to all parts of the financial sector ecosystem including banking, investment, insurance, retirement funds, stock exchanges, credit rating agencies, investment analysts, investment consultants, proxy advisors and asset owners.

²⁷ The National Development Plan: <https://www.gov.za/issues/national-development-plan-2030>

²⁸ EU working group: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

- It is applicable to all types of financial transactions, products and services and at all stages of decision making and during the period of investment.

The immediate practical priorities and focus areas for the South African financial sector include the following:

- The importance of managing an emerging set of E&S risks and impacts, specifically including those related to climate change, associated with clients that have not previously been accounted for and therefore the costs of which have been externalised and carried by the economy and society.
- The risks and challenges posed by climate change and the role of the financial sector to respond to these.
- The growing importance of governance in addressing E&S risks and impacts, such as through adequate regulatory, board and governance oversight and disclosure.
- The need to develop or adopt additional methodologies – beyond those typically covered by environmental impact assessment regulations, the National Environmental Management Act, or the IFC performance standards, to include specifically the identification, management and disclosure of climate-related risks.

As set out in the recommendations of this document, these initial focus areas provide for a manageable starting point to mobilise the financial sector to move towards more responsible practices that will ensure a stable, resilient and competitive economy.

3.2 RELATED DEFINITIONS

The following related definitions refer to different components and activities under sustainable finance. These definitions aim to be consistent with accepted international examples and include the cost of transitioning to a low carbon and climate resilient economy. This recognises that efforts towards addressing climate risks cannot be disengaged from equity and socio-economic development in the process to reshape the economy for long-term competitiveness and sustainability.

TERM	DEFINITION
Circular Economy ²⁹	Looking beyond the current “take, make and dispose” extractive industrial model, the circular economy is designed to restore and regenerate. Underpinned by a transition to renewable energy sources and system-wide innovation, it aims to redefine products and services to reduce waste and negative impacts.
Climate finance	Local, national or transnational financing, which may be drawn from public, private and alternative sources of financing. These financial resources are intended to cover the costs of transitioning to a low-carbon global economy and to adapt to, or build resilience against, current and future climate change impacts (Climate Policy Initiative, 2017). ³⁰
Environmental and social (E&S) risk management	The integration of the consideration of E&S risks into governance and specifically risk management frameworks and systems of financial institutions and the active management and mitigation of those risks.
Environmental benefits	Include reductions in air, water and land pollution, reductions in GHG emissions, improved energy efficiency, responsible use and conservation of natural resources, as well as the mitigation of and adaptation to climate change.
Environmental, social and governance (ESG)	A term increasingly used by investors to refer to the type of risks assessed as part of responsible investment practices. Sustainable finance is used here as an overarching definition that incorporates this concept.

29 White Paper on Science, Technology and Innovation, DSI, March 2019

30 <https://climatepolicyinitiative.org/publication/global-landscape-of-climate-finance-2017/>

3. DEFINING SUSTAINABLE FINANCE - CONTINUED

TERM	DEFINITION
Green bonds	A green bond is a bond specifically earmarked to be used for climate and environmental projects. These bonds are typically asset-linked and backed by the issuer's balance sheet. To promote integrity and overcome inconsistencies in definition and use of green bonds, a set of voluntary Green Bond Principles were adopted by the International Capital Markets Association in 2018
Green economy	An economy that results in improved human well-being and social equity, while significantly reducing environmental risks and ecological scarcities. It is low carbon, resource efficient, and socially inclusive (UNEP, 2011).
Green finance	Financing of investments that provide environmental benefits in the broader context of environmentally sustainable development. It involves efforts to internalise environmental externalities and adjust risk perceptions to boost environmentally friendly investments and reduce environmentally harmful ones. It covers a wide range of financial institutions and asset classes, and includes both public and private finance.
Impact investment	<p>Investments made into companies, organizations, and funds with the intention to generate positive E&S impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending on investors' strategic goals.</p> <p>The growing impact investment market provides capital to address the world's most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education. (Global Impact Investing Network (GIIN))³¹</p>
Responsible insurance	A strategic approach where all activities in the insurance value chain, including interactions with stakeholders, are conducted in a responsible and forward-looking way by identifying, assessing, managing and monitoring risks and opportunities associated with ESG issues. Sustainable insurance aims to reduce risk, develop innovative solutions, improve business performance and contribute to environmental, social and economic sustainability. (UNEP FI Principles for Sustainable Insurance) ³²
Responsible investing	An approach to investing that aims to incorporate E&S factors into investment decisions, to better manage risk and generate sustainable, long-term returns. (UN-supported Principles for Responsible Investment) ³³
Social impact	Social impact is the effect an organisation's actions have on the well-being of the community. ³⁴
Sustainable development	Sustainable development means the integration of social, economic and environmental factors into planning, implementation and decision-making so as to ensure that development serves present and future generations. (National Environmental Management Act (NEMA), (Act No. 107 of 1998))
Sustainable financial system	A sustainable financial system is stable and creates, values, and transacts financial assets in ways that shape real wealth to serve the long-term needs of a sustainable and inclusive economy along all dimensions relevant to achieving those needs, including economic, social, and environmental issues; sustainable employment; education; retirement financing; technological innovation; resilient infrastructure construction; and climate change mitigation and adaptation.

31 <https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing>

32 <http://www.unepfi.org/psi/the-principles/>

33 <https://www.unpri.org/>

34 whs.wharton.upenn.edu/term/social-impact/

3.3 SUSTAINABLE FINANCE INSTRUMENTS AND OPPORTUNITIES

Sustainable finance offers opportunities to mobilise alternative sources of funding. This section aims to give an overview of some sustainable finance instruments, noting that these instruments are evolving and the market is continually expanding. The instruments include bonds and fixed-income instruments, impact-focused investments, taxes and tax incentives and increasingly ways of blending public and private finance, which includes the blending of sovereign and international funds, such as those of the Green Climate Fund, risk guarantees and other means of crowding in finance to fund transformation to a lower carbon, more resilient and sustainable economy. Public funds are insufficient in financing climate related initiatives and projects, and funding can be accessed from international Climate Funds which are funds established to provide funds to finance climate-related investments, programs and projects. Climate Funds are established by multilateral institutions, such as the UNFCCC, form part of financial windows under multilateral development banks such as the World Bank or bilateral agencies. South Africa currently accesses funds, through accredited entities, from the Green Climate Fund³⁵, Adaptation Fund³⁶, Global Environment Facility³⁷ and Clean Technology Fund³⁸.

Green, social or climate bonds are fixed-income debt instruments which can be issued by governments, banks or corporates to fund projects that have positive environmental, social or climate impacts. The proceeds from these bonds are typically earmarked for green, social or climate projects and are backed by the issuer's entire balance sheet. A taxonomy of acceptable projects or fund uses is applied to ensure that bond issuers are not accused of "green washing" or raising funds on the pretext of environmental benefit.

The earliest green bonds issued in South Africa were for clean energy infrastructure and local government initiatives. Since then, there is increasing focus on accreditation of bonds to enhance credibility of the instrument and provide monitoring and transparency on the end use of funds:

- In 2012 the Industrial Development Corporation (IDC) issued a R5bn bond for investment in clean energy infrastructure. The City of Johannesburg followed as the first local municipality to list a green bond on the JSE in 2014 – a R1,46bn issuance to finance initiatives such as biogas to energy and the Solar Geyser Initiative (City of Johannesburg, 2014). The City of Cape Town's R1bn Green Bond will fund projects aligned with the City's Climate Change Strategy, including measures to secure long-term water availability.
- In 2017, the JSE opened a Green Bond segment on the exchange. The first bond issuance, by Growthpoint, was a R1,1bn bond for 5, 7 or 10 years.
- In 2019, Nedbank became the first bank to list a green bond on the JSE, with proceeds ring fenced for renewable energy. It attracted R5,5bn in bids and increased the size of the issue from R1bn to R1,7bn.

Globally, the green bond market has grown significantly, and 2020³⁹ issuances according to the Climate Bond Initiative were at least USD 269bn. Global Green bond issuances to date exceed US\$ 1tn, of which US\$150bn have been certified. Green loans are another debt instrument increasingly identified for lending activities dependent on environmental criteria for the planned use of funds, whether to finance or re-finance, in totality or in part, new or existing eligible green projects, assets or activities. Similarly, Sustainable Linked Loan (SLL) provide a structure that promotes borrowers/ companies/financial institutions to meet their SDG goals. In 2019, Motus Ltd (JSE Listed) was the first South African company to take up an SLL loan.

The SDGs and new initiatives like the Task Force on Nature-related Financial Disclosures (TNFD) are likely to drive expanded innovation in non-climate green and socially focused instruments. Impact Investing is also a growing trend globally which will see greater demand for projects and businesses which meet clear and measurable definitions and outcomes.

35 www.greenclimate.fund

36 www.adaptation-fund.org

37 www.thegef.org

38 <https://www.climateinvestmentfunds.org/country/south-africa>

39 As at 15 January 2020

3. DEFINING SUSTAINABLE FINANCE - CONTINUED

The Luxembourg Stock Exchange, which is a global leader in this market, acknowledges the following standards in determining eligibility for listing: ICMA's Green Bond Principles, Social Bond Principles and Sustainability Bond Guidelines, the Climate Bonds Initiative's eligibility taxonomy, the People's Bank of China Green Bond Endorsed Projects Catalogue and other frameworks aligned with the former. The Luxembourg exchange listed the first-ever green bond in 2007 – the European Investment Bank's 'Climate Awareness Bond'.

Bond issuance has also proven to provide support for disaster management. The World Bank in April 2020 issued the largest single green, social and sustainable bond (US\$8bn) to date aimed at assisting countries to respond to the impact of the COVID-19 pandemic. Additionally, the EU Technical Expert Group on Sustainable Finance has identified the role of the Sustainable Taxonomy, EU Green Bond Standards, and Paris-Aligned and Climate Transitions Benchmarks as playing an important role in the response to the COVID-19 pandemic for both the public and private sector.

The Sustainable Banking Network (SBN) is a voluntary community of financial sector regulatory agencies and banking associations from 40 emerging markets members that have committed to advancing sustainable finance in line with international good practice. The SBN includes a green bond working group to support members in designing market-level frameworks to promote green bond issuance. Common approaches and member experiences, including a case study from the Johannesburg Stock Exchange, were featured in the report "Creating Green Bond Markets", published in 2018. The Banking Association of South Africa (BASA) are a member of the SBN, and both the National Treasury and JSE are active participants.

