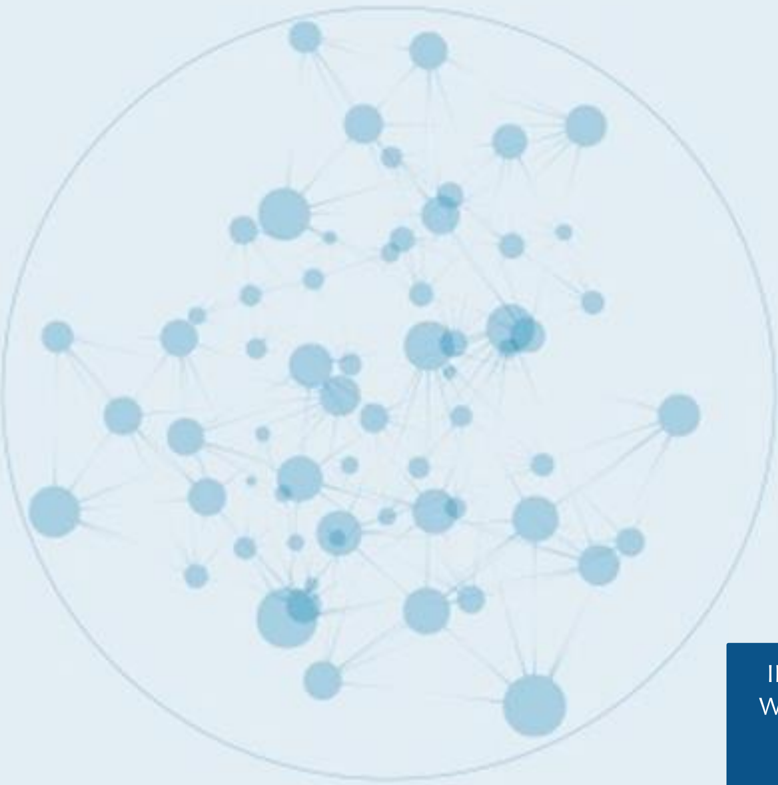
Inquiry: Design of a Sustainable Financial System

Global Green Growth Institute

UNEP

EXPERIENCE AND LESSONS FROM SOUTH AFRICA

An Initial Review



INQUIRY WORKING PAPER

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The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it published its final report, The Financial System We Need, in October 2015 and is currently focused on actions to take forward its findings.

More information on the Inquiry is at: *www.unep.org/inquiry* and *www.unepinquiry.org* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

Global Green Growth Institute

The Global Green Growth Institute (GGGI) is an international organization dedicated to supporting and promoting strong, inclusive and sustainable economic growth in developing countries and emerging economies. Established in 2012, at the Rio+20 United Nations Conference on Sustainable Development, GGGI is accelerating the transition toward a new model of economic growth – green growth – founded on principles of social inclusivity and environmental sustainability.

About this report

This working paper was written by Sharmala Naidoo (GGGI) and Alison Goldstuck. It is an initial scoping study that outlines South Africa's financial system and the challenges and innovations in aligning it to sustainable development. The paper draws on a series of semi-structured interviews, with 37 organizations between May 2014 and January 2015. Organizations included actors directly involved in commercial lending, retail banking, short-term insurance and institutional investing, such as regulators, asset owners, asset consultants, asset managers, industry associations. Experts who support these actors were also interviewed, which included policy think tanks, governance experts, lawyers and academics. Furthermore, the Inquiry recognizes the support of reviewers who gave insightful comments.

Comments are welcome and should be sent to *simon.zadek@unep.org* **and** *algold73@gmail.com***.**

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Executive Summary

South Africa is one of the world's most energy- and carbon-intensive economies. The government has set an ambitious vision to transform towards a resource-efficient development path. This requires nothing less than a structural change of the economy.

The financial sector is one of the country's strategic assets, with a highly skilled labour force, sophisticated infrastructure and the understanding that it needs to play a proactive role in achieving the country's development goals. Over the past decades, government, civil society and the financial sector engaged in a national debate about its role and responsibilities. It resulted in the ***Financial Sector Charter*** (FSC) to provide finance to key priority sectors and underserved communities. This experience suggests the potential for a similar approach to developing a more proactive role for financial policy in the development of the green economy.

South Africa has developed a series of green governance innovations which provide principle-based regulations requiring pension funds to consider environmental, social and governance risks as part of their fiduciary duty (*Regulation 28*), industry guidance on how to do this (*CRISA Code for Responsible Investment in South Africa*) and requiring that listed companies provide *integrated reports* on their social and environmental performance and risks. The approach uses soft regulation and peer pressure to motivate implementation and depends on market forces to drive shifts in investment behaviour. It has been successful in raising levels of awareness and reporting, but to date has had limited impacts on capital allocation.

Many in the financial sector argue that the primary reason for the slow transition to a greener economy are weak real economy signals, stemming from a lack of long-term policy direction that results in an uncertain future market and unpredictable returns for investors. The experience of the Renewable Energy Independent Power Production Procurement Programme demonstrates that the private sector is prepared to invest in areas of the green economy where transactions are reasonably profitable and key risks are mitigated by government.

Stakeholders also identified gaps and barriers in the financial system itself, and specific areas of potential for developing stronger financial policy frameworks for a greener, more equitable economy. Key areas highlighted include:

- Action to strengthen the practice of fiduciary duty;
- Development of the pipeline of projects and facilities to package projects with a developmental impact in the green economy space;
- Development of models to quantify environmental and social risks systematically;
- A clearer framework for lender liability;
- Reforming regulations for unlisted assets; and
- Developing a vision of a sustainable financial system with industry targets

Steps to move South Africa's financial system towards greater sustainability will need to be carefully negotiated and sequenced, alongside supportive real economy measures. The financial sector is one of the country' strengths and is well positioned for leadership. However, it is heavily exposed to the potential stranded assets and is fatigued by the pace and complexity of regulatory changes.

South Africa's experience as a pioneer of green financial policy innovation and more broadly of developing financial policy for social inclusion is likely to be valuable to others internationally facing the same challenges. This paper therefore highlights a series of topics and questions for further and deeper research into South Africa's experience and approach.

Acronyms

ABSA	Amalgamated Bank of South Africa
ASISA	Association for Savings and Investment South Africa
ABSIP	Association of Black Securities and Investment Professionals
BASA	Banking Association of South Africa
B-BBEE	Broad-Based Black Economic Empowerment
BEE	Black Economic Empowerment
BIS	Bank for International Settlements
BSD	Bank Supervision Department
CO_2	Carbon Dioxide
CRISA	Code of Responsible Investment in South Africa
DBSA	Development Bank of Southern Africa
DFI	Development Finance Institution
EY	Ernst and Young
ESG	Environmental, Social and Governance
FDI	Foreign Direct Investment
FIC	Financial Intelligence Centre
FSC	Financial Sector Charter
FSB	Financial Stability Board
FSB-SA	Financial Services Board, South Africa
FSI	Financial Sector Indicators
GDP	Gross Domestic Product
GHG	Greenhouse Gas
IDC	Industrial Development Corporation
IFC	International Finance Corporation
IFI	International Finance Institution
IMF	International Monetary Fund
IPP	Independent power producer
JSE	Johannesburg Stock Exchange
Mzansi	The brand name for the category of basic bank accounts launched in 2004
NEMA	National Environmental Management Act

NBFI	Non-Bank Financial Intermediary
NBI	National Business Initiative
NT	National Treasury
OECD	Organisation for Economic Co-operation and Development
PIC	Public Investment Corporation
PRI	Principles for Responsible Investment
RE	Renewable energy
REIPPPP	Renewable Energy Independent Power Producer Procurement Programme
SAIA	South African Insurance Association
SAM	Solvency Asset Management
SARB	South African Reserve Bank
SME	Small and Medium Enterprise
UNEP	United Nations Environmental Programme
UNEP FI	United Nations Environmental Programme Finance Initiative
WB	World Bank
WWF	World Wildlife Foundation
ZAR	South African Rand

1 Introduction

South Africa's abundant natural resources, unbalanced development and subsidized coal and electricity have resulted in a resource-intensive industry dominated by the mining sector and associated input and processing activities. It is thus one of the world's most carbon-intensive economies. While the emissions intensity of production is falling, it is happening much more slowly than in many other countries (OECD, 2013a).

The country is also environmentally vulnerable. One quarter of river ecosystems are critically endangered and pressures on limited water resources are high. While progress has been made in improving access to environmental services such as water, sanitation, waste management further investment is critical to continue to improve access and quality of services (OECD, 2013a).

The government recognizes the connection between the competitiveness and resilience of the economy and the natural asset base. It also acknowledges that South Africa's resource-intensive economic growth negatively affects the country's natural assets, making it more difficult to address unemployment, poverty and income inequality issues.

The government has set ambitious CO_2 targets which require structural changes in the economy. This commitment prioritized the formalization of green economy objectives into national policies. The Climate Change White Paper (2011) is the guiding framework for the country's response to climate change, while the New Growth Plan and the National Industrial Action Plan both call for developing a green economy. Key issues include waste management, local air and water pollution, pressures on biodiversity and marine resource management.

Significant investment in energy, water, environmental infrastructure and in the development and commercialization of new technologies are needed to fund the transition to a green economy. The amount of capital needed has not been quantified, but the scale of the investment is indicated by government plans to invest more than ZAR827 billion in infrastructure between 2013/14 and 2016/17 and approximately ZAR4 trillion over the next 15 years to 2028. Furthermore public enterprises will raise infrastructure investment funds from the debt market on the back of government guarantees (OECD, 2014).

Even though experts agree a resource-efficient economy will have long-term socio-economic advantages, structural transformation of the economy can impose negative short-term impacts on those whose livelihoods and asset valuations depend on current industries and patterns of resource use. This has created tension between balancing the pressing need to maintain economic growth and improving the quality and sustainability of growth. The government has therefore sought to design and implement environmental, climate and energy policies that support and balance the objectives of lowering inequality, improving food security, improving economic competitiveness and increasing resource-efficient economic growth.

The downgrading of South Africa's sovereign rating following weaker macro-economic fundamentals and a growing budget deficit hurt the government's ability to directly fund infrastructure and investment. Mobilizing additional private capital is therefore critical. Although the private sector has invested considerable capital in renewable energy and energy efficiency, further investment in green sectors and technologies is needed.

This study

Many factors in the real economy and associated public policy play a role in unsustainable patterns of investment, but the rules governing the financial system can be argued to be a key factor driving overinvestment in unsustainable assets (Sinclair *et al.*, 2012; WWF, 2012). Innovations in financial policies, regulations and standards (the 'rules of the game') have the potential to support and accelerate the transition to a green economy. This has been focus of the UNEP Inquiry into the Design of a Sustainable Financial System.

