Key Points

- Risk narratives need to be adopted to straddle the disconnect between climate change concerns and the general operations of the financial sector. Financial sector policy makers and regulators are only likely to address sustainability and climate change concerns if they understand their responsibility and the potential threat of systemic disruption and other market risks.

- In the past, multilateral agencies have employed a narrow definition of climate finance, but the compelling scientific evidence of global warming suggests a way must be found to broaden this definition, in order to crowd in more public and private sector investment. Part of this involves accepting that development finance must incorporate climate change concerns and enhance sustainability.

- Finance to enhance sustainability has to address domestic and regional climate and welfare concerns to be effective. From an African perspective, it needs to identify the most pressing issues, which is likely to involve in-depth, localized research and engagement to enhance climate change resilience.

Introduction

One of the most important and topical discussions within the global multilateral arena is the challenge of meeting the world’s climate finance needs in order to reduce carbon emissions to sustainable levels and support adaptation strategies. The mobilization of finance is key in supporting the transition away from traditional high-carbon or business-as-usual economic pathways toward low-carbon, climate-resilient economic systems.

Global sustainability, climate change and financial policy address innovative methods of regulating resources, including innovative governance arrangements. The conversation on reforming policy that impacts the environment is moving beyond the academic into the realm of practical policy application. The financial system continues to channel investment to unsustainable development and fails to integrate regulatory and physical risks into its assessment of value and return on investment. Implementing these global mitigation and adaption intentions at the national and local levels also presents a major challenge due to capacity constraints, climate readiness and conflicting development priorities.

This debate was interrogated at a conference, Global Sustainability, Climate Change and Finance Policy, organized by the Centre for International Governance Innovation and the South African Institute for International Affairs, held in Johannesburg from July 1 to July 3, in three parts, namely: the role of international organizations and climate finance; the integration of climate and sustainability issues into the financial sector; and, finally, the impact of climate finance at the national level, particularly in African countries.
Box 1: Integrated Reporting and Its Role in Sustainability in South Africa

South Africa was selected as the host country for this discussion, as it has made some progress in incorporating environmental, social and governance (ESG) risk factors in its corporate reporting. Integrated reporting has become entrenched through the JSE (Johannesburg Stock Exchange) as a requirement for listed companies. The King Code of Governance for South Africa 2009 (King III), challenges leaders “to make sustainability issues mainstream. Strategy, risk, performance and sustainability have become inseparable; hence the phrase ‘integrated reporting.’” King III is the culmination of a process that began in the mid-1990s, in which integrated reporting is a key management tool. In contrast to King I and King II, King III applies to all listed entities regardless of the manner and form of incorporation or establishment. Principles are drafted on the basis that, if they are adhered to, any entity would have practiced good governance. Unfortunately, there are companies that are not listed that still have a big environmental and social impact, with associated legacy issues.

King III recommends that entities disclose why they do not present integrated reports. The aim is to improve disclosure to allow stakeholders to comment on and challenge the board to improve the level of governance within an organization. The improved disclosure requires of shareholders that they play an active role in understanding the ESG reporting and, to this effect, the Code for Responsible Investment in South Africa (CRISA) has been published as a voluntary code for investors.

Together, integrated reporting and CRISA provide a foundation for improved transparency and that may cast more light on crucial sustainability concerns and environmental management.

Box 2: Excerpts from the Opening Address by Salim Fakir, Head of Living Planet, World Wildlife Fund South Africa

Climate finance has gained renewed international attention due to the creation of the United Nations Framework Convention on Climate Change (UNFCCC) Green Climate Fund (GCF). The overall GCF pledges now amount to $10 billion. This is far short of the call to fill the GCF coffers with $100 billion by 2020, which is needed to support UNFCCC mitigation and adaptation programs. The GCF is one of many different pots of climate finance that are managed by various multilateral and bilateral institutions. Nonetheless, these will fall far short of the levels of investment required in green infrastructure. The discourse of climate finance itself can define a very narrow scope of what the debate ought to be. It is highly unlikely that climate finance provisions from multilateral sources would meet or be able to unlock the required levels of finance to support global needs for both adaptation and mitigation. Other sources of finance have to be mobilized. Some thought is being given to innovative ideas of mobilizing resources through applying financial transaction levies, through the future pricing of carbon or by applying aviation taxes. Ultimately, long-term climate infrastructure investment visibility will be crucial to unlocking sources of conventional finance from banks, Development Finance Institutions (DFIs), pension funds and private equity sources. This was demonstrated in South Africa’s renewables program, which mobilized (without international climate finance) close to $19 billion worth of private and public investment for renewables projects. A key lesson here is that domestic policies can make a big difference in driving climate investment strategies. More effort needs to go into supporting the creation of climate infrastructure investment visibility than focusing primarily on multilateral processes.
Background: The Financial Sector and Sustainable Development