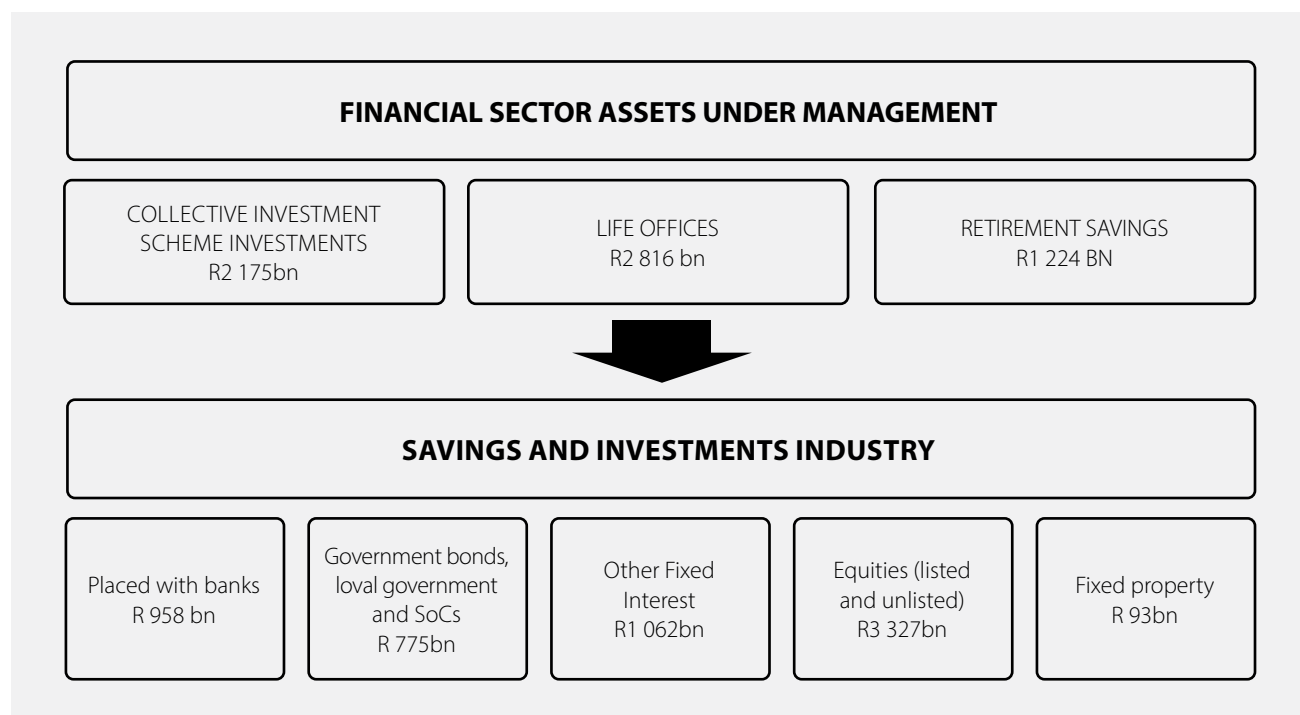
The Sustainable Stock Exchanges Initiative⁴⁰ (SSE) provides a platform for global dialogue and exchange between the stock exchanges, investors, companies, and regulators with the objective to create a greater sustainable capital market. Since its initiation in 2009, the SSE has encouraged stock exchanges to become a Partner Exchange by making a voluntary public commitment to share information on corporate responsibility efforts, such as disclosing environment, social and corporate governance (ESG) performance indicators among shareholders and stakeholders. It now lists 102 member Exchanges with more than 52 000 listed companies with a market capitalisation upwards of USD 88 trillion.

Of these, 32 Exchanges with a market capitalisation of USD 28 trillion, are noted by SSE to have green, social and or sustainability bond listing segments, including South Africa as the only African exchange in this group. As of July 2020, the JSE's Green Bond Segment has been expanded to a Sustainability Segment and interested issuers can now list social and sustainability bonds along with green bonds.

⁴⁰ A United Nations Partnership Programme organised by United Nations Conference on Trade and Development (UNCTAD), United Nations Global Compact (UNGC), United Nations Environment Programme Finance Initiative UNEP FI and the Principles for Responsible Investment (PRI).

4. OVERVIEW OF DEVELOPMENTS WITHIN THE SOUTH AFRICAN FINANCIAL SECTOR

Figure 4: Asisa depiction of the financial sector (source SARB quarterly reports 31 December 2018)



4.1 DRIVERS OF CHANGE

Sustainable finance initiatives in South Africa have taken two distinct forms: those that are driven by government or regulators through regulation and those that have been led by industry.

Prior to the shift to a 'Twin-Peaks'⁴¹ model of regulation, regulation and supervision of the financial sector was siloed. The Financial Sector Regulation Act 9 of 2017 created cooperation mechanisms for regulators, which will assist in driving sustainability initiatives from both a conduct and prudential perspective.

This chapter discusses the South African regulatory frameworks and initiatives that are applicable to each financial subsector and provides a brief overview of:

- Gaps within the existing legislative framework governing each sub-sector of the financial industry
- Trends in international regulations and guidelines related to E&S risk management
- Details of industry progress in sustainable finance, focusing on green finance, and gaps in industry efforts
- Challenges in implementing certain frameworks and recommendations to take the sector forward.

⁴¹ The Twin Peaks model of financial sector regulation created a prudential regulator – the Prudential Authority – housed in the SARB, while the FSB has been transformed into a dedicated market conduct regulator – the FSCA. The Prudential Authority's objective is to promote and enhance the safety and soundness of regulated financial institutions, while the Financial Sector Conduct Authority is tasked with protecting financial customers through supervising market conduct.

4. OVERVIEW OF DEVELOPMENTS WITHIN THE SOUTH AFRICAN FINANCIAL SECTOR - CONTINUED

4.1.1 COMPANIES ACT

Regulation 43(5)(c) in terms of the Companies Act requires all qualifying state-owned companies, listed companies and other large companies to have designated Social and Ethics Committees of more than three directors, one of whom must be independent. Their mandate must include the company's performance in terms of the 10 principles of the UN Global Compact, the OECD recommendations on corruption, employment equity and the Broad-based Black Economic Empowerment (BBBEE) Act as well as the development of communities and environmental, health and safety factors. These are not specific to the financial sector and while they do provide the means for giving board oversight on issues such as climate risk, there are global concerns about the competency of directors to oversee climate and environmental risk identification and management.

4.1.2 REGULATION 28 IN TERMS OF THE PENSION FUNDS ACT (2011)

The regulation requires retirement funds to consider all types of risk affecting their investments, including ESG risks. They are required to understand and communicate to members the nature of the assets in which the fund invests, and must conduct reasonable due diligence and understand the changing risk profile of assets over time. A guidance note on the "Sustainability of investments and assets in the context of a retirement fund's investment policy statement" was published in 2019 to assist retirement funds in giving effect to the requirements for sustainability reporting and disclosure in the regulation, to improve implementation across the sector and achievement of the regulation's aims.

4.1.3 VOLUNTARY ACTION BY FINANCIAL INSTITUTIONS

In the absence of an overarching regulatory and policy framework, the primary driving force behind sustainable finance initiatives has often been industry, largely through voluntary industry association-led initiatives or through international sector-specific initiatives. However, there has been minimal consistency within sub-sectors or coordination across industry sub-sectors, re-enforcing the disparities in progress.

Several guidelines and frameworks for E&S risk management are already in place in South Africa that provide a degree of commonality to the implementation strategies for the various subsectors. However, they do not provide specific guidance on the incorporation of climate-related risk or even more familiar E&S risks. These sector-specific guidelines and frameworks are:

- The King Code of Corporate Governance (King IV): Expects governing bodies to demonstrate thinking that integrates economic, environmental and social aspects into value creation strategies and operations. The Code is principles-based, voluntary and contains no sanctions. JSE listing requirements do, however, require companies to incorporate the principles into their business practices. To give effect to the Code, organisations should establish corporate governance structures to provide oversight in respect of financial, manufactured, intellectual, social, human and natural capitals (www.iodsa.org) and should publish an annual Integrated Report. These focus areas seek to promote long-term value creation. Issues material to decision making should be reported in the annual integrated report.
- Task Force on Climate-related Financial Disclosures: A number of leaders in the financial sector are voluntarily testing the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures. A summary of the risks identified is included in the table below.

Table 3: Summary table of climate-related risks

CLIMATE-RELATED RISKS FACED BY THE FINANCIAL SECTOR *					
Risks	Banking Direct	Banking Indirect	Investment	Retirement Funds	Insurance
Physical	Impacts common to all financial sectors: Dependence on local government emergency response teams; business interruption – impacts on value, market position; supply chain interruptions – e.g. parts from international suppliers; Disasters create increased social vulnerabilities; Links between climate issues and security risks; Migration (inward and outward)				
Physical risks Increased likelihood of extreme weather events, fire, flood, storm damage, sea level rise, water availability	Risks to own facilities; data centres – business continuity; new investments in water security and water quality required for facilities	Land/buildings held as security for loans (e.g. mortgages, commercial); Default risk; Impacts on agricultural output	Investments in land or buildings impacted; Disaster impact on viability of underlying investments;	Retirement funds are significant investors in the urban infrastructure – increasing vulnerability in some locations to extreme weather, ecosystem and biodiversity degradation.	Increasing frequency, quantum of claims; Declining insurability; Potential for convergence – creating black swan events
Transition	Impacts on creditworthiness, ability to attract investment and secure long-term returns, insurability				
Regulatory change – impacts on business viability	Carbon tax; Adequacy of portfolio risk evaluation, management and disclosure	Carbon tax impacts on fuel and costs; Regulatory changes; Border-tax adjustments; Trade sanctions or restrictions - e.g. reduced coal exports	Diminishing long-term investment viability for some sectors until the opportunities focus is taken	Challenge of holding investments to deliver optimum results in uncertain future	Changing flood lines or high-water levels may significantly impact cost of insuring some properties; Increase in solvency requirements may reduce the viability of segments
Consumer/market change	Consumers pushing for change (e.g. anti-fossil fuels); Civil society or global pressure; Reputation management	Changing consumer pressures; Reputation management	Short versus long-term returns; Reputation management; Investment losses	Delivering optimum long-term returns; Members push for climate-friendly investments	Likelihood of decreasing affordability due to risks increasing; Pressure groups pushing for withdrawal of underwriting for some businesses (e.g. coal)
Stranded assets	Assets retired before end of economic life creating stranded investments	Assets retired before end of economic life creating stranded investments	Investments in assets that become unviable before loan or investment periods end	Investments in assets that become unviable before loan or investment periods end	Increasing cost of claims for high risk infrastructure leads to assets being abandoned – creating social issues
Liability					
Directors' and officers' liability insurance and disclosure risk	Cost/pricing and attribution of climate-related risks) Questions re directors' role and adequacy of disclosure Attribution to climate risk challenging; Potential of increased litigation regarding negligence or lawlessness				

* Based on the TCFD and publications of UNEP FI and SA expert input

5. BANKING

5.1 ENVIRONMENTAL AND SOCIAL RISK MANAGEMENT IN BANKING

E&S risk management in banking has been focused on project-related risks or those arising from large deals, usually under the banner of the Equator Principles⁴² and applying the International Finance Corporation (IFC) Performance Standards⁴³ as the benchmark. These standards cover risk management, labour, resource efficiency, community, resettlement, biodiversity and cultural heritage. The application of the Equator Principles is voluntary and applicable to large corporate and investment banking deals, therefore few banks apply E&S risk identification and management of any significance to smaller or short-term finance deals or to their retail portfolios. Application of the Equator Principles or systems for assessment vary considerably from bank to bank and excludes the majority of the deals.

Climate change creates new and additional risks for all banks, not yet fully covered by the performance standards or the Equator Principles and not yet reaching into the commercial and retail portfolios, and therefore warrants significant new focus.

Table 4: Climate change risks for banks

BANK SPECIFIC CLIMATE-RELATED RISKS	CREDIT	MARKET	OPERATIONS
Physical	Increasing flood risk to mortgage or property portfolios	Severe weather events lead to re-pricing of sovereign debt Global supply chain disruptions	Severe weather impacts business continuity (banks and clients)
	Declining agricultural output increases default rates		
	Related water issues impact manufacturing and tourism		
Transition	Regulatory changes impact client margins	Companies revalued due to policy and consumer changes	Stakeholder pressure on banks leads to reputational risks
	Disruptive technology or consumer choices lead to stranded assets and impaired portfolios		
	Disruptive technology leads to client losses		Liability and disclosure issues
	Tightening building and energy efficiency standards impact property portfolios		

42 Equator Principles: <https://equator-principles.com>

43 IFC Performance Standards: https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Policies-Standards/Performance-Standards/

5.2 THE SPECIFIC RISKS POSED BY CLIMATE CHANGE TO THE BANKING SECTOR

Climate change affects the banking sector directly, through their own operations and indirectly through their lending, mortgage, investment and trading books. Extreme weather could potentially threaten their physical assets – many banks have significant property holdings for their retail and back office and data processing facilities – as well as have an impact on the value of the properties they hold as security over mortgage or commercial loans. Normal commercial banking activity could also be severely impacted by weather events.

Transition risks for banks are largely indirect and the result of the impact that disruptive, cleaner technologies, as well as regulatory or market change would have on their clients. These could increase the risk of defaults or stranded assets and also impact on banks' earning revenue from project finance and transactional banking. Potential liability and reputational issues also arise for banks when faced with decisions about what companies and what activities to finance. Growing pressure to move away from funding fossil-fuel-based energy generation is a case in point.