This scoping paper explores these questions in South Africa, a country which has been at the forefront of governance innovation in pursuit of national economic transformation. It draws on a literature review and interviews with 37 organizations between May 2014 and January 2015 including regulators, bankers, insurers, asset managers, industry association leaders, academics, consultants, civil society activists and researchers (see Annex 1).

The paper gives an introduction to the South African financial system, and in particular trends and policy measures towards green investment. It explores the challenges facing the design of a sustainable financial system, synthesizes learning from South Africa's experience to date and identifies areas of potential for research and action.

2 South Africa's Financial System

2.1 Strategic Importance and Concentration

South Africa has a sophisticated financial system with a regulatory architecture that meets international standards (IMF, 2010; FSB, 2013). The 2013/14 World Economic Forum Global Competitiveness Report ranked South Africa third out of 148 countries in terms of financial market development. In the 2014/15 Global Competitiveness Report, it was ranked in first position in relation to regulation of securities exchanges. In addition, South Africa is also ranked highly for factors relating to financial market development, auditing and corporate governance.

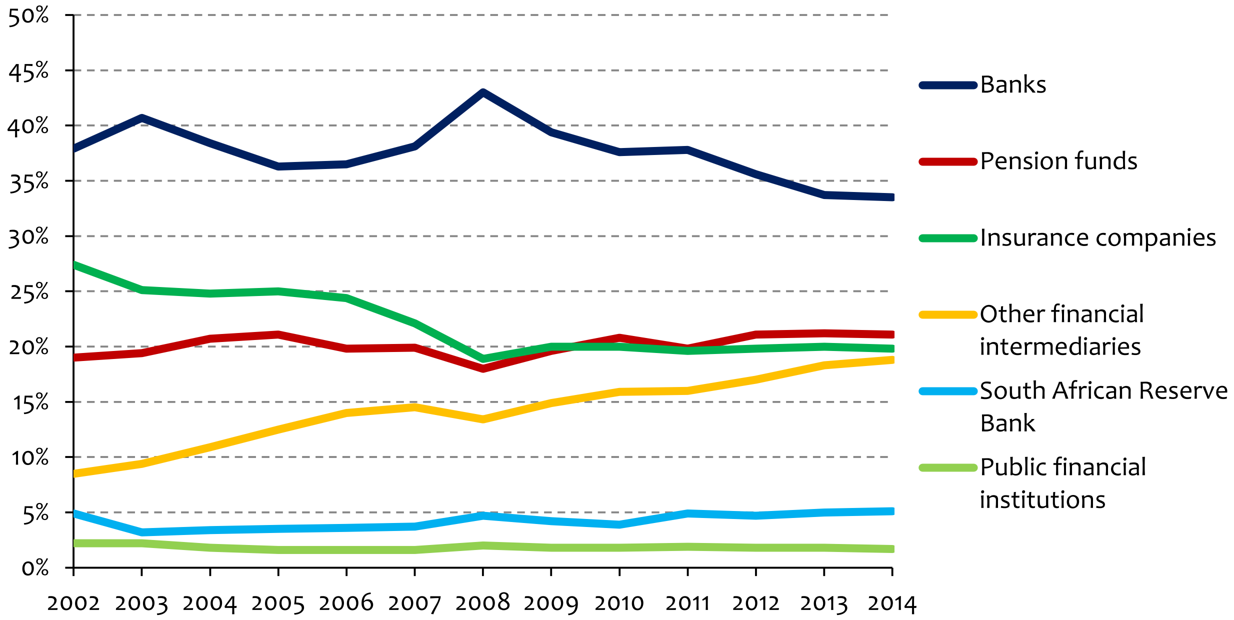
In 2013, the financial sector contributed 10.5% of total Gross Domestic Product (GDP), employed 4% of the labour force and paid 15% of total corporate tax (OECD, 2014). As a world-class sector it can attract highly skilled workers, keep up to date with technological, business model and process innovation.

However, the sector is dominated by a few major financial conglomerates that have interests in banking, asset management, insurance and securities sectors, while the insurance industry is also dominated by four large conglomerates (FSB, 2013). The International Monetary Fund (IMF), World Bank and Organisation for Economic Co-operation and Development (OECD) found that industries with concentrated ownership tend to face less competition, allocate fewer resources to developing innovative products and charge higher prices. Stakeholders interviewed argued that the sector's concentrated structure has impacts on performance, resulting in conservative business practices, barriers to capital allocation to nascent industries and weak provision of financial services to low-income earners. For example, about one third of the adult population does not have a bank account, and millions more have only limited access to formal financial services (OECD, 2014). Another consequence of a concentrated market structure is extensive interlinkages in the financial system, making it easy for instability in one area of the system to spill over into other parts of the system.

2.2 Structure and Composition

Assets under the management of financial intermediaries were valued at ZAR6 trillion in 2013 (OECD, 2014). Together, banks, insurers and pension funds account for the largest share of total financial assets. However, since 2008 the share of banks' total assets relative to all financial intermediaries has steadily declined, reaching 34% of all financial intermediaries' assets in 2014. Conversely, assets managed by other financial intermediaries (such as money market funds, hedge funds, other investment funds, finance companies, participation board schemes and trust companies) have increased, reaching 19% of total financial assets of financial intermediaries in 2014 (SARB, 2015).

Figure 1: Distribution of Total Assets among Financial Intermediaries between 2002 and 2014



Source: SARB, 2015b

- **Banks:** 17 banks are registered in South Africa. In 2014 the banking sector's total assets were ZAR3.9 trillion; the four largest banks held over 83 per cent of the total (BASA, 2014a). These big four commercial banks concentrate on more affluent earners, whereas smaller lenders target middle- and low-income earners. The solvency and stability of the banking sector is strong. Banks are capitalized above the new Basel III[1] level, operating with an average capital adequacy ratio of 15.9% (OECD, 2014). A key concern is the rise in the level of unsecured debt. The IMF and the South African Reserve Bank (SARB) are concerned about the sector's growing vulnerability to credit risk due to a rising level of unsecured loans to households. (IMF, 2013).

- **Non-Bank Financial Institutions (NBFIs):** They are involved in securities markets, especially mobilizing and allocating long-term financial resources. Their activities complement the commercial sector as NBFIs play a minor role in lending activities. NBFIs include pension funds, unit trusts, the Public Investment Corporation (PIC), insurance companies and participation bond schemes. The assets of NBFIs achieved an average annual growth rate of 12% between 2008 and 2012, and the consolidated balance sheet of the sub-sector totalled ZAR6 trillion in 2012. The growth in total assets stems from the activities of the Public Investment Corporation and unit trusts, whose assets increased by about 22% between 2011 and 2012 (SARB, 2013). In addition, according to the IMF (2010), the long-term insurance sector manages more assets than pension funds and aggregate mutual funds combined because long-term insurers have captured a large share of the retirement savings market.[2]

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[1] *The Basel III capital-adequacy framework was successfully phased in in South Africa in January 2013 when all the banks met the prescribed minimum requirements in terms of common equity and Tier 1 capital-adequacy ratios. The banking sector also made some progress in preparation for its compliance with the Basel III liquidity coverage and net stable funding ratios, scheduled for 2015 and 2018 respectively.*

[2] *Approximately 50 per cent of long-term insurers' balance sheets are underwritten by retirement funds, many of which are established and managed as well as underwritten by the insurance company (IMF, 2010).*

- **Equity and Debt Markets:** The Johannesburg Stock Exchange (JSE) is ranked the 20th largest stock exchange in terms of market capitalization (FSB-SA, 2013). In 2012, 400 companies were listed on the JSE (SARB, 2013), with a market capitalization of ZAR7.261 trillion (FSB-SA, 2013). Liquidity, measured on the basis of equity turnover as a percentage of market capitalization, was 46% for the year ended on 31 March 2012. The South African debt market is liquid and also well developed. The nominal value of the JSE bond market was ZAR1.387 trillion in 2012 (FSB-SA, 2013). More than ZAR1 trillion of listed debt is placed by the South African government and accounts for 90% of the market's liquidity. Other issuers include South African state-owned companies, businesses, banks and other African countries. Net issues of fixed-interest securities on the South African primary bond market reached an annual record high of ZAR269 billion in 2012 (SARB, 2013).

In addition to financial intermediaries, service providers (asset managers and consultants) play a key role in advising and managing funds for financial institutions and asset owners. The investment advisor and/or asset consultant "acts as the gatekeeper to the investment decisions of retirement funds." (IFC, 2011)

2.3 The Role of Public Finance Institutions

South Africa has several state-owned development finance institutions (DFIs) seeking to provide finance to projects, economic sectors or sections of the population not well served by the financial system as a whole. The three largest DFIs (the IDC, DBSA and the Land Bank) together account for more than 90 per cent of the development finance sector, while other DFIs are focused on black economic empowerment, small enterprises, youth, housing finance, urban reconstruction, rural self-building, microfinance and small farmers.

- **The Industrial Development Corporation (IDC)** raises finance from international development agencies and commercial facilities, and provides equity and loan financing to entrepreneurs and businesses engaged in competitive industries.

- **The Development Bank of Southern Africa (DBSA)** funds physical, social and economic infrastructure. Its goal is to improve the quality of life of the people in the region. The bank plays a multiple role of financier, adviser, partner, implementer and integrator to mobilize finance and expertise for development projects. The DBSA leverages its capital base with an approximately equal amount of external borrowings.

- **The Land and Agricultural Development Bank of South Africa (Land Bank)** provides financial services to the commercial farming sector and agribusiness.

Overall, the DFIs are mandated to facilitate the development of new industries and value chains and to support public and private investment. DFIs often take a risker position in project finance deals, such as mezzanine and subordinated debt in order to de-risk and make the other portions of the deal more attractive to private investors. National and international DFIs have played an important role in seeding private equity funds.

The government, through the PIC, Government Employees Pension Fund (GEPF) and parastatal pension funds, has mobilized significant capital towards developmental assets in nascent markets. The PIC is a publicly owned investment manager that manages assets of over ZAR1.8 trillion, mainly for the GEPF, which is the largest institutional investor in South Africa and is the world's sixth largest pension fund. The PIC manages 92% of the GEPF's assets and also outsources asset management mandates, with approximately 15% of blue-chip stocks on the JSE (IFC, 2011).