The discussion on sustainability in the context of climate change has largely bypassed the financial sector for many years. Within the financial sector, the term sustainability has usually been used as a synonym for financial sector resilience and stability. For a time, it seemed that sustainability issues, such as global population increase, poverty reduction, environmental degradation and climate change, did not have a significant impact on financial sector stability. However, this view is changing. In 2015, the governor of the Bank of England asked the insurance sector and the banking sector to disclose risks caused by climate change, climate change regulations and economic consequences of climate change (Clark 2014).

While the link between climate change and its consequences for the insurance sector is fairly obvious (payments for compensation of insured loss caused by events such as storms and flooding increased significantly over the last years), the link is more obscure for the banking sector and financial stability. Prior to the 1980s, lenders did not have to take any environmental risks into account in their financial decisions. With the introduction of new environmental regulations, such as the United States Comprehensive Environmental Response, Compensation, and Liability Act, lenders’ risks became sensitive to environmental and social sustainability issues. For example, the value of collateral was undermined where it was later discovered land was contaminated (Garber and Hammitt 1998). In addition, borrowers from polluting industries were forced to invest in environmental technologies to reduce emissions. These investments, of course, did not come without costs, which in turn increased credit risks. Studies suggest that environmental and social sustainability issues have a significant impact on the credit risk of commercial borrowers (Goss and Roberts 2011; Weber, Scholz and Michalik 2010). Consequently, lenders’ credit portfolios were also at risk. Most lenders introduced risk assessment and risk management systems and were able to mitigate these risks.

Today, the carbon bubble, stranded assets and divestment approaches have become more commonplace topics in the financial sector. The realization that climate change is an important risk to the sector, and that environmental and social issues have to be taken into account if sustainable growth is to be achieved, is growing.

The financial sector plays a central role in channelling financial capital into businesses, projects and sectors. A report by the Stockholm Environment Institute estimates that between US$363 billion and US$2.4 trillion need to be invested to support climate change mitigation (Tempest and Lazarus 2014). While the financial sector has been managing financial risks arising from environmental and social concerns since the 1980s, sustainable financial products and services remain niche products and are often not connected with core financial sector strategies. There is also little strategic focus by the financial sector on sustainable development.

Voluntary codes of conduct have been adopted by the financial sector in many industrialized countries in recent years. They focus on general banking practices, such as the United Nations Environmental Programme Financial Initiative, and on particular banking and finance activities, such as the Equator Principles for Project Finance and the Principles for Responsible Investment for Institutional Investors. While they provide some guidelines for sustainable finance and how to integrate social and environmental risks into financial decision making, critics say that their impact is minimal and that they serve as an instrument to increase reputation rather than increasing sustainability performance (O'Sullivan and O'Dwyer 2009). Others argue that a voluntary code of conduct such as the Equator Principles help financiers standardize their social and environmental risks assessment procedures and strengthen the topic inside financial institutions (Weber and Acheta 2014). The voluntary nature of these guidelines means they are not enforced by regulators, but they do create some pressure on non-signatories to participate.

Green financial regulations were recently incorporated by the respective central banks of China, Brazil, Bangladesh and Nigeria in their sector guidelines. This regulatory thrust strengthens the enforcement of the main objective of reducing the negative environmental and societal impacts of borrowing and investment and addressing financial risks for the financial sector arising from environmental risks.

Climate Finance and International Organizations

International organizations and conventions such as the Group of Twenty (G20), the United Nations and the UNFCCC aim to address global sustainability issues. The discussion in Johannesburg looked at whether these institutions could be useful arenas in which to tackle climate change and finance policies.

Accountability, targets and clear guidelines are important issues with regard to broadening the discussion on climate change concerns. If local needs are to be taken into account, a transparent and efficient way of monitoring should be developed and implemented that measures the environmental and societal impact of climate and sustainable finance. This could build on...
the international safeguards and disclosures, such as the Global Environmental Facility’s Policies on Environmental and Social Safeguards Standards and Gender Mainstreaming. Significantly, localization and specificity of project outcomes need to be given consideration.

Before accounting mechanisms can be implemented, more research about the effect of climate change mitigation and adaptation financing instruments is needed. It is still unclear which financial instruments are most effective — whether domestic or international finance and private or public finance, or a combination of them, will have the greatest impact on creating opportunities for sustainable projects. Both Turkey and China have clearly pointed out that climate issues will be important agenda items for these countries as the current and future G20 leaders (for 2015 and 2016, respectively). Many of the G20 members have put their support behind all countries revealing their Intended Nationally Determined Contributions ahead of the Conference of the Parties (COP) 2015 meeting (COP 21).