5.3 SECTOR OVERVIEW

As of June 2019, the Prudential Authority (PA)⁴⁴ reported that South Africa has 19 registered banks, 4 mutual banks, 4 co-operative banks and 15 local branches of foreign banks. In addition, there are 30 foreign banks with authorised representative offices in South Africa. Despite this, the banking sector is highly concentrated with the five largest banks controlling about 90% of total assets, (worth approximately R5,8tn, as of June 2019). The data reported to the PA does not include assessments of portfolio exposure on climate change, E&S risk assessments or details of green or sustainable finance initiatives.

5.4 GOVERNING LEGISLATIVE FRAMEWORK

Banks are subject to numerous pieces of legislation, none of which include specific requirements to identify, evaluate or manage environmental, social or climate-related risks. The legislation includes:

- Financial Sector Regulation Act No 9 of 2017
- The Banks Act No. 94 of 1990
- The National Payment Systems Act No. 78 of 1998
- The Currency and Exchanges Act No. 9 of 1933
- The National Credit Act No. 34 of 2005, which governs lending practices
- Financial Intelligence Centre Act, Act 38 of 2001
- Financial Sector Charter
- The prudential requirements are supervised by the PA and the market conduct requirements are supervised by the FSCA, which published a Conduct Standard for Banks in 2020.

44 SA Reserve Bank June 2019 selected South African banking sector trends. <https://resbank.gov.za>

5. BANKING - CONTINUED

5.5 REGULATORY REQUIREMENTS TO ADDRESS SUSTAINABILITY RISKS

While there is no banking specific legislation or sub-ordinate regulation, which imposes explicit requirements on banks to manage risks to the climate, the physical environment or society, they are subject to the Companies Act, which requires the mandate of the Social and Ethics Committee to address the 10 Principles of the UN Global Compact.

In addition, many of South Africa's leading banks are listed on the JSE and as such are required to comply with King IV.⁴⁵ They should therefore publish an annual integrated report,⁴⁶ which includes material aspects relating to the value creation processes and all forms of capital used or impacted by organisations: financial, manufactured, intellectual, natural, social and relationship, and human. This means that critical risks such as climate change should be integrated into the strategy and operations of the bank before being reported.

While it is not a regulated requirement, as a foundation to integrated reporting, companies should also provide detailed sustainability reports based on the Global Reporting Initiative (GRI), or similar, standards.⁴⁷ Current reporting frameworks do not specifically focus on the underlying ESG risks that banks are exposed to through the activities of their clients.

5.6 INTERNATIONAL TRENDS

The coverage of sustainability issues by banking regulators internationally is variable and responds to different, localised motivations based on the specific dependencies or exposures of their economies to drivers of risk and their existing governmental responses. The recommendations of the Task Force on Climate-related Financial Disclosures, which were developed by the Financial Stability Board at the request of the G20, and the Network for Greening the Financial System, which includes central bankers and supervisors, are driving greater understanding of the climate-related risks to the global economy and appropriate responses. The Reserve Bank joined the Network for Greening the Financial System in 2019.

Some approaches that have been identified:

- i. Understanding the implications of climate change factors through better research into impacts on value creation
- ii. Using guidance notes and prudential regulation to promote the integration of E&S factors in risk management at the transactional level, and in all corporate governance and operational processes
- iii. Stimulating finance / investment to help address or solve the root causes of climate risks by adjusting incentives and requirements available to companies.
- iv. Requiring disclosure of methodologies for determining material risks
- v. Inclusion of progress on sustainable banking principles in supervisory visits.

While South African banks are required to report to their regulators on risk, the frameworks for evaluation and reporting E&S risk are not specified or scrutinised by supervisors. Those in common usage, including the International Finance Corporation's performance standards do not yet fully support an assessment of climate risk. This results in a lack of consistency and creates a challenge for regulators in developing a full picture of the underlying strategic, portfolio or transaction risks, e.g. direct and indirect climate change exposure or exposure to risks resulting from a failure to achieve SDGs. Given the longer term nature of environmental and social risk, further work on methodologies may be required. The IFC performance standards are applicable for project finance transactions but need to be adapted and used in conjunction with local law (which seldom includes climate risk assessment) for other transactions.

⁴⁵ JSE listed banks are Absa, African Bank, First Rand, Standard Bank, Nedbank, Investec, Bidvest through Bidvest Group, Finbond, Capitec, Rand Merchant Bank Holdings.

⁴⁶ **Integrated Reporting Framework:** <http://integratedreporting.org/resource/international-ir-framework>

⁴⁷ **Global Reporting Initiative standards:** <https://www.globalreporting.org/standards/>

Basel III's pillars 2 and 3 are unfortunately limited to credit and operational risk. The risk aversion which emerged post the 2008 financial crisis has led to some critics viewing Basel risk coverage guidelines as contrary to the need to stimulate the uptake of new and transformative technologies, such as renewable energy which have a longer term financing requirement. The EU High-level Expert Group on Sustainable Finance, has recommended a review to prevent curtailment of European bank lending in the areas that are critical for sustainable finance'.⁴⁸

UN Principles for Responsible Banking: At the global launch of these Principles at the UN in September 2019, 130 global banks, including three South African banks became founding signatories. The Principles were developed by banks with extensive stakeholder consultation under the auspices of the United Nations Environment Programme Finance Initiative (UNEP FI). Signatories commit to linking sustainability issues to core banking strategy and to setting targets on issues material to their portfolios in pursuit of the achievement of the sustainable development goals (SDGs) and the Paris Agreements on climate change. The Banking Association of South Africa (BASA) has formally endorsed the Principles but they are not a formal condition of membership.

5.7 BANKING SECTOR APPROACH TO SUSTAINABILITY

The experience of banking practitioners and banking regulators in addressing sustainability issues has so far been driven by concerns of risk management. While this practice remains fragmented and incomplete, it is nonetheless increasing in both volume and sophistication.

Existing E&S risk focus and expertise in banks is by and large at the transactional level, where these risks are a potential source of credit or reputational risk. Internationally, leading banks are also seeking a better understanding of their exposure to specific environmental risks – and the social impacts that these provoke – at a system-wide/portfolio level (e.g. exposure to climate change, drought or energy availability and, for example, the resultant water scarcity, livelihood or migration risks).

Sustainable banking in South Africa predominantly relies on voluntary initiatives, the implementation of which are not currently supervised by the PA or the FSCA. These voluntary initiatives can be thought of as being a combination of internationally developed standards and locally developed strategies (see table below).⁴⁹ Implementation strategies that focus on ensuring consistency in approach and outcome of these standards and moving them from voluntary to regulated may be one means of achieving quick wins for sector supervisory authorities.

Table 5: Banking standards applied in South Africa

STANDARD	APPLICATION IN SOUTH AFRICA
Equator Principles	For project finance transactions in excess of USD 10 million and large corporate finance deals. ABSA, First Rand, Nedbank and Standard Bank have all committed to the Equator Principles risk management framework. EP signatories publish high level details annually of approved transactions.
UN Global Compact	Investec and Nedbank support the global UN Global Compact , which requires that they adopt sustainable and socially responsible practices in their lending practices.
Dow Jones Sustainability Index	Some of South Africa's large banks also participate in the global Dow Jones Sustainability Index , where they are ranked very highly in respect of developing economies. DJSI participants are evaluated on published reports and additional detailed questionnaires.
UNEP FI	First Rand, Standard Bank and Nedbank are members of United Nations Environment Programme Finance Initiative (UNEP FI) . E&S officers from some of South Africa's banks have participated in the UNEP FI Environmental and Social Risk Analysis (ESRA) training courses. Some banks also use a variety of internal awareness raising and/or computer-based E&S risk management programmes and literature. Content and approach varies by institution.

⁴⁸ EU High-level Expert Group on Sustainable Finance, banking recommendations: https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

⁴⁹ For example, where projects fall below the Equator Principle threshold of \$10 million, individual in-house social and environmental risk management frameworks have been developed.

5. BANKING - CONTINUED

STANDARD	APPLICATION IN SOUTH AFRICA
UNEP Positive Impact Manifesto	FirstRand, Nedbank and Standard Bank have signed the UNEP Positive Impact Finance Manifesto . Some of these signatories have already made progress in this regard, e.g. Nedbank's Fair Share 2030 initiative, with the others in the process of creating their own monitoring and reporting dashboards.
Principles for Responsible Banking	UNEP FI and 28 of its members from around the world co-developed a set of Principles for Responsible Banking. First Rand, Standard Bank and the Land Bank as well as banks from Nigeria, Kenya and Egypt participated in this development. The first South African banks to sign their commitment to the Principles were Standard Bank, Absa and the Land Bank. The six principles focus on the alignment of the bank's core strategy with sustainability needs; creating positive impact; working with clients and customers to achieve sustainability goals; collaboration with other stakeholders, such as regulators and public interest groups; establishing effective governance systems to support sustainability; and transparency and disclosure. The signatories are required to annually disclose their performance on material aspects.

Based on the international trend of increased focus on E&S risks by banks, BASA in partnership with its members developed a banking-specific policy framework for E&S risk management. Since 2011, banks have voluntarily committed themselves to BASA's Principles for Managing Social and Environmental Risk, which focus on four areas:

- i. Own operations and procurement** – recognising that members need to manage their own organisational impacts and promote responsible practice through their value chains.
- ii. Lending practices** – ensuring that credit and risk management policies give due recognition to E&S risks when making lending decisions, and lenders are thereby encouraged to adhere to E&S regulations and legislation.
- iii. Investment practices** – requiring members to maintain appropriate E&S due diligence guidelines for investee companies in high-risk industries.
- iv. Products and services** – developing sustainable technologies through the provision of lending facilities and financial products in support of the national agenda.

The Principles apply to all financial activities but the implementation is not mandatory. There is no enforcement or disclosure mechanism nor are there consequences for failing to adhere to them. The BASA Principles could, however, inform a regulatory framework as could the UN Principles for Responsible Banking.

A Sustainable Finance Committee within BASA discusses the implementation of the Principles and shares good practices. In addition, BASA members worked with the BankSETA⁵⁰ to develop E&S risk assessment (ESRA) training. The intent was to provide material which could be used by any bank or the BankSETA to provide frontline staff with an understanding of sustainable finance, including the importance of E&S risk management. However, the big four universal banks in South Africa have their own – individualised – training programmes.

5.8 SECTOR PROGRESS ON SUSTAINABLE FINANCE

Internationally, bonds and loans are increasingly a favoured means of raising sustainable finance, subject to criteria for categorisation and use of funds to ensure credibility. BASA members have issued green bonds of more than R18 billion for renewable energy and have set up green credit lines. Public disclosure of the terms and impact of disbursed funds is not highly visible. Expansion of this market and further innovations will be needed to achieve the scale of financing needed to address the SDGs and the economic transformation needed to respond to climate change. Members of the Sustainable Banking Network,⁵¹ an international network of bank regulators and banking associations from 17 emerging market countries have recently published a paper on creating a green bond market. Development Finance Institutions (DFIs) have also provided concessionary financing used blended finance solutions.

50

51 https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/company-resources/sustainable-finance/SBN_GreenBond

5.9 CHALLENGES

Basel III regulations, which require banks to reduce exposure to longer-term risk, specifically liquidity risks in LCR and NSFT, can pose a challenge. For example, under Basel III, banks are required to hold 5% of common equity of risk-weighted assets, with an additional capital conservation buffer of 2.5%. Disruptive technologies like renewable energy attract a higher capital charge due to its history of default.

A considerable challenge for banks is the need to swap hard currency funding to local currency, which creates additional risks and inefficiencies when considering these funding decisions.

Practices, products and methodologies vary across the banking sector and not all locally registered banks subscribe to all the voluntary principles. This does therefore mean that there is, as yet, no national benchmark for performance on social and environmental risk assessment or management practice.