2.4 Legislation and Regulation

The National Treasury (NT), under the leadership of the Minister of Finance, is responsible for setting policy related to private and public sector investment and for steering the approval of legislation through parliament. Key regulatory authorities include:

- **The South African Reserve Bank** is responsible for formulating and implementing monetary policy, supervising the banking sector and administering exchange controls. It monitors the health, soundness and vulnerability of the financial system to external and internal shocks, collecting quantitative data concerning capital adequacy, asset quality and liquidity of the financial market. It uses stress-testing, scenario analysis and indicator trend analysis to assess risk of financial instability. The Bank Supervision Department of the SARB is responsible for prudential regulation and the supervision of banks. It reports both to the Governor of the SARB and to the Minister of Finance on certain legislative matters.
- **The Financial Services Board (FSB-SA)** is an independent institution, established by statute to oversee the South African non-banking financial services industry in the public interest, including retirement funds, short-and long-term insurance, companies, funeral insurance, schemes, collective investment schemes (unit trusts and stock market) and financial advisors and brokers. Operations of the FSB-SA are structured along sector lines with separate pieces of primary legislation for each area (Loubser and Bennett, 2012).
- **The Johannesburg Stock Exchange**[3] is a self-regulatory organization that sets listing standards and disclosure obligations for listed companies (FSB, 2013). The JSE plays a leading role in other regulatory areas: market surveillance and taking disciplinary action against member firms and their employees, listed companies and company directors.
- **The Department of Trade and Industry**, through the National Credit Regulator, regulates market conduct aspects of granting consumer credit by all credit providers.

The FSB (2013) describes the regulatory system as “complex, involving multiple government agencies, advisory and oversight committees and self-regulatory organisations”. Similarly, an industry survey concluded that the regulatory system is fractured because of unclear, overlapping duties and functions. Both the IMF (2008 and 2010[4]) and the FSB have identified poor coordination, both across and within institutions, as the main problem facing the regulatory system.

The table below outlines key pieces of legislation and financial regulation. Some sub-sectors clearly face greater regulation than others. For example, pensions Regulation 28 is not applicable to GEPF and other parastatal pension funds. Unlisted private equity assets are unregulated, which increases risk, making pension less likely to invest in these instruments.

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[3] *The JSE is the primary and secondary market for listed equity securities, financial derivatives, agricultural commodities, and the bond market.*
[4] *The 2010 IMF study also emphasized the importance of improving regulatory independence and stressed improving coordination among regulators.*

Table 1: Key Legislation

Sector	Key legislation	Description
Insurance	Long-term Insurance Act Short term insurance Act Solvency Assessment and Management framework (final implementation in 2016)	• **Capital adequacy requirements** to be determined by insurer's statutory actuary. • **Prudential spread requirements**, which set the maximum permitted holdings in particular kinds of assets. • **Risk-based supervisory regime** based on EU Solvency II. Three pillars: quantitative (Pillar 1) requirements and qualitative (Pillar 2) enhanced reporting and public disclosure (Pillar 3).
Banks	Banks Act, 1990 Banks Amendment Act, 2014 Basel III	• **Capital standards enhanced**: more restrictive capital definitions, higher risk-weighted assets, additional capital buffers and higher requirements for minimum capital ratios. Liquidity standards could drive new balance sheet strategies designed to limit illiquid assets, restrict wholesale/unstable sources of funding and manage higher funding costs (PwC, 2013). • **Resolution framework** improved by Banks Amendment Bill, clarifying the powers of the curator of a bank.
Pension Funds	Pension Funds Act, 1956 Regulation 28, passed in March 2011 Amendments to Regulation 28	• **Fiduciary responsibility** of trustees to act the best interest of the members of the fund (Pension Funds Act, 1956). • **Fiduciary capacity**: new regulations being prepared trustee training, 'fit-and-proper' requirements for trustees, improving fund governance and promoting the harmonization and consolidation of retirement funds. (PwC, 2014). • **Prudent investment limits**: asset classes and investment limits specified in Regulation 28. Amendments to Regulation 28 prescribed conditions under which pension funds can invest in derivative instruments, private equity and hedge funds.
Hedge Funds	Collective Investment Scheme Control Act	• New regulations covers the duties of managers, leverage, liquidity, collateral and monthly reporting to the Registrar of Collective Investment Schemes, disclosure of information to investors and exposure limits for permitted asset classes.
Private Equity	No government agency exercises regulatory oversight	• Fund managers are required to register as financial services providers under FAIS.
Public Investment Corporation	Public Investment Corporation Act, 2004	• **Mandate to contribute to economic development**. • Bound to comply with the Public Finance Governance Act but not subject to regulation and supervision In terms of section 34 of the Pension Funds Act of 1956 as amended.

Source: PWC (2013, 2014), Loubser and Bennett (2012), FSB (2013), KPMG (2013), FSB-SA (2013), SARB (2015a, 2015b)

The collapse of African Bank was a recent test for the South African financial regulation system. While experts agree that swift and decisive action from the SARB prevented contagion, it also raised concerns about the financial system's potential fragility and the lack of available information for managing exposure to non-financial risks.

Box 1: The Collapse of African Bank

African Bank Investments Limited (Abil), which comprises African Bank (an unsecured lender) and retailer Ellerines, collapsed on 6 August 2014, following CEO's resignation and worse than expected market results. The SARB took swift and decisive action to stop contagion by providing a bailout package for African Bank, recapitalizing it and purchasing non-performing loans. African Bank's downfall followed growth in unsecured consumer lending to middle-income consumers.

2.5 Financial Reforms

Over the past five years, regulators have focused their attention on rapidly implementing international regulatory reforms, touching every aspect of financial intermediaries' operations. The rapid pace of reform has placed South Africa "at the forefront of financial sector regulatory reform globally" according to the IMF (2013), which is confident that the adoption of Basel III in 2013, the implementation of 'Twin Peaks' and other regulatory reforms will further strengthen South Africa's already strong financial architecture.

South Africa is shifting to a 'Twin Peaks' model of financial regulation. This will see the creation of a new prudential regulator (the Prudential Authority, housed in the SARB), while the FSB-SA will be transformed into a dedicated market conduct regulator – the Financial Sector Conduct Authority. The objective is to strengthen South Africa's approach to consumer protection and create a more resilient and stable financial system.[5]

The FSB-SA will regulate market conduct with a framework focused on 'Treating Customers Fairly' (how firms conduct their business, design and price their products, and treat their customers). It will focus on protecting customers, building financial market infrastructure, improving the business conduct of financial service providers and promoting effective financial consumer education. It will be responsible for supervising insurers, micro-insurers, banks, exchanges and other financial markets infrastructure. The SARB will regulate macro- and microprudential matters, to ensure the stability of the financial system and the solvency and liquidity of financial institutions. Structures will be in place to ensure proper coordination between the two authorities and other regulators.

According to the FSB (2013) review, while the reforms will not reduce the overall complexity in terms of the number of agencies involved in regulation and supervision, they provide more clarity in the assignment of responsibilities and the concentration of related expertise.

Steps to implement Twin Peaks began in 2011 with the release of 'A Safer Financial Sector to Serve South Africa Better', followed by a 'Roadmap for Implementing Twin Peaks Reforms' in February 2013. Both documents provided the context for the passing of the Financial Sector Regulation Bill in 2013. The bill outlines the two-phase implementation approach of Twin Peaks and also creates statutory inter-agency

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[5] *Drafting and tabling the Financial Services Laws General Amendment Bill (FSLGAB) seeks to rationalize and align supervisory powers and functions by the various Registrars in the FSB-SA in terms of the various laws administered by it. The FMA inter alia lays down the foundation for the exchange of information related to systemic risk between the FSB-SA, the SARB and the National Treasury.*

committees to improve coordination of regulators' activities. In October 2015, the Financial Sector Bill[6] was tabled in Parliament and will be enacted into law in 2016, giving effect to the adoption of Twin Peaks.

The relative scale and importance of South Africa's financial sector and the government's reliance on market instruments to fund its deficit means that the sector is particularly influential; stakeholders argue the financial sector's strategic position has affected the approach, design and implementation of financial reforms, favouring incumbents over innovation and competition.

[6] *This bill also gives the SARB an explicit financial stability mandate, making it 'responsible for the identification, mitigation and prevention of systematic events (SARB, 2015b).*

3 Market-driven Responses to Environmental, Governance and Social Issues

The financial sector in South Africa has been a leader and an innovator in integrating environmental, social and governance (ESG) issues into its practices, driven by the need to address socio-economic legacy issues and to demonstrate world-class governance. However, these three pillars received different degrees of attention:

- **Most progress has been made on governance issues**, which are comprehensively integrated into capital allocation decisions and seen as part of the core concern of financial intermediaries. Factors driving the integration of governance issues were the private sector's need to mobilize capital and the country's existing strong auditing and accounting skills base.
- **Social issues have received significant attention and resources** given the priority needs for job creation and poverty alleviation. In particular, financial intermediaries have prioritized providing more of the population with access to financial services.
- **Environmental issues tend to be seen as a lower priority,** but are increasingly raised in a developmental economics framework that recognizes the economic opportunity from greener technologies and industries, and the threat of environmental and competitiveness damage from unsustainable practices.

3.1 Savings and Investment Industry

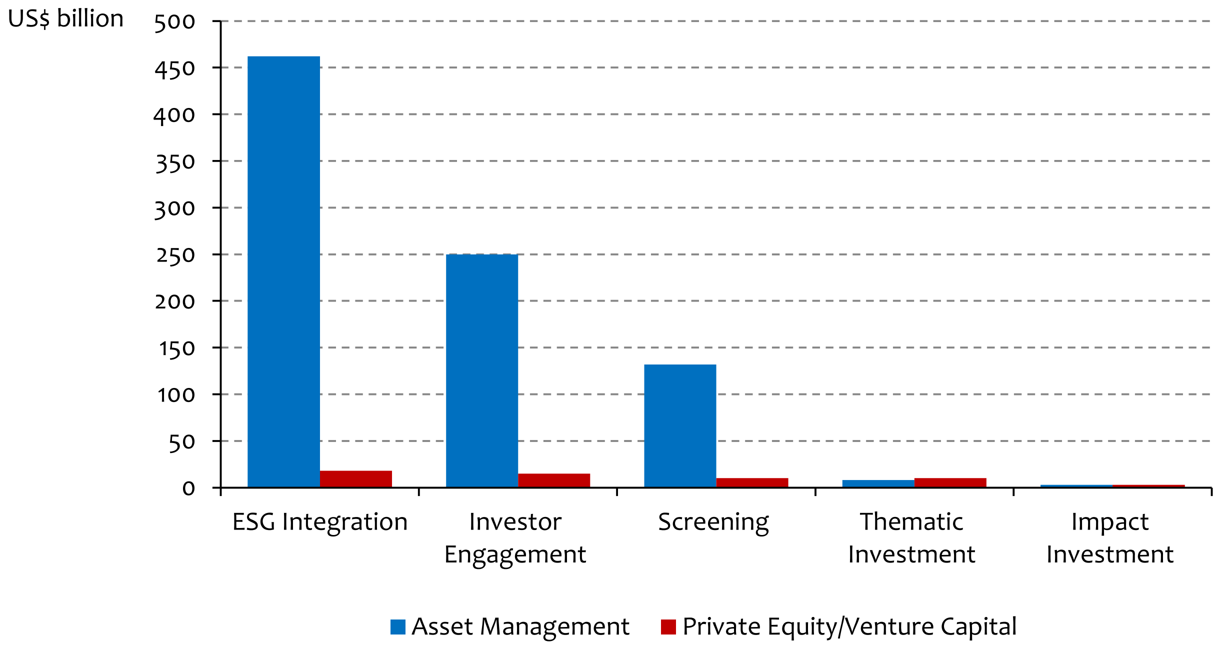
The savings and investment industry is experimenting with a range of investing for impact strategies that combine environmental and/or social objectives and criteria with financial return (Giamporcaro and Dhlamini, 2015):

- **ESG Integration:** Systematic Integration of ESG factors into research and analysis and financial performance measurement;
- **Investor Engagement:** Engaging as a way of influencing a company's governance or management of sustainability issues;
- **Screening:** Using positive or negative screens based on social or environmental criteria;
- **Thematic**: Funds targeting specific sectors such as renewables or agriculture; and
- **Impact investment**: Investing in projects which explicitly seek a positive social impact.