DFIs should develop a two-degree road map to conduct development finance in a way that is compatible with climate change goals. Therefore, different concepts — such as carbon pricing, low carbon projects, sustainability-related financial regulations, guarantees and public private partnerships — should be explored.

Integrating Sustainability and Climate Change into Financial Sector Activities to Support a Transition to a Green Economy

Environmental and sustainability risks are usually not addressed in financial regulations, although the financial sector is often seen as being important for a transition to a green economy.

Significant innovations and investments are necessary for climate change mitigation and adaptation. The financial sector can play an important role in this regard. The connection between the financial sector and climate change, however, is twofold. First, climate change may become a significant risk for the financial sector by having negative impacts on financial sector investments. Second, the financial sector may be an intermediary that can contribute to and support activities that reduce carbon emission levels and that foster climate change adaptation.

In order to understand the role of the financial sector with regard to climate change and sustainability, long-term risks and opportunities have to be taken into consideration, in addition to short-term thinking. Only a longer-term perspective is able to recognize broader systematic risks and opportunities, including climate change, for the financial sector.

In South Africa, the financial sector is sometimes seen either as an example of innovative governance to address socio-economic issues (as in the Financial Sector Charter) or, alternatively, as separate from the rest of the economy (the National Development Plan is silent on the role of the sector in contributing to development). The South African banking sector is globally acknowledged to be stable and has a considerable footprint in Africa. It could potentially play an influential role in galvanizing sustainable finance across the continent. Key to raising the sustainable finance debate is asking what sorts of intervention does business have to make now to still be doing business in 20 years. It seems clear that this requires a combination of voluntary codes and regulatory incentives.

In Nigeria, for example, the Nigerian Sustainable Finance Principles (NSFP) came about as a consequence of the voluntary actions of Nigerian banks, as led by international development banks in September 2012. As this illustrates, pressure from development financiers and the influence of domestic or regional financial sector sustainability leaders may lead to the development of industry sustainability guidelines. Problems with the enforcement of the guidelines could be solved by the involvement of the financial regulator or the central bank. The Central Bank of Nigeria is now driving the implementation of the NSFP, currently guiding banks to comply with reporting requirements over a period of five years. The regulator is an independent body that may supervise and enforce the sustainability guidelines, as the Nigerian example demonstrates. However, there is no experience with the enforcement of sustainability guidelines and codes of conducts yet.

From a financial regulator’s perspective, climate finance and sustainable finance regulations make sense if they address abnormal market influences. Impacts of climate change and climate change regulations on the banking sector could be such an abnormal market influence. In addition to abnormal market influences, the lack of transparency may be regulated. For instance, banks could be asked to disclose financial risks caused by climate change risks, such as portfolio risks caused by impacts of extreme weather on borrowers. Although reporting about climate finance and sustainability may be important first steps, it must be ensured that climate finance and sustainable finance do not become just accounting issues. Instead, evaluating the climate and sustainability impact of finance decisions should become integrated into business strategies, products and services in the banking sector.

From the renewable energy perspective, the financial sector should realize that renewable energy presents a good lending and investment opportunity. It is obvious that sustainable and climate finance in Africa needs to address different mitigation and adaptation imperatives than those in North America, Europe or Asia. In this context, the creation of both positive incentives (such as good investment opportunities) and negative incentives (such
as regulatory requirements) have a role to play in encouraging the financial sector to play its part in addressing sustainability and climate change concerns in developing countries.

The Impact of Climate Finance on Sustainable Development

Debates on a post-2015 sustainable development agenda have focused on how to improve the intersection between climate change, the environment and resource-use efficiency, in particular in energy provision and access. Given the emphasis by African policy makers on equitable growth and social inclusion, climate finance must support Africa’s commitment toward sustainable resource governance, inclusive growth and a transition to a low-carbon and climate-resilient development pathway. More effort is needed to translate climate finance debates into tangible outcomes at the national and grassroots levels through capturing context-specific realities to inform the implementation of global (for example, sustainable development goals) and continental development plans. A number of areas should be explored: how climate finance is linked to socio-economic development and green growth; to what degree it is consistent and aligned with national policies; and the potential contribution to long-term development. Furthermore, ways to address climate readiness and share lessons on how to overcome key constraints in the absorptive capacity of African countries should be analyzed. Of particular interest is the link between climate finance and Nationally Appropriate Mitigation Actions and National Adaptation Programmes of Action.