Regulators are therefore unable to draw conclusions on exposure to climate change and other ESG risks from published information – which in the case of some banks focuses only on operational or in-house facilities and in the case of others extends partially into major transactions funded, such as those project or bridging finance deals that fall within the Equator Principles. No system of assessing performance maturity exists as there is no requirement for banks to account for or disclose their implementation of the BASA principles. Internationally there is growing pressure on the financial sector as a whole and banks in particular to recognise their role in enabling financial flows to address global challenges.

The drivers behind regulatory adjustments, both local or global, often acknowledge a broader relationship between societal needs and expectations and the safety and soundness of the financial system than has previously been accepted. Moreover, the increasingly mainstream focus of banks and banking regulators on topics such as financial inclusion sets a precedent for greater involvement of financial institutions and their regulators in finding solutions to E&S risks.

5.10 BANKING SECTOR RECOMMENDATIONS

The PA and FSCA might need to:

- Engage with banks on a set of minimum requirements for sustainable finance, including long-term climate and biodiversity-related strategies and portfolio level risk management during supervision programmes.
- Engage with banks on the risks posed by international regulations, such as non-tariff barriers to trade, that may be a consequence of South Africa not moving fast enough to reduce the carbon-intensity of its energy system.
- Do further analysis on feasible regulatory instruments which focus on:
 - Formal climate risk management policies and strategies, disclosure of targets, methodologies and performance data using internationally endorsed disclosure frameworks and science-based methodologies; and the incorporation of climate risk management provisions and investment conditions into legal agreements; as well as disclosure of funding policies and exclusion lists.
 - Requirements for banks to publish a climate risk management policy and strategy, aligned with South Africa's international climate commitments, including supporting financial stability. They may consider using agreed minimum disclosure requirements, such as reporting of portfolio exposure to climate change.

Regulators and industry to:

- Co-develop technical guidelines to facilitate implementation and disclosure on performance with regard to addressing climate and other key environmental and social risk management.
- Develop specific capacity building and technical training programmes to enable regulators and directors of banks to exercise sufficient oversight and bank management teams to implement sustainable finance strategies.

5. BANKING - CONTINUED

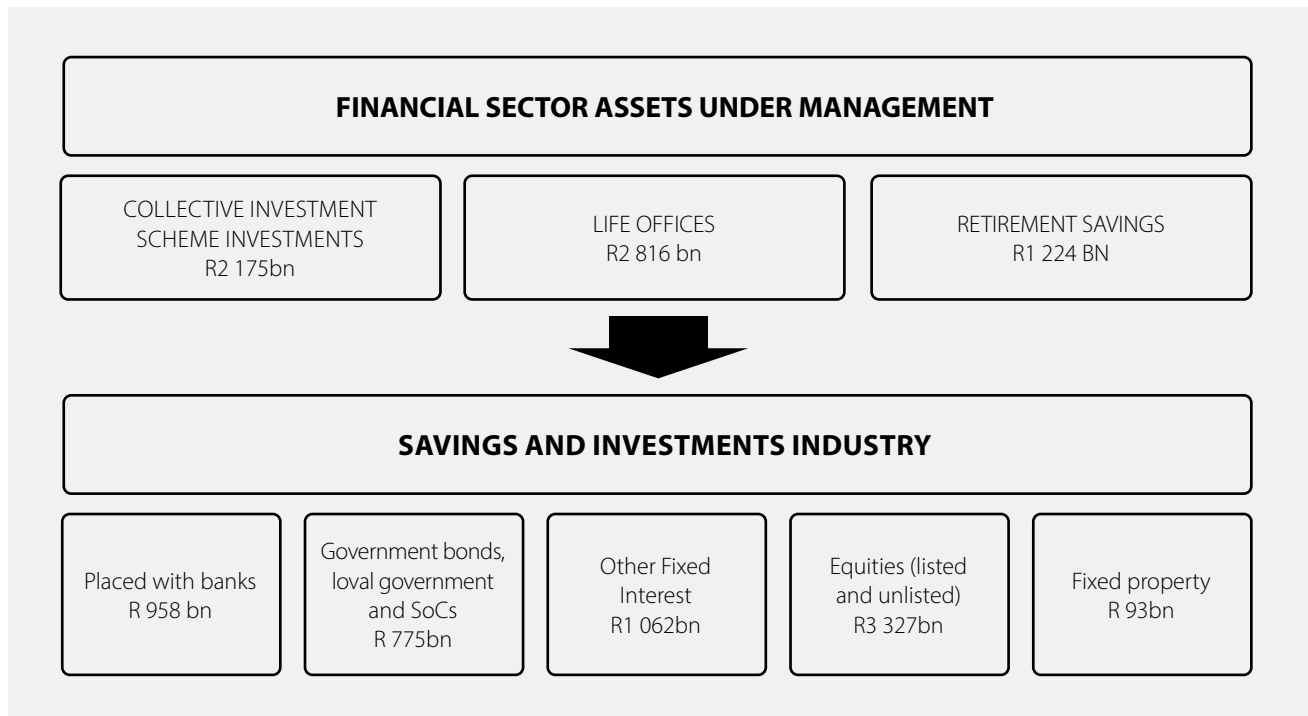
- Work together to find solutions to challenges linked to longer term risk and capital holding requirements as well as the tax implications of attracting and allocating international concessional funding.

Banks to:

- Fast track implementation strategies for the international standards listed in Table 3, which address both climate change, biodiversity conservation and the SDGs.
- Internally, define roles, systems and methodologies, responsibilities and competencies and incorporate the substance of the BASA Principles into their oversight regime.

6. RETIREMENT FUNDS

Figure 5: The savings and investment industry



6.1 RETIREMENT FUNDS SECTOR OVERVIEW

Retirement funds are one of the primary savings vehicles for most South Africans. There are 5143 retirement funds in South Africa (not all of which may be active), which administer funds and protect the long-term savings of more than 16 million contributing members and pensioners. The assets are some 110% of GDP⁵² and are administered through 2946 privately administered funds, 2188 underwritten funds⁵³ offered by insurers and public sector funds.

Retirement funds are fundamentally long-term investors on behalf of their members. They are particularly vulnerable to climate change risk, and the risk posed by investing in stranded assets.⁵⁴ For example, an investment in a coal mine may deliver short-term returns but over time may not hold value, as consumer trends and regulation force reductions in the use of coal-based energy. Climate change and environmental and social factors are potentially important drivers of portfolio risk and return.

The savings of contributing members are cycled by retirement funds mainly into fixed-interest investments and equities. They have collectively invested R4,4bn into renewable energy, township development, affordable housing, urban regeneration, student accommodation, water, roads and agriculture (emerging farmers). See Figure 8.

52 Source Asisa

53 The only assets of this type of fund are policies of insurance. Contributions are paid directly to the insurer and the insurer then undertakes to pay benefits as and when they become payable by the fund.

54 Stranded assets are primarily a problem of countries, investors and consumers that have invested in a specific resource. Stranded assets can be investments, infrastructure, equipment, contracts, know-how and/or jobs.

6. RETIREMENT FUNDS - CONTINUED

There is, however, no consistent methodology across the sector for the screening of risk, or the establishment of key metrics for measuring, monitoring and disclosing progress. ASISA has called for the inclusion of some categories of infrastructure development in the definition of sustainable finance.

6.2 GOVERNING LEGISLATIVE FRAMEWORK

The primary legislation regulating the retirement funds sector is the Pension Funds Act No. 24 of 1956, which provides for the registration, incorporation, regulation and dissolution of retirement funds.

6.3 REGULATORY REQUIREMENTS TO ADDRESS SUSTAINABILITY RISKS

The updated Regulation 28 under the South African Pension Funds Act came into effect in July 2011, and included a new requirement for retirement funds to consider environmental and social issues in assessing factors that materially affect the sustainable long-term performance of retirement fund assets. It offers broad principles rather than specifying the approach. The FSCA supports the Code for Responsible Investing in South Africa (CRISA) as a means of giving effect to Regulation 28. On 14 June 2019 the FSCA issued Communication 1 of 2019 (PFA),⁵⁵ relating to a Guidance Note on the sustainability of investments and assets in the context of a retirement fund's investment policy statement. Regulation 28(2)(c)(ix) requires that all boards of funds consider ESG factors before investing in an asset. The Guidance Note is to provide guidance to boards of funds on how the fund must comply with the Regulation, in particular how its investment philosophy and objectives, as reflected in its investment policy statement seek to ensure the sustainability of its investments and assets.

6.4 INTERNATIONAL TRENDS

From a policy perspective, there is a desire to harness the financial weight of institutional investors to support global accords such as the Paris Agreement, the Convention on Biological Diversity and the Sustainable Development Goals. Civil society is also putting growing pressure on institutional investors to use their influence to change ESG practices at investee companies.

The inclusion of ESG factors in regulatory frameworks for retirement funds is relatively new. In nearly all countries, it is at the discretion of retirement funds and asset manager to determine how ESG integration is consistent with prudential standards, risk controls, legal requirements, conflict of interest safeguards and any other obligations they may have towards their beneficiaries.⁵⁶

Internationally, retirement funds have been leaders in requiring additional disclosure of E&S risks from target investees. In France, the French additional retirement fund invests government employees' funds only in companies that have been E&S risk screened using publicly declared methodologies.

6.5 SECTOR APPROACH TO SUSTAINABILITY

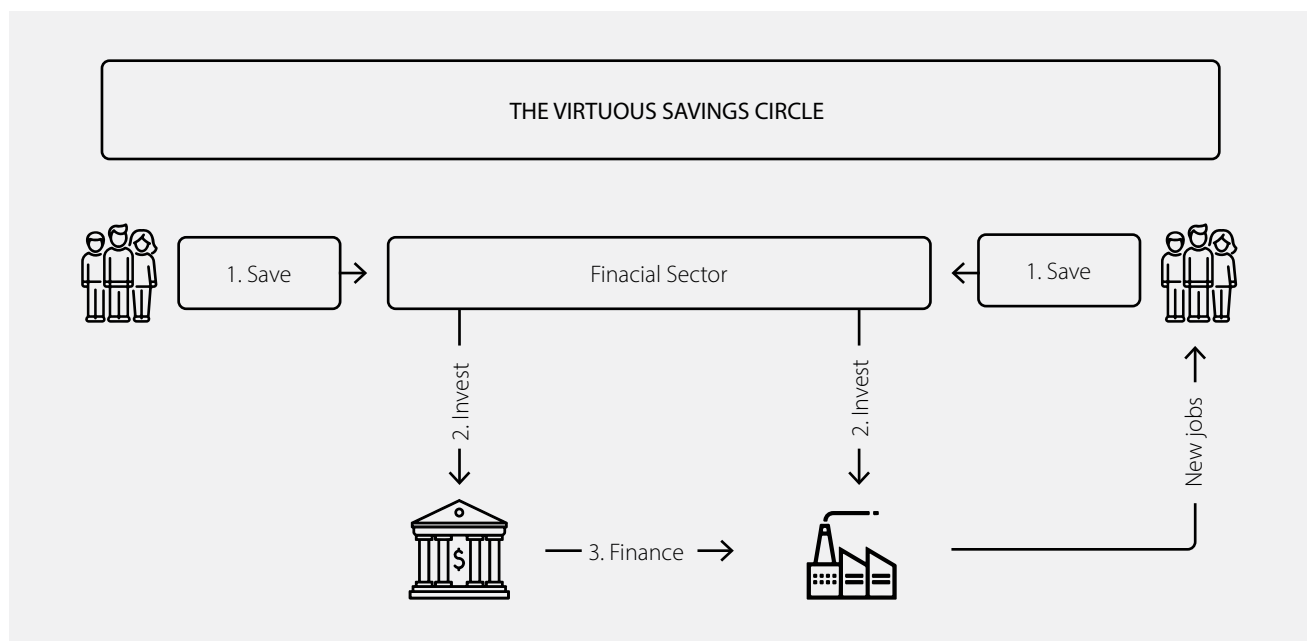
The sector approach has been driven largely by voluntary codes of practice, such as CRISA, which was adopted in 2011. The five key principles were inspired by the UN Principles for Responsible Investing (UNPRI) and were strengthened by law in 2011 (Regulation 28 under the Pension Funds Act) and by the King Code (Principle 17) in 2016.