A survey of 1,115 funds in 2014 found that 71% of capital invested is managed by asset owners who say they employ some form of investing for impact strategy (a handful of large institutions investing mainly in listed stocks accounts for the majority of this). They favour strategies of ESG integration and investor engagement, including ESG factors in research and analysis, and raising issues with investees including through shareholder motions. However as Figure 3 highlights, these tend to be characterized by only limited or partial implementation, with only 10 per cent of capital invested using this strategy consistently and comprehensively in investment analysis, valuation and decision-making.

Private equity and venture capital funds tend to implement ESG integration more robustly and are more strongly represented in providing thematic and impact investment funds focused on areas such as agriculture, socio-economic infrastructure, inclusive finance, Small and Medium Enterprise (SME) development and renewable energy.

Figure 2: Invest for Impact Strategies



Source: Own calculation based on African Investment for Impact Barometer survey (2015)

Figure 3: Variation in Implementation across Strategies

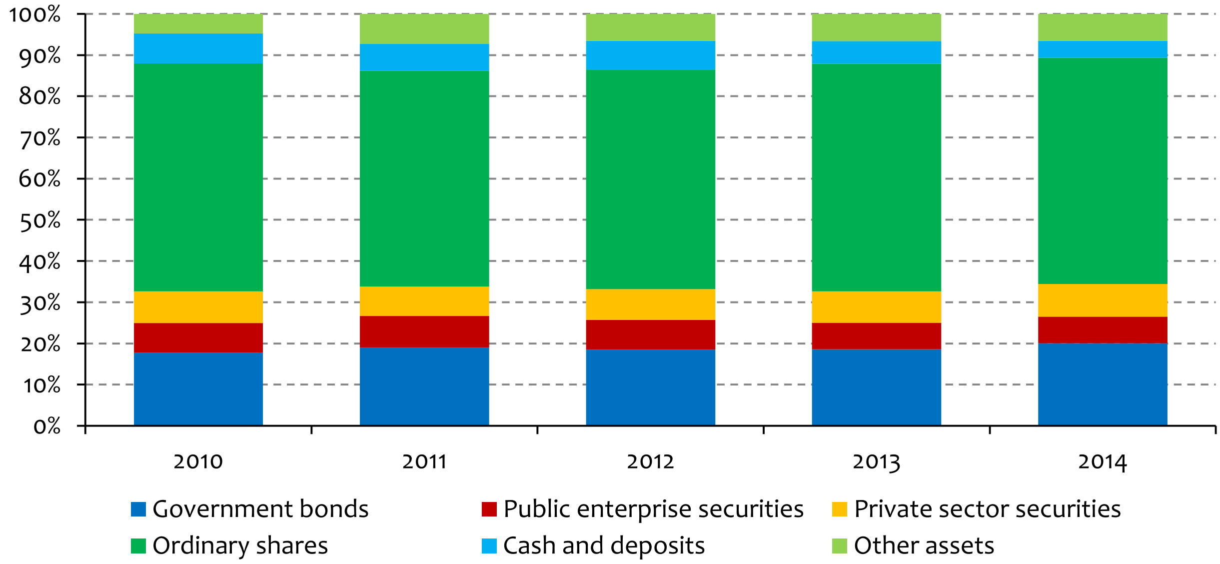
	ESG Integration	Investor Engagement	Screening	Thematic Investment	Impact Investment
Total capital invested (billion US$)	480	465	142	18	6
Strong implementation of strategy	10%	9%	22%	5%	25%
Partial implementation of strategy	47%	37%	44%	40%	58%
Limited implementation of strategy	43%	54%	33%	55%	17%

Source: African Investment for Impact Barometer survey (2015)

Public sector investment funds such as the PIC, the GEPF and parastatal pension funds are significant investors and have championed responsible investment practices in South Africa. For example in 2011, the GEPF allocated 5% of its assets, roughly US$7 billion, to ESG investing under its Developmental Investment Policy (IFC, 2011).

Despite commitments and innovations by the saving and investment industry on ESG issues, in practice investment portfolios remain heavily exposed to industries with high environmental impacts. The majority of the industry's investment is in blue-chip listed JSE equities that tend to be dominated by industries linked to mining, minerals and fossil fuels. The carbon footprint[7] of the JSE 40 Index is larger than the S&P 500, MSCI Europe and MSCI Asia ex-Japan indices and seven out of 10 major South African equity funds in June 2011 had larger carbon footprints than the JSE 40 Index, indicating a bias towards carbon-intensive investment (Sinclair *et al.*, 2012).

Figure 4: Investment Allocation of Pension Funds between 2010 and 2014



Source: SARB (2015b)

Nevertheless, Sinclair *et al.* (2012) created a hypothetical portfolio of South African equities that demonstrates it is possible to invest a greater percentage of a portfolio in more carbon-efficient companies, while maintaining financial performance consistent with the market benchmark.

3.2 Commercial Bank Lending

The government has used a cooperative regulatory approach to encourage banks to adopt 'responsible financier' principles, develop ESG governance standards and join international initiatives. Reputational and peer pressure have helped to drive participation in initiatives such as the UNEP Finance Initiative, the Equator Principles and the Banking Association of South Africa (BASA)'s Sustainable Finance Forum.

The big four commercial banks apply the Equator Principles and have standards for determining, assessing and managing ESG risks for project finance transactions valued from US$10 million. Implementing the Equator Principles has increased their ability to identify ESG risks, evaluate them financially as part of a standardized credit assessment process and work with potential borrowers to lower them to acceptable levels. Commercial bankers from two of the largest commercial banks confirmed, in principle, that they do not finance projects where a borrower does not meet designated social and environmental policies and/or have the resources to implement Equator Principle procedures (such as action plan and management system, consultation and disclosure, and a grievance mechanism). They also cautioned that assessing a borrower's level of compliance with the Equator Principles is often a matter of degree. Often, borrowers are compliant in certain aspects and not others, which has caused commercial banks to adopt an approach where they work with borrowers to comply with the Equator Principles.

[7] *It is worth noting that the JSE40 Index excludes utilities, which affects the carbon footprint result.*

However, project finance at around US$10 million is a small proportion of the big four banks' total lending. An interviewee from one of these banks remarked that these transactions comprise approximately 2 per cent of the total loan book. The procedures and processes underlying the Equator Principles are not transferable beyond project finance, where banks have a high degree of visibility and control of the use of funds and are able to impose strict terms and conditions on borrowers. Banks have started to consider environmental and social risks as part of their pre-investment screening process for more general working capital loans. However, quantifying and systematizing non-financial variables into the loan process is difficult and currently experimental.

Commercial bankers and an industry association also mentioned that the National Environmental Management Act (NEMA) and recent environmental legislation have sensitized financiers to ESG risks during the credit assessment process. One key driver is the possibility of lender liability. Lender liability is a means to internalize the costs of pollution incidents back to the financiers, encouraging them to assess this risk and internalize the cost into the credit risk assessment. If a bank funds a project that pollutes the environment, it may become liable for the associated damage to the environment where it is deemed to have some measure of control over the polluting company's assets.

Although commercial banks support the principle of lender liability, they argue that implementation will have mixed results. On the one hand it is a potentially powerful tool to encourage the inclusion of environmental costs into banks' credit models and processes. On the other hand, by making land a more risky form of collateral, it can reduce credit availability. Furthermore, they argue that current environmental legislation is ambiguous and liability is too broad. The application of the principle remains untested; insufficient local case law exists and the interpretation of the lender liability principle is unclear. As consequence, commercial bankers and an industry association argue that the legislation creates policy uncertainty, and they remain cautious whether the legislation will have its intended benefit of pricing ESG risk into credit extension decisions.

BASA suggested that a 'Safe Harbour' model for lender liability, as used in the US Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), should be explored. In this system, a 'superfund' is established with the power to undertake the cleaning up of hazardous waste. The superfund then seeks to recover costs from the polluters, including lenders to the project. Lenders can secure limited liability if they can demonstrate that they undertook adequate due diligence according to agreed criteria in granting the loan.