A key challenge related to climate finance is predictability. In order to be able to plan long-term activities based on climate finance, financing must be more predictable. To create climate finance mechanisms that address the main challenges for African countries, it is imperative that member states speak with one voice. In this regard, the African Group of Negotiators to the UNFCCC has a consolidated negotiating position on international climate finance. Consequently, this strength could help to develop new and effective ways of climate finance that leads to a win-win situation between the developing and the developed world. However, innovation and credibility are at the core of this process.

The main goal of climate finance in Africa should be to delink economic growth and greenhouse gas (GHG) emissions. Breaking this connection could help African economies become more efficient and create greater benefits for the African populations. For example, as the highest contributor of GHG emissions per capita in Africa, the South African economy is inefficient in terms of GHG emission per capita relative to welfare creation. (The current South African GHG emissions are comparable to countries such as Poland or Germany, both of which have a much higher GDP per capita.) Because of the predicted economic growth in Africa, GHG emissions will grow significantly if no strategy for a low-carbon economic development is in place.2 The example of Chinese economic development, which rapidly increased GHG emissions, should be taken as a warning.

The connection between development finance and climate finance has to be considered carefully. From a practical perspective, it may seem difficult to distinguish between climate finance and development finance. Moreover, it should not just be assumed that development finance is climate finance. This could lead to double counting of development and climate finance and to a total decrease of financial support. At the same time, there is a need for a heightened awareness that development aid should not finance activities that have a negative impact on climate change. Therefore, the question remains how development aid decisions can apply sustainability criteria to ensure they have positive rather than negative impacts on climate change.

The discussion highlights the need for an improved dialogue between development finance and climate finance practitioners to address the practical steps to ensure better alignment of development and climate finance. One step toward mutually beneficial outcomes between development and climate finance would be better definitions and methods to track the impact of activities. This would help ensure that funds spent on climate change mitigation or adaptation projects achieve “additionality,” meaning additional climate change mitigation or adaptation outcomes are delivered. These needed impact assessment measures, however, are still in their infancy.

Conclusions

The discussion during the workshop showed that opportunities should be created to make sustainable development attractive for the financial sector. The initial stumbling block is a fixation on climate finance that is often quite divorced from the financial sector and for which there is no single definition.

Currently, the discussion about integrating new players into climate and sustainability finance is more focused around problems than opportunities. Because the financial sector is still uncertain about the risks that are connected with financing climate change mitigation and adaptation, innovative risk-mitigating mechanisms should be developed. For example, one view is that South Africa’s public-private partnership for energy worked because government guarantees fundamentally altered the risk calculations of finance institutions. In this

2 In some cases, African countries are still looking to increase basic electricity services to people; there are opportunities here for decentralized, off-grid renewable energy projects.
way, regulatory amendments and government guarantees can potentially alter the risk profile of potential investments, thereby making them bankable. Another approach would be to “translate” climate and sustainability finance into financial terms that can be understood by the financial sector to support the development of innovative financial approaches.

Furthermore, it seems that a combination of different policies, such as voluntary codes of conduct, financial sector regulation and national and international public programs, are the best way to support climate finance. Instead of discussing whether a certain policy is the best, different approaches that complement each other should be used. Voluntary guidelines, for instance, could help the financial sector to achieve certain goals that are set by regulators.

Climate finance and development finance should not be played off against each other. Rather, both aspects should be taken into consideration at the same time when it comes to developing financial mechanisms. Only an integrated approach will lead to efficient financing mechanisms that do not create trade-offs between development goals and climate change mitigation and adaptation goals. These mechanisms should also focus on regional-specific needs instead of applying the same criteria for all regions.

It was also concluded that climate and sustainability finance will ultimately make up only a small part of sustainable finance needs and that there is a pressing need to look beyond the current multilateral funding mechanisms. National plans should be developed that have long-term goals and that try to mobilize additional finance from the financial sector that creates financial returns as well as environmental, societal and economic benefits.

More research is needed to explore effective and efficient ways to connect the financial sector with a green economy transformation and sustainable development. What is the best way to make the financial sector a supporter of sustainable development and create financial sector stability at the same time? What can we learn from regulations and guidelines that already have been implemented, and will it make sense to support similar activities in more countries? How can we internalize global issues that have been externalized by finance so far?


**Acronyms**

COP Conference of the Parties
CRISA Code for Responsible Investment in South Africa
DFIs Development Finance Institutions
ESG environmental, social and governance
G20 Group of Twenty
GCF Green Climate Fund
GHG greenhouse gas
NSFP Nigerian Sustainable Finance Principles
UNFCCC United Nations Framework Convention on Climate Change

**Works Cited**

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