⁵⁵ FSCA Guidance Note on Sustainability of Investments: [www.fsc.co.za/Regulatory%20Frameworks/Temp/FSCA%20Communication%201%20of%202019%20\(PFA\).pdf](http://www.fsc.co.za/Regulatory%20Frameworks/Temp/FSCA%20Communication%201%20of%202019%20(PFA).pdf)

⁵⁶ OECD Paper: <https://www.oecd.org/cgfi/Investment-Governance-Integration-ESG-Factors.pdf>

The Code for Responsible Investing in South Africa (CRISA) provides guidance on how institutional investors should execute investment analysis and investment activities and promote sound governance. Its voluntary principles are aligned with those of the UN Principles for Responsible Investing (UNPRI).⁵⁷ Following international trends, the CRISA committee is exploring the need for increased focus on disclosure requirements and is developing a business plan and finance model to increase CRISA's impact and ability to deliver on its objectives

Figure 6: ASISA depiction of financial flows



6.6 INDUSTRY PROGRESS ON SUSTAINABLE FINANCE

Launched in 2011, the Sustainable Returns for Pensions and Society project, an initiative of BATSETA (formerly the Principal Officers Association), with support from industry stakeholders and the International Finance Corporation IFC, set out to empower South African retirement funds to comply with revised Regulation 28 and the CRISA code.

The initiative led to the publication of "Responsible Investment and Ownership – A Guide for Pension Funds in South Africa",⁵⁸ which includes recommended action steps for pension funds to implement the requirements of Regulation 28. The outcomes were endorsed by National Treasury and the FSCA. The Guide identifies the key practices and outcomes involved in responsible investment and ownership and includes:

- Using ESG insights to help manage investment risks and returns, particularly over the long term
- Engaging with investee companies on ESG issues of concern
- Exercising the voting rights conferred by share ownership
- Formalising these points through appropriate policies and service provider agreements
- Being transparent and accountable on the above.

⁵⁷ The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practices. In implementing them, signatories contribute to developing a more sustainable global financial system.

⁵⁸ **Responsible Investment and Ownership Guide for Pension Funds in South Africa:** <http://sustainablereturns.org.za>

6. RETIREMENT FUNDS - CONTINUED

6.7 CHALLENGES

The following challenges to the integration of E&S risk management into the retirement funds sector and promoting sustainable finance have been identified:

- Difficulty in identifying appropriate investment vehicles.
- The short-term return on investment requirements which ignore long-term or systemic risks.
- The lack of a track record on returns of such investment vehicles and adequate proof that such investment initiatives achieve their objectives.
- Fund requirements from members for minimum growth each year highlighting the conflict between short-term growth and long-term risk.
- Lack of understanding of systemic and long-term ESG risks by boards of funds.
- Inadequate proof that certain investment vehicles will be in the best interest of the fund and its members without exposing a fund to excessive risk.
- Lack of capacity – knowledge, staff and tools. For example, Regulation 28 requires boards to, in making an investment and while invested, consider the investment's ESG character. However, they have not invested in the expertise for identification, evaluation and monitoring of investment opportunities and vehicles.
- To date the lack of detailed requirements for disclosure on implementing Regulation 28 has resulted in the potential for inconsistency and un-level playing fields. This will potentially be addressed through uptake of the guidance note on disclosure that was issued in 2019. It should provide the regulator/policy makers with a clearer view of what, e.g., funds are being invested into, how retirement fund board members assess their risk and it will enable greater consistency and risk mitigation.

6.8 RETIREMENT SECTOR RECOMMENDATIONS

- Regulators should issue guidance or regulatory instruments on sustainable finance.
- All investment decisions should consider environmental and social factors as well as climate risk, with implications for the training of boards, trustees and actuaries as well as investment managers.
- Co-develop or adopt guidance for the identification and monitoring of compliance to the sustainable finance framework and the Responsible Investment and Ownership Guide.⁵⁹
- Amend requirements for annual financial statement and other reports to ensure the disclosure, monitoring and reporting of responsible finance investments.
- Technical workgroup, including analysts and academics, to determine or adopt guidelines for Regulation 28 implementation, including making it easier to invest in sustainable finance investment vehicles or projects, green investments, monitoring and disclosure frameworks, and implementation of the guidance note published in 2019.
- Retirement funds and asset managers to develop and disclose E&S risk management policy frameworks and governance systems in line with the recommendations in the Guidance Note published in 2019.
- Include climate risk management capability in 'Fit-and-Proper' requirements for trustees, directors and executives.
- FSCA to work with National Treasury in developing the strategic framework indicated in this paper and specifically work on the harmonisation of requirements relating to sustainable investments across the financial sector.

59 UN Principles for Responsible Investment (UNPRI): <https://www.unpri.org/asset-owners/introduction-to-responsible-investment-for-asset-owners/4385.article>

7. COLLECTIVE INVESTMENT SCHEMES (IN SECURITIES AND HEDGE FUNDS)

7.1 SECTOR OVERVIEW

The Collective Investment Schemes Control Act (CISCA) 45 of 2002 defines a collective investment scheme as open-ended investment companies, through which members of the public invest money or other assets in a portfolio. Two or more investors hold a participatory interest through shares, units or any other form of participatory interest and share the risk and the benefit.

At the end of March 2017, the Collective Investment Scheme (CIS) in securities industry had R2.25 trillion assets under management, spread across 1626 portfolios. The industry saw R257 billion in net inflows from the previous year. At the end of 2017 R62,4 billion rand was invested in the CISs in hedge funds, a decline of R5 billion from 2016.⁶⁰

Hedge funds: South Africa is one of the few countries that regulate hedge funds, which since April 2015 are regulated under CISCA as per BN52 of 2015, but with different limits to those applied to CIS in securities. This provides for stricter regulation of Retail Hedge Funds (as opposed to Qualified Investor Hedge Funds) to ensure commensurate protection of ordinary investors, while the restricted (qualified investor) hedge funds target qualified investors, with commensurate and proportionate regulation, and a focus on systemic risk reporting, monitoring and adequate disclosure to investors. These do not include E&S risk assessments.

7.2 GOVERNING LEGISLATIVE FRAMEWORK

Investor's invested funds are commonly pooled for investment purposes through a FSCA-regulated CIS, managed by a CIS Manager. The issued participatory interests are normally available through the CIS Manager, a life insurer's linked investment service provider (LISP) or the Stock Exchange's brokers if it is an Exchange Traded Fund (ETF). LISPs are administrators that offer investors access to collective investment schemes (or unit trusts) across a number of different management companies, and invest proceeds in products with different tax implications, such as unit trusts, endowment policies, living annuities and retirement annuities.

A CIS in Securities is regulated by BN90⁶¹ in terms of asset limits and the permitted manner of investing by a portfolio.

CISCA regulates and controls the establishment and administration of CISs. As indicated, the assets of a collective investment scheme are managed by a CIS Manager (although usually outsourced to an investment manager, also referred to as an asset manager, authorised by the FSCA), who needs to be registered with the FSCA in terms of the CISCA. Each CIS must be approved by and registered with the FSCA and comply with the CISCA.

7.3 REGULATORY REQUIREMENTS TO ADDRESS SUSTAINABILITY RISKS

CISCA currently has no explicit requirements pertaining to E&S issues. However, there are requirements for the proposed manager of a CIS to have a documented risk management plan and for the manager to explain how frequently periodic evaluation of the risk management

60 <https://www.fsc.co.za/Annual%20Reports/FSB%20Annual%20Report%202017.pdf>

61 For further information on BN90 see: <https://www.fsc.co.za/Notices/Board%20Notice%20090%20of%202014.pdf>

7. COLLECTIVE INVESTMENT SCHEMES (IN SECURITIES AND HEDGE FUNDS) - CONTINUED

will be undertaken and provide detail. Notice 911 of 2010⁶² (currently under review for updating), sets out fit and proper conditions and requirements, including the need to provide the FSCA with information on the availability of appropriate resources, procedures and technological systems to eliminate possible risk of theft, fraud, dishonest acts, poor administration, negligence, professional misconduct or culpable omissions in order to protect the interests of investors.

7.4 INTERNATIONAL TRENDS

Work by the EU's High-level Expert Group on Sustainable Finance⁶³ has recommended that the definition of 'fit and proper' as it applies to directors and executives in the sector be amended to ensure that they are able to direct ESG risk assessment and mitigation, and in particular climate change risk assessment. The FSB's TCFD's recommendations on climate-related financial disclosures are gaining traction internationally with both regulators and leading companies. There is increasing evidence of litigation threats to companies or agencies that continue to invest in climate risky products and projects, such as the challenge to New York City over its investments in oil companies.

7.5 INDUSTRY PROGRESS ON SUSTAINABLE FINANCE

CISs in South Africa are in the initial stages of considering E&S risks and sustainable finance in general. Active ownership and investor engagement are at an early stage in South Africa but will likely have an increasingly key role in driving more sustainable financial outcomes. Anecdotal evidence suggests that retail customers are increasingly looking for sustainable/green options. A more systematic approach to defining sustainable finance would enhance the ability to attract funds and clarify benefits and expectations for investors.

7.6 CHALLENGES

The majority of the CIS industry do not yet take into consideration E&S issues and there is no overarching E&S risk management policy or guidance document for the industry. This reflects the low awareness of E&S risks faced by the sector.

It is viewed in a democratic society that an investor cannot be dictated to how he/she must invest their funds. Appropriate options need to be sought to balance out E&S interests, such as launching specific Green Funds for elected investment.

7.7 CIS RECOMMENDATIONS

- Identify potential financial policy innovations in order to increase sustainable finance in SA.
- Identify and address any perceived regulatory barriers that hinder industry's incorporation of E&S risks into their portfolio approach and transaction processes.
- Industry and regulators to increase technical collaboration, upskill and enhance capacity to align with international best practice and implement through education and training, by adapting the principles, methods and programmes which are widely applied by leading organisations in other financial industries.

⁶² For further details see: <https://www.fsc.co.za/Notices/Forms/AllItems.aspx/>

⁶³ https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

8. PRIVATE EQUITY

8.1 SECTOR OVERVIEW

According to the SAVCA Private Equity survey, Southern Africa's private equity industry recorded R158,6 billion in funds under management at the end of 2017. This represents a compound annual growth rate of 9,4% since the first edition of the SAVCA Private Equity Industry Survey which was published in 1999. Climate change risk may not at first appear to be a relevant risk to private equity firms, because they typically limit their holding periods. However, there is an increased risk to them if transitional factors linked to climate change, like changing regulation, the introduction of disruptive technologies or a decreasing appetite for products that have a high carbon intensity, make it harder to sell the investment at the planned exit in five to seven years. Awareness and regulation associated with climate change are growing, increasing transition risk.

In 2017, 77,3% (R122,7 billion) of funds under management (FUM) were unrealised investments, with the remaining R25,9 billion classified as undrawn commitments.

- Total FUM by captives – financial services increased by R3,5 billion in 2017.
- The captives – Government category recorded R28,2 billion under management in 2017, unchanged from 2016.
- FUM by independents decreased by R19,5 billion, to R88,4 billion at 31 December 2017.
- Total undrawn commitments at 31 December 2017 reached R35,9 billion (2016: R58,2 billion), of which R32,5 billion (2016: R54,9 billion) are undrawn commitments of independent fund managers.
- Private equity fund managers predominantly have a generalist mandate, with some 65% of the FUM at 31 December 2017 in the generalist category (2016: 61%)

8.2 GOVERNING LEGISLATIVE FRAMEWORK

Private equity in South Africa is unregulated. The industry is not specifically catered for in the Financial Advisory and Intermediary Services Act.

The allocation by international retirement funds to private markets in developed markets can be as high as 30% to 40%. Regulation 28 has limited the allocation in South Africa to 15%.