3.3 Financing for Green Infrastructure

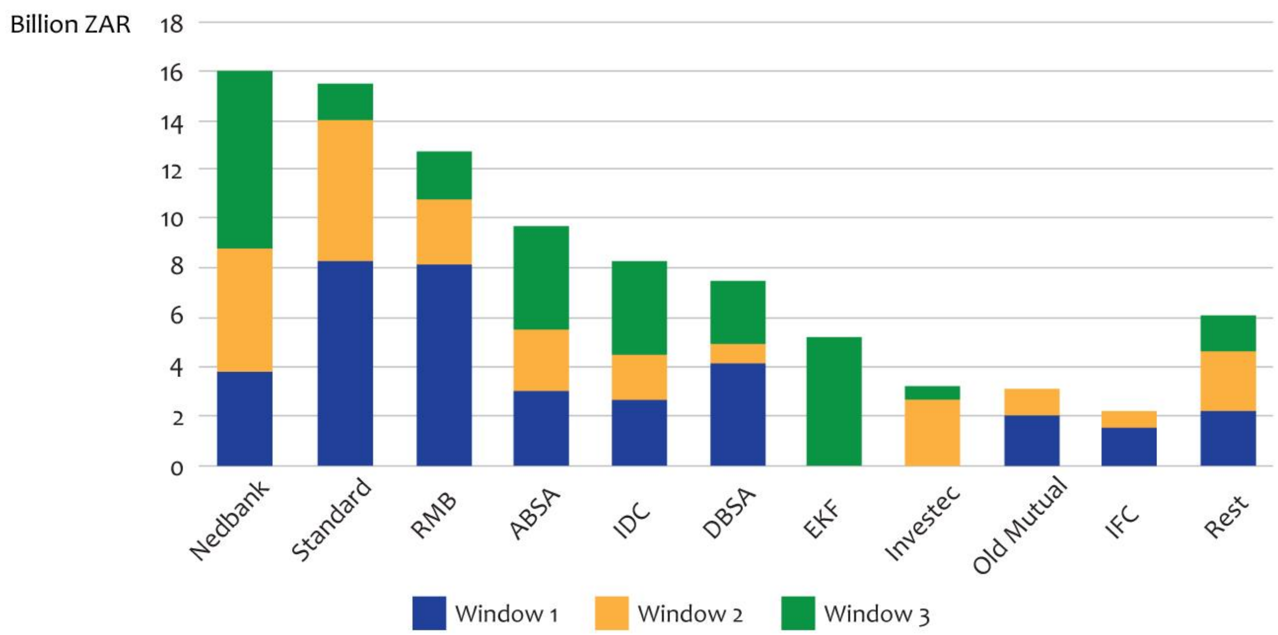
The South African Government has recently sought to increase the proportion of renewable energy in the national electricity supply. The Renewable Energy Independent Power Producer Procurement Programme (REIPPPP), launched in 2011, uses a competitive tender process to procure grid-connected renewable electricity from Independent Power Producers (IPPs). The REIPPPP was designed as a series of transparent and efficient bidding rounds where winning bidders received power purchase agreements backed by a sovereign guarantee, providing attractive low risk cash flows to successful projects. This design helped to build confidence, minimize risk and improve the bankability of projects. Initial price caps were set relatively high to attract bidders but have fallen rapidly through competition and learning curve effects.

Despite the commercial banking sector's conservative attitude and lack of familiarity with the sector, the REIPPPP mobilized large-scale private sector investment. The renewable energy sector was insignificant before the REIPPPP, but following its launch, Bloomberg New Energy Finance ranked South Africa in the top 10 clean energy investment countries ahead of ahead of Canada, Brazil, Spain and France (BNEF, 2013).

Over three rounds of bidding the government had procured 3,922 MW from 64 IPPs and US$14 billion of private sector capital was committed (WB, 2014). Project finance was used for 56 out of the 64 projects (WB, 2014). Approximately two thirds of funding has been through long-term debt, a further quarter was funded from pure equity[8] and shareholder loans, and the outstanding balance was sourced from corporate finance (WB, 2014). The majority of debt funding has been from commercial banks (ZAR57 billion or 64%), with the balance from DFIs (ZAR27.8 billion or 31%) and pension and insurance funds (ZAR4.7 billion or 5%) (WB, 2014).

The financial sector played a leading role in mobilizing finance as it raised 86% of debt whose tenor extend 15 to 17 years from commercial date of operation. Five local South African commercial banks dominated total lending – Standard Bank, ABSA, RMB and Investec. They also facilitated deals by being a 'lead arranger', participated as co-senior lenders and provided subordinated mezzanine debt. After local banks, local DFIs (IDC and DBSA) collectively contributed the most debt funding that was mainly used for BEE vendor financing and community participation. Lastly, pension funds and the insurance industry (Old Mutual, Sanlam and Liberty) were also involved in debt financing (WB, 2014). These types of financial intermediaries are expected to increase their capital allocation through purchasing syndicated debt from commercial banks in the secondary capital market.

Figure 5: Share of Initial Debt Providers in REIPPPP in the Three Rounds in Terms of Value



Source WB (2014)[9]

The REIPPPP experience demonstrates that the financial system in South Africa can mobilize capital for large-scale, low-risk green projects that use commercialized technologies and benefit from economies of scale and sovereign guarantee. It shows that financial legislation and regulation in South Africa per se

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[8] *In terms of the number of projects per shareholder, Old Mutual Insurance (16) was the most prominent shareholder followed by the IDC (9), Standard Bank (4) was ninth and the PIC (3) was seventeenth (WB, 2014).*

[9] *Rest in chart refers to OPIC, AfDB, Liberty Group, ACWA, EIB, Sanlam, FMO, PROPARCO and Sumitomo.*

does not impede financial intermediaries from investing in the green economy. While other RE projects have floundered, the REIPPPP has been successful because “the procurement process is well designed and transparent; transactions are reasonably profitable; and key risks are mitigated by government.” (WB, 2014) Interviewees supported this view and confirmed that REIPPPP had three critical ‘bankable’ features: articulated targets and clearly defined tender qualification and evaluation criteria, low risk cash flows (because developers had signed power purchase and implementation agreements with state institutions) and a strong counterparty as the government provided credit enhancement and/ or security arrangements. Lastly, even more remarkable is that the two factors that project developers and banks raised as crucial bottlenecks were not addressed. Banks’ credit approval process remained relatively unchanged and the government did not release a green economy roadmap.

However, while renewable energy is important, other areas such as natural resource management, technologies for emissions and pollution control, and the roll-out of rapid bus transport projects also require investment (IDC, 2012). Commercial banks and institutional investors perceive the risk-adjusted return on these projects to be inadequate. On the one hand, small- to medium-scale projects use novel technologies developed by start-up companies, which have weak balance sheets and insufficient capital for self-financing early-stage project development. On the other hand, large-scale infrastructure projects, outside of renewable energy, use commercially untested technologies and long-term policy direction is unclear.

4 Policy Innovations to Integrate ESG Issues

4.1 Governance Innovations

South Africa has developed three governance innovations that seek to integrate ESG factors into the financial system.

The King Code regulates corporate governance, in particular of listed securities. The King Committee was commissioned by the Institute of Directors in Southern Africa (IoDSA), drawing on the support of the Institute for Chartered Accountants, the Institute of Chartered Secretaries, Business South Africa, the JSE and international organizations. The Committee adopted a principles-based approach to corporate governance drawing on four values: responsibility, accountability, fairness and transparency (Schulschenk, 2012). The Committee has developed three iterations of South Africa's corporate governance code: King I (1994), King II (2002) and King III (2009). It provides general principles regarding ethical leadership and corporate governance, and specific principles related to board and directors, audit committees, risk and information technology, compliance with laws, codes, rules and standards, internal audit, stakeholder relationships and reporting and disclosure. It is a non-legislative code, however companies listed on the JSE are obliged to follow the code with some principles mandatory and others applied on an 'apply or explain' basis.

As part of King Code III, **integrated reporting** is required for all JSE-listed companies on an 'apply or explain' basis. Integrated reports cover economic, social and environmental impacts and are intended to communicate and clarify how the company creates and sustains shared value for all stakeholders.

Regulation 28 under Section 36 of the Pension Funds Act was amended in 2011. One key consideration in the update was the government's desire for pension funds to increase investment in developmental assets, while ensuring beneficiaries' savings are not exposed to undue risk.[10] The regulation does not require pension funds to direct capital into specific public purposes. However, it extends the traditional definition of financial prudence to include ESG factors (Girdwood, 2013). For trustees to fulfil their fiduciary duties, they must give "appropriate consideration [to] any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance character." (NT, 2011a) A fund and its board have the discretion to decide how they will satisfy this obligation in terms of implementing processes and procedures. The revision also relaxed the rules on asset allocations, for example increasing the limit on exposure to unlisted assets increased from 2.5 per cent to 25 per cent of the portfolio allowing them to invest in private equity and infrastructure.

The Code for Responsible Investment in South Africa (CRISA) was launched in July 2011 as a voluntary, institutional investor-led initiative driven by ASISA and the GEPF. The code, which is based on the PRI policy framework, seeks to provide a guide to institutional investors and their service providers on developing and implementing responsible investment strategies. It provides institutional investors with practical guidelines to fulfil their Regulation 28 obligations. When institutional investors endorse CRISA, they must disclose how they implemented the principles on an 'apply or explain' basis.[11] In addition, the

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[10] *According to the explanatory memorandum to regulation (NT, 2011b), "the aim of retirement fund regulation is to ensure the savings South Africans contribute towards their retirement is invested in a prudent manner that not only protects the retirement fund member, but is channeled in ways that achieve economic development and growth."*

[11] *Although the poor level of disclosure has weakened the effectiveness of the disclosure-accountability model. Approximately 50% of institutions "provide a general description of their approach to CRISA, whereas only about 30% provide details on how the CRISA principles are applied, and less than 10% provide an explanation for not applying certain principles." (E&Y and CRISA Committee study, 2013)*

GEPF and PIC require asset managers they contract with to demonstrate their competence concerning ESG investing practices.

The governance innovations have tended to evolve through collaborative processes to resolve tensions and pressures between private sector industry associations, government and other stakeholders. The approaches that have emerged have therefore been partly driven by direct business concerns, such as the need to demonstrate governance standards in line with international norms in order to gain access to international capital, partly by public incentives and institutions such as the decision of the GEPF and the PIC to include responsible investment criteria in their selection of asset managers, and partly by moral suasion and the threat of stronger regulation.

In general, labour tend to argue for some form of policy-directed investment such as a development bond, while business argues that a prescribed asset regime distorts asset prices. At the launch of Code of Responsible Investment in South Africa (CRISA), Minister of Finance Previn Gordon remarked that if the voluntary, market-driven, principle-based approach is unsuccessful they might take a tougher stance on trying to enforce, implement and encourage responsible investment.

The governance innovations tend to take a principles-based approach, which companies interpret and then report on their progress on an 'apply or explain' basis. This places the onus on the applicant to apply the principles voluntarily, explain how the principles have been applied differently, or why they have not been applied at all (Girdwood, 2011; IFC, 2011). They have a 'light-touch' enforcement mechanism that relies on market forces to encourage self-regulation instead of direct punitive sanctions or publicly funded incentives. Through disclosure, companies are exposed to reputational risk and losing credibility if implementation lags behind peers and/or information inaccurately reflects implementation. Alternatively, if they can demonstrate that their approach to ESG investment results in superior returns, they may attract more investors.

The innovations address a specific market failure (asymmetric information, misaligned incentives and short-termism) that led to the underestimation of ESG risks, and are designed to work together and complement each other. CRISA gives institutional investors the toolbox to articulate their responsible investment approach, design processes supporting active ownership and measure their success. The King Code and integrated reporting guide companies on behaving responsibly and require them to provide the information that asset managers (and other service providers) need to judge their performance.