On 11 December 2018, the Conduct of Financial Institutions Bill (COFI) was published for public comment. The COFI Bill provides a consolidated code of conduct for business framework across all financial services sectors and will be supervised by the FSCA. The COFI Bill also proposes to include private equity within its ambit. Therefore private equity will, in future, fall within the same regulatory framework governing all financial institutions. The COFI Bill is, however, still under development and may take some time before it is finally promulgated.

8.3 REGULATORY REQUIREMENTS TO ADDRESS SUSTAINABILITY RISKS

As the sector is currently not regulated, except via listings requirements where applicable, it is difficult for regulators to have a direct impact. This situation will change once the COFI Bill is enacted. Notwithstanding, pressure to incorporate E&S risk management models and increased disclosure of material risks could be exercised by development finance institutions, retirement funds and institutional investors or via specific directives. A review of the 'fit and proper requirements' for those directing or managing investments could also add a level of awareness and oversight.

8. PRIVATE EQUITY - CONTINUED

8.4 INTERNATIONAL TRENDS

The European High-level Working Group has recommended that the EU Commission create an action plan, including:

- Update its directives relating to financial statements and related reports to place greater emphasis on the need to integrate non-financial information and discuss the governance of addressing long-term and sustainability risks and opportunities.
- Change its accounting rules to specifically include 'sustainability and long-term investment objectives'.
- Investigate alternative accounting approaches to fair value/daily market valuation for long-term investment portfolios of equity and equity-type instruments. (They highlight that IFRS9 is seen by many companies as having a negative impact on long-term finance, including both investment and lending.)
- Embed a clear commitment to sustainability in the duties of company directors and into the governance rules related to company management, supervision and incentive structures.

The G20 2018 SFSG Synthesis report highlights voluntary options for developing sustainable private equity and venture capital markets, including:

- Promoting the establishment of incubators to accelerate sustainable finance initiatives.
- Facilitating multi-stakeholder dialogues to work on the interpretation of sustainability in investment obligations.
- Supporting the launch of demonstration projects and dissemination of good practice.
- Encouraging the clarification in the use of standards for managing sustainable investments via better disclosure and measurement of risks, results and impact.
- Promoting the development of a range of sustainable financial products and fund structures, suitable for a broad range of private equity investors (funds of funds).

8.5 SECTOR APPROACH TO SUSTAINABILITY

There is no universal approach to sustainability but the sector has innovated by being early investors in start-ups or growth companies or those applying sustainable technologies and business models. Private equity and venture capital funds are well positioned to back innovations through equity capital, which can tolerate risks and align quickly with the long-term interest of companies. There was significant private equity and venture capital interest in SA's REIPPP, for example. Private equity or venture capital funds typically hold investments for 3-7 years and exit by listing on public markets or selling to strategic buyers. The emergence of 'patient capital' funds, follow-on funds and other innovations has seen private equity claiming a stake in the sustainable finance markets. E&S risk management guidance is available from the IFC, the Dutch development bank, FMO, and the CDC toolkit. Development finance institutions that back private equity funds have pushed for the underlying companies in the private equity portfolios to comply with their guidelines as well as with local standards. However, few of these are yet to fully incorporate climate-related risk management. It is believed, by the IFC and other international funders, that sound environmental, social and governance practices improve the returns of private equity funds.

Private equity has played a significant role in enabling BEE participation in investments, which is fundamental to the growth and sustainability of the South African economy. In 2017, 36,9% of investments made were in businesses with ratings levels 1 to 4 of the Department of Trade and Industry (the DTI) BEE codes. These figures are in line with the general ratings for South African companies.

8.6 SECTOR INNOVATIONS IN SUSTAINABLE FINANCE

Internationally, private equity has played an increasing role in impact investing including in developing country markets such as Southeast Asia. Impact investors look for projects in which a financial return can be achieved alongside a positive social and environmental impact.⁶⁴ Internationally, impact investors sometimes seek out projects where they can play an early stage catalytic role or act as ‘patient’ capital accepting a slower return on capital invested. Impact investing is on the radar of the South African private equity sector not only from a risk management perspective, but also as potential opportunities to invest in sustainable businesses. ESG considerations and basic reporting tend to be a minimum consideration for private equity, with specific impact intentionality as well as detailed measurement methodologies and reporting for the market leaders.

8.7 INDUSTRY PROGRESS ON SUSTAINABLE FINANCE

Private equity has been a significant investor in the REIPPP scheme. However, uncertainty associated with offtake agreements resulted in the programme being delayed.

8.8 CHALLENGES

The limited size of the market and uncertainty about investment returns as well as a general lack of standardised terminology and methodologies for determining ESG and externality risks are believed to limit the development of this market. An added challenge is that the holding periods for investments of 5 to 10 years means that some risks may not be considered because they will manifest outside of these timeframes. The lack of an appropriate regulatory framework governing private equity also adds to the limitation on regulators to intervene and facilitate the implementation of requirements relating to ESG.

8.9 PRIVATE EQUITY RECOMMENDATIONS

- Request academics and professional bodies to analyse accounting rules for long-term investments and identify any potential barriers to sustainable finance practices.
- Promote the clarification and standardisation of terminology and methodologies for determining sustainability, which the sector believes hampers further investment.
- Disseminate case studies and best practice, such as those published by SAVCA,⁶⁵ the IFC and development finance institutions.

Embed requirements for sustainability assessments and commitments in the rules for governing bodies of all companies and requirements of directors.

⁶⁴ www.thegiin.org

⁶⁵ SAVCA: https://www.savca.co.za/wp-content/uploads/2017/04/Case-Study-Compendium-Final_Feb-2017.pdf

9. CAPITAL MARKETS

9.1 SECTOR OVERVIEW

Capital markets are the critical link between those who have capital and are willing to invest it, and those who require capital from others to grow and develop businesses. These businesses in turn contribute to economic growth and, ideally, benefit society by providing goods and services needed by society and by offering an avenue for the investment of savings to generate returns. There are five operational exchanges in South Africa. The JSE is currently ranked the 17th largest stock exchange in the world by market capitalisation and the largest exchange in the African continent. An exchange performs an integral function in the capital markets but is not the only actor in the ecosystem.

Increasingly the capital markets are providing finance for economic transformation – either for blending with public sector finance or as a private sector means of funding key initiatives. Green, social or climate bonds have attracted significant funds since their launch in 2007.

9.2 GOVERNING LEGISLATIVE FRAMEWORK

The JSE and other exchanges are governed by the Financial Markets Act and fall under the supervisory mandates of the Financial Sector Conduct Authority and the Prudential Authority. Exchanges in South Africa are recognised as self-regulatory organisations and supervise their own members. The JSE, for example, is licensed both as an exchange (market operator) and a clearing house (JSE Clear), which is a separate legal entity with its own board.

9.3 REGULATORY REQUIREMENTS FOR SUSTAINABILITY ASSESSMENTS

There are no regulatory requirements imposed on capital markets exchanges to introduce E&S risk assessments or screening, other than those specified in terms of the Companies Act,⁶⁶ regulated by the Department of Trade and Industry. However, the JSE Listing Requirements promote strong governance and disclosure by listed companies. In addition to compliance with specific governance requirements, companies must report on the extent to which they implement the principles of the King Code on Corporate Governance on an apply or explain basis. The A2X exchange follows an ‘admit to list’ model whereby they are secondary listing JSE-listed companies. The JSE can, however, be an important supporter of sustainable finance by driving awareness creation and through its convening capability to build capacity and promote innovation in the development of sustainability-related financial products.

9.4 INTERNATIONAL TRENDS

The World Federation of Exchanges (WFE) has released sustainability principles with the aim of enabling decision making based on improved environmental, social and governance information and to contribute to the mobilisation of sustainable finance and listing bonds, developing sustainability indices and ratings.

The WEF principles address disclosure guidance, the promotion of disclosure in accordance with international standards and against

⁶⁶ Regulation 43

science-based indicators, building consensus on a sustainability taxonomy and collaborating with market participants to develop products that will advance the sustainable finance agenda. The principles also call on exchanges to be effective in their own governance, operational processes and policies to support sustainability efforts.

The Sustainable Stock Exchanges Initiative (SSE), a body of 82 partner exchanges from around the world, has recently produced a report on how exchanges can promote the achievement of the SDGs, based on the collective input and analysis of the actions of 70 of its members. Their proposed Action Plan includes five main action areas and five supporting actions.

The action areas are:

- Strengthening disclosure (improving both the quality and quantity of disclosure of environmental and social data)
- Clarifying the duties of investors to integrate sustainability into their decisions
- Strengthening governance by introducing board responsibilities related to environmental and social factors
- Building capacity by training market participants on sustainability topics
- Facilitating investment towards achieving the SDGs by aiding investment flows via financial products.

The recommended supporting actions include:

- Working with relevant international or regional bodies to implement standardised guidelines or frameworks
- Producing roadmaps to support national or regional plans for sustainable finance
- Sharing experiences with other regulators
- Analysing the factors that influence the ability of market actors to support the SDGs
- Collaboration with relevant organisations to align efforts in support of the SDGs.

9.5 SECTOR APPROACH TO SUSTAINABILITY

The JSE is a signatory to the UNPRI, a founding member of the Sustainable Stock Exchanges Initiative (SSE) and active in serving on panels and committees related to responsible investment, sustainability and integrated reporting.

9.6 INDUSTRY PROGRESS ON SUSTAINABLE FINANCE

Investors progressively recognise that they can no longer ignore E&S risks when performing fundamental analysis and valuation. As such, the JSE has developed the following initiatives:

- i) The **JSE Socially Responsible Investment (SRI) Index**, launched in May 2004, in response to the emerging need for guidance for companies in relation to sustainability issues, and an opportunity for investors to acknowledge strides being made. The criteria served as the benchmark for companies striving to be or remain included in the SRI Index and offered a yardstick for companies. The Index was terminated in December 2015.
- ii) From June 2015 the JSE partnered with FTSE Russell, the global index provider, to establish the FTSE/JSE Responsible Investment index series. The JSE adopted the **FTSE ESG Ratings methodology**, and aligned with FTSE Russell's evolved ESG criteria and assessment process.

The adoption of the FTSE ESG Ratings methodology enables eligible JSE-listed companies to form part of a global universe of corporates whose disclosure practices are assessed against ESG factors. The comprehensive methodology and expanded access to ESG data provide investors with increased opportunities to integrate ESG considerations into their investments by making granular, comparable ESG data available on JSE listed companies on a historical basis.

- iii) To enhance issuer-investor interface about sustainability issues, the JSE has hosted the **ESG Investor Briefing** annually from 2011, inviting listed companies to present their sustainability strategies to representatives of institutional investors and asset managers.

9. CAPITAL MARKETS - CONTINUED

In September 2017 the JSE launched the Green Bond Segment. The intention is to ensure that the entry requirements are in line with emerging global standards for green securities, while retaining sufficient flexibility to cater for the local context. The rules then underwent formal consultation with relevant JSE advisory committees, the FSCA and a public comment process. In June 2020, the FSCA approved the extension of the JSE's Green Segment to be renamed the "Sustainability Segment". This segment now includes Social Bonds and Sustainability Bonds, and allows for the inclusion of other thematic bonds as required.

The regulatory principles that have been adopted by the JSE are in line with key factors that ensure the credibility and transparency of the instruments through the requirement for disclosure of the use of proceeds pre-issuance, external review and ongoing disclosure. The Green Bond Principles, Social Bond Principles and the Sustainability Bond Guidelines governed by the International Capital Market Association, were used as a benchmark standard that issuers would need to comply with, verified by a third party with the appropriate expertise to do so.

9.7 CHALLENGES

Despite being lauded as influencing corporates and offering a useful benchmark for investors, the SRI Index was not fully utilised as the investment tool it was intended to develop into. Beyond the fact that the investment community still lacked understanding about sustainability in general, barriers identified through consultation included:

- Limited availability of investment-grade ESG data
- The lack of differentiation from other core indices due to the fact that it was weighted in the same manner as other equity indices (i.e. no specific differentiation based on sustainability performance)
- The need to develop a trackable index to ensure continued value data used for the JSE SRI has not been consistent in format or readily comparable or accessible to investors.

9.8 CAPITAL MARKETS RECOMMENDATIONS

- Work with Institute of Directors, accounting professions, professional and industry associations and academic institutes to build capacity and enhance skills to undertake ESG risk identification, assessment and management for long-term issues.
- Regulators to strengthen reporting requirements for licensed exchanges to disclose both their E & S management and risk assessment frameworks and where feasible, those of their listed entities in comparable and science-based formats.
- Exchanges should promote green, social and sustainability bonds and other product innovations, based on adherence to best practice criteria and principles, to build credibility of these instruments.
- Regulators to develop a roadmap for increasing the contribution of capital markets to more sustainable financial markets.
- Roundtable with licensed exchanges to discuss collaboration with the regulators in writing requirements for long-term ESG risk identification, management and disclosure in their listing requirements.
- Regulatory requirements related to E&S should be issued.

10. INSURANCE

10.1 SECTOR OVERVIEW

Insurance companies consider risks over a relatively long-time horizon. The Prudential Authority's (PA) role as the prudential regulatory authority for insurance brings challenges such as climate change and the frequency of extreme weather events into focus and provides a starting point for examining the impact of systemic risks.

Long-term ESG risks are linked. Environmental disasters, such as floods or droughts or the destruction of infrastructure, inevitably cause social and health stresses – particularly for those who are not insured or under insured. Governance factors are critical to ensure that all consumers are treated fairly and that insurance companies are adequately capitalised to meet their obligations in a rapidly increasing risk environment.

Insurers are the entities to which others transfer their risk. Insurers are also institutional investors in their own right. The insurance sector therefore manages and prices risk, as well as being a source of long-term funding for individuals who invest in policies to protect their families in the event of death or disability. The challenge is the correct matching of risk and return to provide risk cover for the predicted more frequent and more extreme weather-related disasters, the changing demographics and emerging health issues linked to climate change, increasing pollution, etc. In addition, the FSCA has identified a need to increase access to both non-life and life insurance cover to individuals and businesses currently financially excluded from these protections.

10.2 NON-LIFE INSURANCE

It is estimated that the non-life market is split on a roughly 50/50 ratio between domestic line and commercial (including corporate) business. The two most significant classes are motor and property, which account for almost 74% of the total, with the balance of the six classes making up the remainder. The contribution per class of business to the total ranged from 3.0% (transportation) to 40.6% (motor) and remains relatively steady at these levels.

10.3 LIFE INSURANCE

The South African life insurance industry holds assets of more than R2,84 trillion and injects capital into the economy through payments to policyholders and beneficiaries, as a result of death and disability or when policies are surrendered.⁶⁷ The industry is strongly capitalised and recurring premium policy demand is linked to tax-free savings and investment products although retirement annuities fell by 17% in 2017, with drops also in single-premium retirement annuities.

10.4 GOVERNING LEGISLATIVE FRAMEWORK

- The prudential components of the Short-term Insurance Act and Long-term Insurance Act (53 and 52 of 1998) have been consolidated into a single Act, namely the Insurance Act, 18 of 2017, which came into effect on 1 July 2018. The Insurance Act gives effect to a

⁶⁷ 2017 statistics are the latest available audited figures: The sector grew by 6% to R2,84tn in 2017 compared to 2016. R469bn was injected into the economy.

10. INSURANCE - CONTINUED

number of policy projects by the National Treasury, inter alia, the solvency assessment and management (SAM) framework. The Prudential Authority (PA) is responsible for supervising the Insurance Act.

- The Insurance Act repealed all the prudential sections of the 1998 Acts. However, the conduct of business sections in the 1998 Short and Long-term Insurance Acts remain in force until a consolidated Conduct of Financial Institutions Bill⁶⁸ is enacted.
- The Insurance Act promotes financial inclusion in the insurance sector by providing a licensing framework for micro-insurers. The intention is to increase the availability of relevant insurance products and mechanisms that are simple to access and fit-for-purpose for low-income earners or, for example, weather insurance to small-scale farmers. The Insurance Act also lowers the barriers for entry into this market to enable the emergence of new or smaller service providers.
- The guiding principles for market conduct supervision are intended to be outcomes-based, intensive and intrusive whilst also being risk-based and proportional, in order to ensure that the regulatory framework ensures that fair consumer outcomes are being achieved across the financial sector.

10.5 REGULATORY REQUIREMENTS TO ADDRESS SUSTAINABILITY RISKS

The PA has two statutory objectives regarding insurance: promoting the safety and soundness of insurance firms and contributing to securing an appropriate degree of policyholder protection. A risk-based regulatory framework was legislated and became effective on 1 July 2018 to enable the PA to achieve these objectives.

This framework allows for all material risks to be identified and assessed even if not explicitly modelled (e.g. climate risk). Physical climate risk is dealt with more explicitly by requiring insurers to calculate capital requirements for natural catastrophe risk (although it is currently only calibrated for certain types of catastrophes). The framework deals further with both physical risk and transition risk implicitly by requiring insurers to have a documented risk management strategy. Apart from other aspects, it must describe each current material risk and emerging risk, and the insurer's approach to managing those risks. Operationally, an insurer's suite of risk management procedures and tools must, at a minimum, include a process for identifying and assessing new and emerging risks. An own risk and solvency assessment (ORSA) report containing this information needs to be submitted to the PA at least annually.

The following enhancements to this risk-based framework, relating to climate risk (i.e. physical and transition risk), are under consideration:

- Provide training to supervisors and create supervisory guidance on how to supervise this risk. For example, types of questions that can be posed to senior executives and board members in order to obtain more information from on-site visits.
- Enhance Pillar I requirements to quantify the risk more appropriately (i.e. as part of the ongoing assessment of appropriateness of the standard formula).
- Possibly creating Pillar II guidance on the risk management and governance requirements (e.g. those relating to the investment policy) that allows for climate risk to be explicitly considered.
- Enhance Pillar III requirements in order for important information on climate risks to be reported consistently.

Another key element for increasing the PA's understanding of sustainability risks is the attendance of and participation in insurance seminars, conferences and workshops (local and internationally) where climate-related topics are discussed and debated. The PA is also close to industry initiatives where innovative products are considered to mitigate the effects of climate risks (e.g. weather-based index insurance).

During the first half of 2019, the PA also surveyed the insurance sector in South Africa in order to assess its maturity in terms of climate risk reporting and more specifically the adoption of TCFD recommendations. Despite the voluntary nature of the survey, a response/

⁶⁸ The market conduct aspects of the LTI and STI Acts (including the relevant pieces of subordinate legislation i.e. the regulations and policyholder protection rules) will be transferred to the COFI Act or issued as standards initially under the FSRA and then likely under the COFI Act, once it is passed.

completion rate of 66% of all insurers in South Africa was observed. 79% of respondents surveyed believe that climate change will affect their business but only 37% already report on information relevant to climate change impacts. The survey did not only serve as an information-gathering exercise that helped the PA understand the maturity of climate risk reporting by insurers in South Africa but it raised awareness and signaled the importance of considering climate-related risks as part of an insurer's risk management framework.

Other challenges identified by the non-life insurance sector is that all spheres of government need to be more closely aligned in terms of managing E&S risks, which should be more strongly linked to government requirements at all levels. In this way these risks can be mitigated or avoided through improved town planning and development approvals processes and the uptake of water-smart or lower carbon technologies in provincial or national infrastructure development, for example, as well as incorporating these requirements into tenders, approvals and capital raising. By stronger coordination through all spheres of government in the creation of new city, provincial or national infrastructure projects, for example, risks would be lowered.

10.6 INTERNATIONAL TRENDS

The PA is a member of the Sustainable Insurance Forum, which has committed to undertaking work in six areas, including:⁶⁹

- Raising awareness of climate change risks and supporting related capacity building efforts
- Undertaking a survey on the adoption and supervision of the TCFD recommendations
- Establishing a working group to implement a recently developed question bank into supervisory practices
- Identifying priorities for research and analysis
- Engaging with central banks and supervisors
- Developing strategic communications and thought leadership on emerging issues.

Research by the Forum and the International Association of Insurance Supervisors shows that a growing number of financial regulators are beginning to incorporate sustainability into the way they oversee the sector.⁷⁰ Case studies from Australia, Brazil, France, Italy, the Netherlands, Sweden, the United Kingdom, California and Washington state were published and these indicate that while many of these are still at early stages, they are focused around national and sectoral financial stability and solvency, risk identification, stress testing and disclosure.

Over the last two years, there has been a noted shift in how supervisory and regulatory institutions are approaching sustainability issues, with a growing number of authorities acting based on their core prudential mandates and extending these to new environmental threats. Across this emerging body of experience, the International Association of Insurance Supervisors has a five-step framework for action by regulatory authorities:

- i. **Initial assessment:** Assessing the materiality of sustainability issues for the insurance sector, and implications for core mandates, objectives and strategies.
- ii. **Deepening risk analysis:** Exploring how environmental factors can be better evaluated and integrated into routine supervisory oversight at the firm level, as well as system-level stress testing.
- iii. **Improving information:** Gathering information from firms and promoting enhanced disclosure through voluntary guidance, surveys, and implementation of mandatory requirements, as well as enhancing transparency for consumers.
- iv. **Market transformation:** Supporting new insurance markets through product frameworks and partnership facilities and encouraging change in investment practice – building awareness and examining regulatory barriers.
- v. **Making systemic linkages:** Exploring connections between insurance and other financial sectors, real economy policy frameworks, and wider sustainable finance processes.

⁶⁹ Press release issued on 19 November 2018 by the Sustainable Insurance Forum

⁷⁰ For more information on Sustainable Insurance- Emerging Agenda For Supervisors and Regulators: https://docs.wixstatic.com/ugd/eb1f0b_0496a436802446f9a54b09c439417d0f.pdf

10. INSURANCE - CONTINUED

In addition to the work of the Sustainable Insurance Forum, insurers created the **UN Principles for Sustainable Insurance**, under the auspices of the UN Environment Programme's Finance Initiative. These are similar to the UN Principles for Responsible Investment and the Principles for Responsible Banking, and provide a global framework for addressing key risks in the insurance sector. They have been endorsed by SAIA but have not been widely adopted in South Africa

10.6.1 DISASTER RISK REDUCTION

Sustainable Finance is in essence about building resilience and addressing key ESG risks. At the time of the renegotiation of the global Disaster Risk Reduction Framework (the Sendai Statement) the UNEP Finance Initiative's Principles for Sustainable Insurance initiative, which includes leading South African non-life insurers, partnered with the UN and captured the role insurance could play in future as risk managers and risk carriers.⁷¹ This is based on the sector's ability to identify, assess and price risk and develop risk transfer solutions and reduction strategies. Resilience in the built environment must be driven by the public sector setting minimum standards and more generally with the insurance industry playing its role alongside governments in raising awareness of disaster risk and developing risk-sensitive investments and risk transfer solutions.

For life insurers climate change and emerging ESG risks are also significant factors. Increasing longevity and increasing health stresses linked to rising critical illness burdens, air pollution, heat waves and other factors require the industry to reconsider products to ensure access to finance over longer 'retirement' periods and for periods of long-term care.

10.6.2 PRODUCT INNOVATION

International trends in life insurance show innovations in product design such as longevity insurance, longevity swaps, bonds and releases of funds from existing properties while they are still occupied by the insured policy owners.