In general, they are seen as mainstreaming sustainability as a business issue in strategic conversations and investment decisions. They have provided actors with guidance on ESG investing and rethinking strategies for sustainable value creation, and the combination of reputation and moral suasion has encouraged companies to demonstrate that they are implementing the principles.

However, implementing these approaches does not appear to have significantly affected the allocation of capital. Institutions tend to 'tick the box' in terms of integrated reporting and adopting broad statements on sustainable investment but this has only marginally affected capital invested in developmental assets.[12] Integrated reports reflect the required form but not the substance of understanding how a business creates value. This lack of depth means asset managers rarely use these reports for decision-making and prefer gathering information from a company's website.

[12] *Only one interviewee felt the governance interventions should not be judged on whether they have directly affected the allocation of capital as CRISA and Regulation 28 were intended to sensitize long-term investors to consider a broader suite of risks across their asset portfolio and the effect of implementing longer-term investment strategies on managing sustainable risk.*

Some interviewees felt that the governance innovations might have inadvertently slowed down the pace of reform. They place a higher premium on reporting than action and have not resulted in a genuine integration of ESG risk factors into decision-making processes. However, judging the effectiveness of these innovations might be premature as Regulation 28 and CRISA were launched in 2011 and are still gaining momentum.

4.2 Financial Sector Charter

From 2000, the financial sector, especially retail banking, faced pressure from civil society to extend financial services to low-income earners and the threat of government regulation through the Community and Reinvestment Act. The financial sector saw this as a watershed moment: it could either have an adversarial relationship or a constructive partnership with government and sought to develop a solution to broadening and deepening access without risking the sector's solvency and profitability.

The National Economic Development and Labour Council brings together government, business and organized labour and the community to consider all socio-economic and labour policy and legislation. At its 2002 Financial Sector Summit, a Financial Sector Summit Agreement was negotiated that included a commitment to develop a black economic empowerment charter for the financial sector. After the Summit, the Financial Sector Charter (FSC) was developed including commitments and targets on widening access to financial services and providing 'empowerment financing'.

Financial institutions are incentivized to participate because they receive black economic empowerment (BEE) points for achieving FSC targets, which are part of the criteria used in bidding for contracts. The Financial Sector Charter Council was established as the governing structure for the FSC, and as such managed the scorecard process that assessed both financial intermediaries and the sector's performance against targets.

In January 2004, the FSC came into effect as a non-legally binding, voluntary partnership agreement between the government and financial sector stakeholders. The FSC was harmonized with a broader national approach to Black Economic Empowerment Codes of Good Practice in 2012.

The financial sector's willingness to adopt FSC commitments can be traced to the design principles underpinning the initiative. From the outset, architects of the FSC designed the FSC process to encourage participation and gain trust. First, transformation commitments were not framed as undertakings or obligations, but as stretch targets that balance the competing needs for urgent social transformation and long-term sustainability of business. Second, participation in the Charter and process was voluntary and driven by the financial sector and Association of Black Securities and Investment Professionals (ABSIP). The government was not directly involved in the process and did not intervene or participate in the determination of the targets. However, the Minister of Finance[13] facilitated the process, which helped the architects of the FSC to focus on key issues and navigate the political system (BASA, 2014b). Third, the industry perceives targets to be legitimate and credible targets as they are set through a collaborative process in consultation with the financial sector, government and civil society.

The FSC supported the channelling of capital into empowerment financing. According to BASA (2016), in 2008, over ZAR60.3 billion of loans were originated for low-income housing, agriculture and black SMEs, and a further ZAR64.6 billion was achieved under the targeted investments element of empowerment

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[13] *He highlighted the importance of access to financial services and of human resource development as key pillars of the FSC and de-emphasized ownership transfer (BASA, 2014b).*

financing, while ZAR101.2 billion was granted under BEE transaction financing. It also drove financial inclusion: access to first-order transaction[14] banking, insurance, and credit and saving services increased, with the largest progress made in transactional banking services. For example, between 2004 and 2010 4.6 million Mzansi accounts were opened, 74.4% of low-income earners had access to a bank branch within a 15 km radius and 79.2% could access a branch within a 10 km radius (BASA, 2014a).

Box 2: Lessons Learnt from the Mzansi Experience

The Mzansi bank account is an iconic part of South Africa's banking history because it challenged banks' understanding of markets and pricing models. Banks had failed to recognize low-income earners' demand for simple accounts and assumed that serving this market would be unprofitable. Despite a reduction in transaction fees, these accounts were profitable (WB, 2013b). Banks did not anticipate that lending products would generate profits.

In addition, the Mzansi experience also highlighted constraints in traditional retail banks' infrastructure. Excluding loan products, other transactional banking services were unprofitable because costs in branch organisation were high, servicing was expensive and account transactions were low – perhaps a reflection of banks' inadequate cost accounting systems and limited competition. The World Bank argues institutional and regulatory reform is needed to "encourage a broader range of financial service providers to enter the market and apply technological innovations." (WB, 2013b)

The government has acknowledged that improving financial inclusivity probably requires a change in the structure of South Africa's banking sector when it released the Dedicated Banks Bill and the Co-operative Bank Bill to create a multi-tiered banking sector. Nevertheless after ten years of policy indecision, the National Treasury announced it has reconsidered its policy position presented in the Dedicated Banks Bill because its priority is ensuring financial sector's stability following the aftermath of the global financial crisis (Hawkins, 2015).

Despite this progress, FSC targets were not met. Judging success based on targets alone does not acknowledge the catalytic role of FSC in the evolution of low-income transactional banking products, from a government-sponsored requirement to be superseded by competition for the market. Today, the four largest retail banks offer their own simple bank accounts as part of their standard product offering (WB, 2013b).

The development and implementation of the FSC have important lessons for other countries as an embedded financial policy to channel capital into an area of the economy that the financial sector once considered too risky and unprofitable. Although the content of FSC is innovative, more lessons for mainstreaming social issues can be gained from understanding the management of the FSC process,[15] to gain stakeholder buy-in for financial reforms in complex institutional environments, where competing policy objectives must be balanced.

[14] *For example, a set of life insurance products was launched under the Zimele brand, household content and structure insurance products were launched under the Mzansi brand, and a savings product for tertiary education savings was launched under the Fundisa product brand (Chamberlain et al., 2011).*

[15] *For example, when stakeholders perceive the process to have integrity, they are more likely to discuss sensitive issues. The process had integrity because discussions were confidential; each stakeholder had an opportunity to understand what they sought from the process, agreed principles informed the discussion of targets, and financial intermediaries collectively agreed on the scope of discussion then outside stakeholders were consulted (BASA, 2014b).*

5 Issues and Debates

This section draws on interviews with actors directly involved in commercial lending, retail banking, short-term insurance and institutional investing, such as regulators, asset owners, asset consultants, asset managers, industry associations. Experts who support these actors were also interviewed, which included policy think tanks, governance experts, lawyers and academics.

5.1 What Are the Barriers to Green Investment?

A dominant theme across interviews was that the most significant bottleneck hindering green economic transformation was a lack of bankable projects. Many interviewees argued that too few good-quality green economy projects have an acceptable risk-return profile, that transaction costs for green economy projects are substantial, and that a pipeline of packaged bankable green economy projects does not exist.

The majority of interviewees (especially commercial bankers) argued that the success of the REIPPPP demonstrated that economically viable (based on their risk-return profile) green investment opportunities will be financed. Therefore, the key recommendation that many focused on was reducing the real and perceived penalty in the risk-adjusted returns of green investments.

While emphasizing real economy barriers to investment, interviewees acknowledged that market failures in the financial system have contributed towards a systematic bias in the financial sector's assessment of ESG investing and lending opportunities. The most common mentioned failures were asymmetric information and ignoring or underestimating environmental and social risks.

Alternatively, a handful of interviewees suggested that mainstreaming ESG investing and lending activities is more complicated than challenging the perception of lower risk-adjusted returns and presenting a stronger business case. They felt it was an ontological question about questioning the nature of returns and shifting away from the mindset of maximizing short-term financial profits towards building long-term sustainable value.

Box 3: Summary of Real Economy and Policy Interventions

- Strong carbon price signals through a carbon tax or carbon markets.
- Removal of subsidies supporting the development of an energy-intensive extractive economy
- Comprehensive policy framework on the green economy, including regulatory incentives, standards and integration into international markets.
- Energy and transportation policies to accelerate green investment.
- Alignment of policy inconsistencies at the sector level between the real economy and financial sector and long-term strategic plans and White Paper level.
- Clear roles and responsibilities among government departments, agencies and parastatals.
- Education programmes and incentives supporting behavioural changes in consumption and production patterns.
- Demonstration projects which could change financial intermediaries' perception of green investment opportunities.

5.2 How Effective Are the Current ESG Policies and Codes?

South Africa's approach is based on principles-based, 'light-touch' regulation, using positive incentives and the 'apply or explain' compliance method. The vast majority of interviewees supported this approach. Lawyers and regulators argued that the diversity and evolving nature of sustainable business practices and financing channels makes a strong case for principles-based regulation, which can be implemented according to context. The lawyers also mentioned that a principles-based approach allows for new strategies, business models and products to be developed in the market and then codified. This is faster and more responsive than a top-down process of regulators defining these practices.

Emerging from the interviews was a view that the light-touch approach is a pragmatic best solution to the tensions and challenges for green investment in South Africa. Interviewees were concerned that a rules-based approach would increase transaction costs, push up hurdle rates, cause asset inflation that could threaten the financial system's stability, and reduce investment in alternative assets classes that offer greater opportunity for green investment. Also, many interviewees felt the state has insufficient resources to implement more stringent regulation, making the passing of more rules-based regulation a paper-based exercise with little practical value.

Nevertheless, interviewees acknowledged that progress under the light-touch approach has been slower than expected and gains took more effort than anticipated. In part, they felt this reflected weak monitoring and implementation. For example, one interviewee mentioned that the JSE should be more diligent on holding companies to account under its 'apply or explain' requirement, whereas the majority of interviewees voiced concern that the FSB-SA has not been active in asking trustees to substantiate how they are fulfilling their Regulation 28 obligations. In particular, interviewees mentioned the significant gap between trustees' envisaged and actual role in championing ESG investing practices. Trustees' commitment to ESG investing has not moved beyond attending training and advocacy. Asset managers and asset consultants remarked that trustees focus on whether their investment surpassed or fell below the benchmark and rarely ask their service providers questions about ESG investing.

Despite these weaknesses in implementation, only a few interviewees considered a more prescriptive regulatory approach, such as prescribed assets or green credit guidelines to be needed. As one sustainability manager put it, ESG polices and codes "are trying to pull the market into a conversation it does not really want to have about sustainability and [the pace of change will be slow because] we are talking about a fundamental reshaping and restructuring of the market." A regulator remarked "that at some point, a continuum of tools based on private and public rules [will be] needed to build a sustainable financial system." The banking sector was adamant that more rules-based regulation would not be an effective tool for channelling more capital into ESG lending activities because bottlenecks are primarily a real economy issue. The consensus among interviewees was that large-scale, complicated financial innovations to increase ESG lending and investing would not be useful. Interviewees echoed the sentiment of Angeline Kemna, the Dutch pension fund's Chief Investment Officer, that the goal of ESG financial policy innovations should be "controlled simplicity" – one that does not necessarily result in more regulation, but steers capital intelligently towards long-term sustainability (UNEP, 2014).

5.3 Financial System Barriers

While interviewees supported the current system of principles-based regulation and market response, they highlighted a number of barriers and obstacles within the financial system that remain ineffectively addressed:

- **Asymmetric information:** Nearly every interviewee referred to integrated reports as being form over substance, leaving investors without access to standardized quantitative ESG information. One niche information provider prepares information on a proposal basis, but South Africa has no ESG rating agency. As a consequence actors conduct primary ESG research for themselves, but this route is expensive and time-consuming. Raw data is scattered throughout the system, data is incomparable and methodologies and analytical tools for quantifying E&S risks are not standardized. Too few financial journalists are analysing the effect of ESG issues on financial performance and the standard of reporting on these issues is weak.
- **Remuneration structures:** When remuneration packages have a large bonus component based on the value of deals closed, a more complicated, time-consuming deal with a greater chance of failure is a deterrent. Compared to business-as-usual projects, developmental projects have higher transaction costs and they are discounted at a premium. Hence the remuneration structure incentivizes lenders to pursue mega-deals, with low transaction costs and a favourable risk-return profile; generally opportunities benefiting from scale economies, a commercialized technology with a strong track record and a project with a 5-7 year time.
- **Trustees' capacity:** Over 80 per cent of interviewees cautioned that trustees' ability to drive ESG investing is influenced by the governance framework of pension funds. Trustees are under pressure to achieve industry benchmarks and have limited time and resources. As a consequence, they often find it difficult to question their service providers on ESG issues. A few interviewees remarked that asset consultants, who bridge the knowledge gap between trustees and asset managers, are insufficiently guiding trustees through responsible investing practices,[16] which has negatively affected trustees' confidence and ability to ask questions.
- **Difficulties in coordinating between commercial banks and DFIS**: DFIs aim to provide catalytic funding for more risky projects dealing with early-stage technologies or developmental impact. However, DFIs can also compete with commercial banks for senior debt because both are seeking safe investments, leaving a funding gap for equity (NBI, 2013a). The danger is that DFI funding may be allocated to projects that do not require concessional funding, crowding out private finance, while at the same time failing to fund projects at the cusp of commercial viability where they could crowd in private finance (NBI, 2013a).

Several interviewees highlighted the need for reforms in the real and financial economy to be aligned and for financial measures to be based on a clear understanding of barriers to investing and lending in the green economy. The majority of interviewees (and every banker) remarked that the starting point for exploring environmental policy innovations is to understand what drives financial intermediaries' lending and investment decisions.

Some felt that mainstreaming ESG investing and lending into the core activities of financial intermediaries would take time and involve the emergence of a stronger business case challenging perceived notions about the lower risk-adjusted return of ESG opportunities. Others, however, felt that it was more complex than this, with an ontological question about the nature of the financial system and the returns possible from the economy. Furthermore, they proposed that challenging the nature of the financial system positions financial reform as a broader political economy issue.

[16] *For example, Riscura is the only asset consultant to sign up to the Principles for Responsible Investment.*

5.4 Areas for Action

Specific areas of potential include:

- **Strengthening implementation of principles-based regulation**: Most interviewees felt that greater standardization and monitoring of implementation could be undertaken without losing space for market-led innovation.[17] Their aim was not to directly drive investment decisions through compliance, but to improve the flow and analysis of information across the value chain, to expose the value of integrating E&S factors in investment decisions (for example through more structured reporting, monitoring and evaluation mechanism that makes it easier for stakeholders to compare information). The regulator could also provide guidance notes for implementing principles-based policy/codes and more diligently hold actors accountable under the 'apply and explain' requirement.
- **Action to strengthen the practice of fiduciary duty:** Financial intermediaries believe trustees of pension funds should take a more active approach towards ESG investing, as the mandate from trustees provides the catalyst for asset managers to change their investment process. Steps to encourage this could include stronger monitoring of Regulation 28, a more proactive approach, by asset managers to sensitize trustees to ESG issues, trustee training and education.
- **Development of models to quantify risk:** Banks are beginning to integrate ESG risks into decision-making mostly on a qualitative basis, as part of pre-investment screening processes. However, interviewees emphasized that risks will not be adequately considered unless they can be quantified and priced. Improving the understanding and quantification of ESG risks would allow commercial banks to assess them better and to pass them on in the syndicated debt market. This needs to be an industry-wide initiative as otherwise pricing ESG risks would be seen as uncompetitive.
- **Better coordination between funding institutions, especially commercial banks and DFIs:** As institutions have different risk appetites, coordination initiatives should connect relevant parties to supply back-to-back financing, which will crowd in partners to unlock finance through de-risking. Key issues highlighted include improving term matching between commercial banks and DFIs, and harmonizing and standardizing the monitoring and reporting requirements for different concessionary credit lines. The NBI proposed developing a refinancing vehicle that allows lenders to either exit or alter their exposure, without affecting the product's risk profile. This could be supported with the collaborative development of an assessment tool and setting criteria that inform how commercial banks and DFIs will allocate projects (NBI, 2013a).
- **A clearer framework for lender liability:** Lender liability can be a powerful way of internalizing environmental risks into investment decision-making, including by developing demand for insurance products to hedge environmental risks. Commercial bankers and the industry association argue that legislation and guidelines should be developed to address policy uncertainty. One option is the Safe Harbour model used under the US CERCLA (superfund) legislation, which sets agreed due diligence processes and criteria for banks and provides that if

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[17] *The case for striking a better balance between open-ended principles and guidelines was echoed in the E&Y (2013) CRISA survey. Their survey showed actors find the principles open-ended and little clarity makes the implementation of ESG investing difficult. Furthermore, the study concludes that 'standard definitions, clear monitoring actions and in-depth knowledge are needed in order to move the industry forward' (E&Y, 2013).*

they undertake these safeguards they will have limited liability for the costs incurred in rehabilitating the land.

- **Reforming regulations for unlisted assets:** A number of interviewees highlighted the important role of private equity and hedge funds which have more experience with ESG investing and their portfolios' exposure to ESG investments is greater. A common theme highlighted by interviewees is that the 'big opportunity for ESG investment is in the unlisted space' while the policy innovations tend to target general asset management funds and listed equities. They argued that reforming regulations that affect investors' willingness to invest in the unlisted would be more effective in driving green investment.
- **Developing a vision and roadmap:** A number of interviewees highlighted the need to reframe the conversation on what is needed for a sustainable financial system in South Africa – what action is needed by government, by the private sector and through international collaboration. A number reflected on the successful model of the Financial Sector Charter in developing a new vision and new social compact for the financial sector and in driving financial intermediaries to re-examine established beliefs about the characteristics of a profitable market, pushing them to develop new products, business models and infrastructure. Similarly, a national compact for a sustainable financial system would describe what success looks like, identify a package of interventions and assign ownership and responsibility for actions among the private and public sector (including potential areas for collaboration with international bodies).

In discussing the potential for South Africa's financial system to transform towards sustainability, interviewees discussed the political economy of change. South Africa's financial sector is one of the country's strengths, with a highly skilled labour force and sophisticated infrastructure – it is well positioned for leadership. However, it is heavily exposed to the 'dirty industries' because the economy is built on the extraction and mining of resources. Furthermore, it is fatigued by the pace and complexity of regulatory changes, which have stretched the resources of government and financial intermediaries. The financial sector has enough political power to influence the pace of regulatory reforms if they are likely to impact on the financial sector's performance metrics and rewards. Therefore, these steps will need to be carefully negotiated and sequenced, alongside supportive real economy measures.

Industry associations felt strongly that South Africa's experience with financial policy innovations provided important process lessons about gaining stakeholder buy-in for financial reforms in complex institutional environments, where competing policy objectives must be balanced, such as increasing social equity while maintaining the strength of the financial sector.

A common sentiment, raised by regulators and sustainability experts, was that ESG investing and lending might require a fundamental change in mindset among market participants, especially if ESG lending and investing requires sacrificing short-term financial returns for longer-term productivity gains across the economy. Interviewees argued that encouraging greater stakeholder and shareholder activism requires convincing people there is a direct benefit. An academic felt that the starting point is "making the issue more relevant, using the social agenda as the main draw card". The BEE agenda has a strong legacy and has been economically transformative. Lessons from BEE could be used to reposition the discussion of environmental issues, paying attention to understanding what stakeholders and shareholders care about, and using this knowledge to make the consequences of either acting or ignoring environmental concerns more tangible and immediate.

5.5 Macroprudential Risk Management

Even though environmental issues have been integrated into the government's real economy policies, these issues remain on the periphery of financial policy discussions. ESG issues have not been integrated into the SARB, NT and FSB-SA's responsibilities and policy outputs, as the chief policy concern is the health, stability, solvency and profitability of the financial system. This agenda has been influenced by international regulatory developments and South Africa's status as a G20 member to meet international standards.

Over the past five years, the financial sector has faced waves of regulatory reforms, such as such as Basel III and anti-money laundering regulations. As a consequence, regulators have prioritized the implementation of international regulatory standards and ensuring the financial sector is fully compliant.

The stage of the ESG debate in the financial regulatory space is not an indication of these issues' importance, but mirrors international experience where regulators, especially central bankers, are experimenting with frameworks to understand how environmental risk feeds into capital allocation decisions. Regulators have also prioritized the implementation of international regulatory standards and ensuring the financial sector is fully compliant.