Africa: In 2018, around 100 significant weather events were registered for the continent of Africa. Almost 1,200 people were killed, the majority in flood events and flash floods in Nigeria and Kenya. Overall losses for 2018 are estimated at US\$ 1.4bn. Because of the low insurance density, however, insured losses are extremely low. In developing countries many victims of extreme events have virtually no insurance cover, meaning very few are able to replace their homes or belongings and the recovery takes years. Cyclone Idai, which hit Mozambique, was in relative terms worse for that country than the Tohoku earthquake – of the costliest natural disasters on record was for Japan in 2011.*

Source: Munich Re:

*The natural disasters of 2018 in figures, Munich Re: <https://www.munichre.com/topics-online/en/climate-change>

10.7 SECTOR APPROACH TO SUSTAINABILITY

Insurance is a market-based mechanism for the transfer of risk. The PA's role, through its statutory objectives, is to contribute to ensuring that this risk transfer can occur in a reliable and effective way through the South African insurance sector. There is, however, a need to extend access to affordable insurance to small-scale farmers, for example, who currently cannot effectively access insurance, and a public private partnership has been proposed to resolve this. (See box on page 48).

⁷¹ Statement on Disaster Risk Reduction commitment: <http://www.unepfi.org/psi/united-for-disaster-resilience/> and <https://www.tralac.org/news/article/10893-disaster-risk-reduction-africa-backs-action-onsendai.html>

Non-life insurance provides protection against damage and loss from a wide range of causes. Liability risks underwritten by general insurers can have a long tail, with compensation being sought several decades from the date of the insured event. On these timescales, the challenges of climate change become very real and significant

Non-life insurance is perhaps the more obvious sector for actively insuring against weather-related events. Therefore, some non-life insurers are at the forefront of evaluating and managing the day-to-day impact of extreme weather. A challenge for the regulator lies in the lack of consistency in and transparency about the models and methodologies used to evaluate risk.

10.7.1 INSURANCE CLIMATE RISK

The ways in which the insurance sector, and hence the PA's objectives, could be impacted by climate change are diverse, complex and uncertain. Importantly climate-related risks impact on the business strategies and balance sheets of all financial institutions, and by aggregation have the potential to impact national financial resilience and stability. The primary channels ('risk factors') through which such impacts might be expected to arise are:

- **Physical risks:** the first-order risks, which arise from weather-related events, such as floods and storms. They comprise impacts directly resulting from such events, such as damage to property and those that may arise indirectly through subsequent events, such as disruption of global supply chains or resource scarcity. For example, much of South Africa's communication and transport infrastructure passes through river valleys and mountain passes which are particularly vulnerable to damage by storms and floods. In addition to direct costs, disruptions in connectivity can result in significant additional secondary social and economic effects. Internationally there is intense focus on the need to "build back better" after disasters and this too is part of assessing, disclosing and addressing climate-related risks.
- **Transition risks:** the financial risks, which could arise for insurance firms from the transition to a low-carbon economy. These can come about through changes in regulation, changes in technology or consumer pressure. For insurance firms, this risk factor is mainly about the potential re-pricing of carbon-intensive financial assets, and the speed at which any such re-pricing might occur. There is potential for rising costs, and therefore decreasing affordability, of insurance premiums given the increase in risks. To a lesser extent, insurers may also need to adapt to potential impacts on the liability side resulting from reductions in insurance premiums in carbon-intensive sectors.
- **Liability risks:** risks that could arise for insurance firms from parties who have suffered loss and damage from climate change, and then seek to recover losses from others who they believe may have been responsible. Where such claims are successful, those parties against whom the claims are made may seek to pass on some or all of the cost to insurance firms under third-party liability contracts such as professional indemnity or directors' and officers' insurance.
- **Infrastructure risks:** For each of these risk factors, it is vital to explore the nature of the risk, the possible impacts on the liability and/or asset sides of insurance firms' balance sheets, and the actions firms are taking to mitigate them. The clearest risk is from the first category – physical risks. The other two risk categories are less well developed and more uncertain – nonetheless, they could have a meaningful impact on the PA's objectives over time.

Across these risk factors, there is potential for climate change to present a substantial challenge to the business model of insurers. While there are opportunities for the sector from writing new climate change-related business, it is also possible that climate change would reduce or eliminate the sector's appetite to provide insurance cover for specific sets of activities, assets or customers. This is relevant for the PA's objectives of safety and soundness and policyholder protection and could also be an area of interest for other policymakers, a point the report highlights where appropriate.

Potential impacts are most likely to impact the liability-side of general insurance firms' balance sheets. However, there is also some potential for significant asset-side impacts that could affect both general and life insurers.

By their nature, these risks do not appear likely to crystallise in full in the near term and a number of mitigatory steps are in place, which means that sector leaders are reasonably well-equipped to manage the current level of physical risks. Looking further ahead, increasing physical risks could present meaningful challenges to insurance business models and the full range of risks from climate change identified in this report will be important to consider.

10. INSURANCE - CONTINUED

Non-life insurance plays a very important role in providing financial resilience when extreme weather events occur. As such the sector is potentially exposed to environmental risk in a way that other financial subsectors are not, and it cannot ignore the impact of climate change on the South African landscape and the financial exposures it entails. A functioning insurance market is a key instrument to support the resilience of a country given the increased weather risk exposures that are anticipated.

10.8 INDUSTRY PROGRESS ON SUSTAINABLE FINANCE

The South African Insurance Association (SAIA), the industry association for non-life insurers,⁷² is a supporter of the United Nations Environment Programme's Principles for Sustainable Insurance Initiative⁷³ and ClimateWise.⁷⁴ However, they do not require their members to commit to these Principles, nor to disclose their impacts or activities. They have launched several initiatives over the past five years:

- **Seismic hazard and risk assessment for the Gauteng province research** – Research by the Council for Geoscience and University of Pretoria on the Probabilistic Seismic Hazard and Risk Assessment for the Gauteng Province, particularly related to the province's mining heritage and acid mine drainage.
- **Partnerships for Risk & Resilience⁷⁵ (previously Business-Adopt-a-Municipality)** – The programme was launched to encourage business to partner with local government structures to strengthen capability for risk management of environmental issues (fire and flood) as well as good governance in the form of regulations in terms of building codes, to enable local government to meet national disaster risk framework requirements. The Department of Cooperative Governance works together with insurers and reinsurers and municipalities to improve service delivery capacity of municipalities and create conditions for social upliftment and economic growth. While not yet a sector-wide initiative it has gained traction with some local and international companies.
- **Agriculture PPP Project** – Working together with the National Treasury and the Department of Agriculture, Rural Development and Land Reform on a public private partnership to provide index insurance. The Land and Agricultural Bank of South Africa, which is wholly owned by the government, also provides crop and asset insurance to farmers. In September 2019 the Land Bank Insurance Company signed an agreement with the InsuResilience Solutions Fund for a grant which will co-fund the development and market introduction of an innovative index-based insurance for crop and livestock for smallholder farmers in South Africa.

Weather-based index insurance:

The Department of Agriculture, Rural Development and Land Reform and the non-life insurance industry have for a number of years been working on an agricultural insurance solution to cover both commercial and emerging farmers. For emerging farmers a weather-based index insurance product offering has been designed, which will increase accessibility to insurance for emerging farmers affected by drought as the most pertinent starting point.

The non-life insurance industry, represented by the South African Insurance Association (SAIA), has provided significant insights, extrapolated from the experience of providing commercial farmers with agricultural insurance. The model proposed to the National Treasury would be a Public-Private Partnership (PPP) with the government and participants from the non-life insurance industry who are already underwriting agricultural insurance.

⁷² Non-life insurance provides protection against the happening of unplanned or uncertain events, other than a life event or death event or disability event not resulting from an accident. Life insurance is typically linked to mortality risks and long-term savings, such as annuities and endowments.

⁷³ More information on the PSI Initiative together with possible actions that insurance sector actors can take for increased sustainability can be found here <http://www.unepfi.org/psi/the-principles/>

⁷⁴ <https://www.cisl.cam.ac.uk/business-action/sustainable-finance/climatewise>

⁷⁵ <https://www.santam.co.za/financial/sustainability/>

Weather-based index insurance enables the grouping of emerging farmers in specific geographic zones to be insured at a reduced cost of insurance due to the product type that allows for the increased accessibility of drought insurance. The proposal is a request for financial support in the form of drought insurance premium subsidies for both commercial and emerging farmers against drought. The insurance is seen as increasingly important as farmers in South Africa face increasing adverse climate-related weather events, especially drought, for which insurances are increasingly becoming unaffordable.

- **Green Geysers Replacement Project with Department of Energy** – The programme was designed in 2014 to assist in climate risk mitigation. By replacing electric hot water heating systems with heat pumps or solar water heaters, the programme would have resulted in a significant reduction in greenhouse gas emissions and would have also taken demand pressure off the national grid. Hot water heaters (or geysers) are a major energy user in most households, adding significantly to household energy costs. The project did not achieve its original intentions due to numerous challenges, including localisation of manufacturing, life-cycle management and minimal impact on electricity demand. The programme is undergoing revision, including developing a framework for load reduction.

10.9 CHALLENGES

The insurance industry has identified the lack of coherent climate risk management policy definitions and standards (international, national and departments within government) and lack of clear and consistent policy signals as key challenges for integrating E&S risks into their operations. Other challenges include data gaps, the prohibitive cost of accessing data and tools, as well as public data not being accessible in risk tools.

The integration of environmental and social risks is still seen as a specialist activity which is costly. Reporting requirements with incentives to adopt a sustainable approach do not yet exist, which is a further hindrance to the integration of these risks and to the reporting of progress in working with clients to reduce the risks.

Non-life insurance risk data is currently held by each company for operational and risk management purposes. Prudential authorities need access to sector-wide data to ensure key risks have been identified and mitigated, to understand risk profiles and to ensure financial stability and long-term solvency. The potential for major events to affect the whole industry and thereby concentrate the risks, makes it essential to have a clearer picture of what steps are being taken to reduce the risks, including through client awareness raising, and to disclose residual risks.

Time horizons are not aligned for risk management and reporting purposes and consistent definitions and time frames linked to a financial system-wide taxonomy is needed.

A national adaptation plan is required, based on climate risk modelling and transition risk models for the South African economy.

Local government capacity and ability to manage climate change and associated social risks should be developed as they are accountable for a significant portion of infrastructure development and maintenance and hold primary responsibility for emergency services after events.

10. INSURANCE - CONTINUED

10.10 INSURANCE SECTOR RECOMMENDATIONS

- The PA may consider the impact of climate risks by way of gathering more information (initial surveys have been completed at the time of drafting this paper).
- The PA may enhance its supervisory processes to deal more explicitly with sustainability risks.
- The PA may consider various tools and instruments that can assist with the identification, assessment and reporting of material risks, including emerging risks.
- The PA may use regulatory instruments and supervisory tools to better its understanding of climate risks and the impacts on insurers as well as on the financial system.
- The PA should signal the importance of adhering to international standards and best practice.
- The PA may consider enhancing its ORSA requirements to more explicitly deal with the risk management of sustainability and specifically climate risks.

11. CONCLUSION

This paper highlights the urgency of enabling sustainable finance to flow towards building a more climate resilient and lower carbon economy for South Africa. Greater consistency is needed in defining both the problems and solutions and to this end regulators and industry sectors should consider the adoption of existing, international work to create a taxonomy for South Africa. Sustainability and making a just transition towards a lower carbon economy need to inform all financial decision-making, as the cost of post impact remedy far outweighs a precautionary approach.

To unlock the R2tn needed to address the transition risks faced by the country as a result of climate change, Treasury, working with government colleagues and the financial sector as a whole, must find ways to stimulate the flow of public, private and blended funds through improved capital allocations, enhanced risk identification and management, and the generation of new products dedicated to solving these problems. Greater disclosure will be needed and far speedier adoption of measures to achieve a resilient and developmentally focused economy.

An action plan is needed to turn this discussion into meaningful actions to enable:

- Building of capacity across all financial sectors
- Adopting of voluntary initiatives that include performance measures and monitoring as a precursor to regulation
- Adopting of a taxonomy that will assist in building credibility and consistency.
- Strengthen, implement and adapt existing regulatory tools and frameworks to drive better climate disclosure and mobilise finance for the Sustainable Development Goals.

The South African financial sector has an opportunity to work with urgency, and in concert with regulators, to take steps to protect the natural resource base and economy in the face of climate change and to create resilience in order to protect all citizens.



FINANCING A SUSTAINABLE ECONOMY

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