The macroprudential risk assessment model analyses the relationship between the economic system and financial markets to assess whether the financial system is vulnerable to shocks and its resilience. This model considers many variables, but credit risk is prioritized as the main source of instability. A senior official at the SARB confirmed that the assessment of macro-prudential risk is "based on bad-debt profiles, the extent of impairments, the level of banks' solvency ratios, and the possibility of a financial institution defaulting and its potential to destabilize other banks [the likelihood of contagion]". Hence the SARB's macro-prudential risk assessment model does not consistently or comprehensively include qualitative and/or qualitative information on ESG factors.[18]

However, the effect of social-political unrest on the financial system has increased regulators' interest in exploring ESG issues. Strife at Marikana[19] provided regulators with an example of how social and political factors impact macroprudential risk, as it highlights the interdependence between the wage dispute at Marikana and the financial sector's exposure to greater credit risk.[20] The National Credit Regulator demonstrated that microlenders were charging exorbitant usury rates and granting excessive loans. These lending practices placed miners under excessive financial pressure, which exacerbated the intensity of the wage dispute, resulting in protracted mass action. Following the Marikana incident, the SARB has a greater appetite to consider the effect of possible labour disputes, as part of a broader macro-economic analysis, on the vulnerability of the banking system to credit risk. For example, the SARB (2013) Financial Stability Review identifies the possibility of labour tension from Marikana spilling over into others sectors and the growing level of unemployment as two critical risks effecting financial stability.

The SARB has the mandate to review broader system issues that could possibly influence macro-prudential risk on a case-by-case basis. Most of these reviews have investigated the rapid expansion of unsecured lending to households, seen as part of the broader financial inclusion agenda and protecting

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[18] In addition, according to a regulator, compared to the SARB, the NT probably has a greater appetite for climate change work, especially the effect climate change will have on the balance sheet of insurers.

[19] Lonmin and miners were involved in a protracted wage dispute as negotiations between management and competing unions had resulted in a stalemate. After the failure of these negotiations, violence erupted on 6 August 2012, and 34 striking miners were killed.

[20] Reckless lending reduces the disposable income of households, which increases the likelihood that households will default on their debt payments.

the financial system from excessive exposure to credit risk. The demise of African Bank tested the government's policy towards unsecured lending. It also showed that the focus of financial regulatory reform has broadened from pushing to bank the unbanked to ensuring their access to banking services and products is sustainable. Regulators from the SARB, the NT and the FSB-SA suggested research and debates on sustainable financial inclusion potentially provides an entry point for considering ESG issues.

6 Potential Topics for Further Research

Through the stakeholder engagement process, this paper has identified four areas of experience and debate as potential areas for further research:

- The REIPPPP highlights the interrelationship between the bankability of ESG opportunities and developing a strong green economy, creating a strong argument for the **careful sequencing of interventions in the real and financial economy**.
- The **governance innovations** are an example of a green policy innovation resulting in new rules governing aspects of the financial system to integrate ESG information.
- The **Financial Sector Charter** was focused on social rather than environmental aspects but highlights the potential for negotiating a roadmap for transition through a structured process of engagement between the financial sector, government and civil society.
- A final area involves **exploring whether the SARB should include environmental risk as part of its macroprudential risk assessment process**.

This section outlines questions arising from the initial review of these four areas.

6.1 Renewable Energy Independent Power Producer Procurement Programme

What does the success of the REIPPPP teach policymakers about the role of financial regulation and legislation in channelling capital into the development of an inclusive, green economy?

1. How can real economy policies best be combined and sequenced with a financial regulatory reform approach?
2. Has participation in the REIPPPP increased the commercial banking sector's comfort with accurately assessing the cost and benefit of non-traditional technologies?
3. Have lessons of assessing green technologies been incorporated into their standard credit assessment process?
4. How can the lessons from participating in the REIPPPP be used to stretch a banks' willingness to experiment with more complicated green projects?

6.2 Governance Innovations

What lessons can be gained from the governance cluster and how can these lessons inform other countries' development of a sustainable financial system?

1. How can the success of the voluntary 'apply or explain' governance approach be assessed?
2. What effect has the governance cluster had on the ability of financial intermediaries to manage risk?
3. To what extent can long-term environmental and social risks be integrated within the fiduciary duty framework?
4. What is the relationship between measures to improve the ability of individual financial actors to assess ESG risk and the stability and sustainability of the financial system?
5. How do the different elements of the governance cluster support each other?

6.3 The Financial Sector Charter

Could the model of sector-led reform used in the FSC be replicated in developing a negotiated social compact focused on greening the financial system to meet the needs of society?

1. How did the FSC evolve? What other government policies or socio-economic events facilitated the implementation of the FS Code and the achievement of targets?
2. Where has the FSC made the greatest contribution to transformation? What pillars of the FSC have been the most effective in driving transformation?
3. Did it succeed in shifting stakeholders' mindset?
4. How important was the link to government procurement criteria?
5. What lessons can be gained from the experience of developing and implementing the FSC and how can these lessons inform other countries on the subject of developing a sustainable financial system?

6.4 Macroprudential Risk Assessment

How could regulators in South Africa more broadly integrate ESG factors into the macroprudential risk assessment framework?

1. What will be the relationship between ESG indicators and financial instability and can a model with predictive power be developed?
2. What would be the effect of including ESG factors as a macroprudential risk element? Would it result in the reformulation or modification of the risk assessment framework?
3. Does the architecture of the institutional environment affect the ability of regulators to assess and monitor macroprudential risk in a holistic manner, which includes the integration of ESG risks?
4. What lessons can be gained from the exercise and how can these lessons best inform the development of sustainable financial systems in other countries'?

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Annex I: Interviews

Interviews were carried out with individuals from the following positions and organizations:

DNA Economics (Policy Consultants), Climate Change Expert

Hollard Insurance and Yellowwoods, Executive Chairman

Genesis Analytics (Economic Consultants), Executive Management

Standard Bank (Large Commercial Bank), Group Sustainability Management

Stanlib (Large Commercial Bank), Senior Management: Research

Standard Bank (Large Commercial Bank), Executive Management: Investment Banking

Hollard (Large Insurer), Treasury

First Rand Group (Large Commercial Bank, Environmental and Social Risk Management

University of Cape Town, Faculty of Law, Centre of Criminology

Association of Savings and Investment South Africa, Responsible Investment Standing Committee

Association of Savings and Investment South Africa (industry association), Policy Advisor

National Business Initiative (Think tank), Executive Management and Climate Change Expert

South African Reserve Bank (Regulator), Advisor

National Treasury (Regulator), Senior Management, Financial Investments and Savings

Financial Services Board (Regulator), Senior Management Regulatory Framework, Insurance Division

South African Insurance Association (Industry Association), Executive Management and Consultant

University of Pretoria, Governance and Innovation Seminar

Wits University (University), Professor Economics and Public Finance,

World Wildlife Foundation (Think tank), Living Planet Unit

Johannesburg Stock Exchange (Regulator), Executive Management, Strategy & Public Policy, Social Responsibility Index & Sustainability

The Banking Association of South Africa Association (Industry Association), Executive Management and Senior Management

Financial Intelligence Centre (Regulator), Economist

Section 27 (Think tank), Executive Management and team

Old Mutual Investment Group (Integrated financial provider), Sustainability Research and Engagement

Investec (Large Corporate), Senior Manager Sustainability

Element (Medium Corporate), Senior Manager Asset Management

Sanlam (Integrated Financial Provider), Compliance Managers

First Principles (Sustainability Consultancy), Governance Expert

PIC (Parastatal), Senior Corporate Governance Specialist

GEPF (Parastatal), Senior Management ESG

Aimee Girdwood (Lawyer), Sustainability Advisory and Legal Specialist

Riscura (Domestic Asset Manager), Executive Management

UCT-GSB (Business School), Responsible Investment Specialist

USB (University), Governance Expert

Incite (Sustainability Consultancy), Integrated Reporting Expert

Wits (University), Integrated Reporting Expert

Towers Watson (International Asset Manager), Executive Management

International Finance Corporation, Programme Managers

Annex II: Interview Questions

First Set of Interviews

1. What pieces of financial legislation and/or financial policy are a priority (for example FAIS Act, Basel III)?

2. Are environmental perspectives and inclusive economy issues integrated into the design of the financial system's architecture, especially policies, regulations, standards, fiscal measures shaping the governance of the financial system and the governance of institutions?

3. What are the critical financial policies, financial regulations, guidelines and or practices that facilitate or hinder the channelling of capital by financial institutions into the green economy and local economic development?

4. Are there any opportunities for the better integration of environmental perspectives and inclusive economy issues into the financial system, using policies, regulations, standards, fiscal measures?

5. If you could change and/or introduce any piece of financial regulation and/or financial policy to make it easier to fund projects that support a green, inclusive economy, what would the reform be?

6. Are there any new or emerging developments on the horizon that are pushing the creation of a financial sustainable system forward (includes initiatives and projects)?

7. What effect have King Code III and Pension Policy (Regulation 28) had on the channelling of capital into investments in the green economy and local economic development?

8. Which respect to King Code III and Pension Policy (Regulation 28):

    - What are the market conditions under which information on green and inclusive outcomes becomes material to financial decision-makers?
    - What are the policy and regulatory options for ensuring a ready flow of credible and material information?
    - How can financial institutions themselves improve the disclosure of the sustainability performance of their capital allocation decisions?
    - What is the experience of including broader sustainability goals and risk assessment frameworks on performance in private and public institutions?
    - How important is the perceived gap between fundamental financial responsibilities (such as fiduciary duty) and sustainability factors, and what are the most effective market and policy mechanisms to achieve alignment?

9. What should be the project's focus over the next 6 months or year?

Second Set of Interviews on Governance Innovations

1. When the policy innovation was designed, what was its purpose, from the perspective of architects?

2. What is the decision-making mechanism underpinning the policy innovation and how does it support the purpose of the policy innovation?

3. What is the principle connecting the policy innovation's decision-making mechanism to influencing stakeholders' decision-making pathways and the outcome of their capital allocation decision process?

4. Have the envisaged benefits of the policy innovation identified by its architects, during the design phase, been realized?

5. What factors have helped and/or hindered the realisation of the policy innovation's intended benefits?

6. Can any lessons be drawn from post-design execution experience, especially the decision-making mechanism underpinning the policy innovation and its direct and indirect effect on ESG lending and investing?

7. What is the most significant post-execution learning, and are there opportunities for the architects of the policy innovation to draw on learnings to refine the policy innovation?

8. What measures are used to gauge whether the policy innovation is achieving its intended objective? Are adoption rates, proportion of ESG lending and investing compared to traditional activities, and intermediary outcomes considered as measures?

9. If you could change/refine any design principle underlying the policy innovation, especially those dealing with the decision-making mechanism, what would it be? In other words, what would the next generation of the policy innovation look like?

Are there any new or emerging developments on the horizon that are pushing the creation of a financial sustainable system forward and what potential role can the policy innovation play in driving developments in ESG lending and investing?

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