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Aligning Africa's Financial System with Sustainable Development

BRIEFING



The 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 will publish its final report towards the end of 2015.

More information on the Inquiry is at: www.unep.org/inquiry/ or from:

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This Briefing

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It draws on the Inquiry's ongoing research, and country engagement as laid out in more detail in two recent publications *Aligning the Financial System to Sustainable Development: Insights from Practice* (2014) *Aligning the Financial System to Sustainable Development: Pathways to Scale* (2015), both available from www.unep.org/inquiry/

Errors and omissions remain the responsibility of the Inquiry.

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SUMMARY

Adequate, appropriate finance is crucial for Africa's sustainable development. Its availability depends on African countries developing financial systems that can effectively draw on and deploy to best use domestic and international, private and public sources. With the growing importance, in particular, of both domestic sources of finance, and private investment (both domestic and international), it is critically important that Africa's financial and capital markets develop in ways that will promote sustainable development on the continent.

Aligning a financial system with sustainable development does not happen automatically. The increasing scale and sophistication of Africa's financial system alone will not achieve it. Indeed, international evidence amply demonstrates that financial and capital markets can — and often do — become detached and fail to adequately serve the long-term needs of inclusive sustainable development.

Innovative financial and capital market policies, regulations and standards can improve the alignment of the financial system with sustainable development. Lessons from developing countries in particular highlight the potential roles of central bankers, financial regulators and financial policy makers in delivering financing for sustainable development.

The UNEP Inquiry into the Design of a Sustainable System is identifying and distilling many of these innovations to enable them to be more widely and effectively adopted. Initiated in early 2014, the Inquiry will complete its work in late 2015, but can already highlight a portfolio of promising innovations, including those drawn from experience in Africa. A number of high potential areas are identified in this briefing, including specific developments in disclosure, credit risk management, fiduciary duties, lender and investor liability and bond markets.

AFRICA AND SUSTAINABLE DEVELOPMENT

Africa has achieved sustained economic growth over the past two decades, with real GDP increasing by 5 per cent on average in the years up to 2011. Major social and economic challenges, however, remain. Almost half of Sub-Saharan Africans are still living in extreme poverty, and two thirds of households are not connected to the grid or lack access to adequate sanitation. Economic growth has to be sustained, making use of time-limited, natural resource revenues to finance the transition to a more integrated, technologically developed, continental economy.

African development need not come at the cost of the environment, as socio-economic development and natural capital are closely tied in Africa. Indeed, African countries are among the global front-runners leading the transition toward greener and more inclusive economies. Many of these developments are highlighted in UNEP's recent report, "Building Inclusive Green Economies in Africa", which sets out the lessons from initiatives in recent years as well as the broad terms of the economic opportunity to Africa in greening its development.¹

AFRICA'S FINANCING ON THE MOVE

Africa's diverse financial and capital markets are on the move, growing in size, sophistication and potential as the driving force in financing the continent's development. In terms of public budgets, governments across the continent have developed the volume, diversity of sources, efficiency and costs of revenue-raising, including:

- **Domestic tax revenues** have been increasing across Africa since the beginning of the 1990s, including both direct and indirect taxes, and growth in natural resource revenues. The tax ratio (collected taxes expressed as share of gross domestic product) of the continent's "upper middle income" countries has converged with that of OECD countries (about 35 per cent), although for the "lower middle income" group it remains at around 22 per cent and the "low income" group at about 15 per cent.² The UN considers 20% as minimum benchmark necessary to achieve the Millennium Development Goals.³
- **Sovereign bond issuance** has grown rapidly over the last decade. Ethiopia has recently issued its first eurodollar bond, becoming the poorest country in terms of GDP per capita to tap the global sovereign bond market. Bond issuance across the continent in 2013 exceeded US\$8 billion.⁴ Importantly, yields in this fledgling market have remained low, although they have been rising more recently in the face of tightening US monetary policy. Furthermore, Africa's total hard currency debt remains low at about 4 per cent of the region's GDP, as compared to about 11 per cent for Latin America and 5 per cent for Asia.⁵
- **Sovereign Wealth Funds** have developed rapidly (albeit slowing more recently in the face of the commodity downturn)—from the larger US\$60-70 billion-plus North Africa oil-based funds of Algeria and Libya, to Botswana's multi-billion dollar fund to the new multi-million dollars funds of Gabon and Mauritania.⁶

Private finance has also been developing rapidly across the continent, in terms of volume, source and the means of its deployment:

- **Banking**, the core of the continent's private financial system, has continued to develop over the last decade. Sub-Saharan African banks are well capitalized, having average leverage ratios well over Basel III requirements. The median value for liquid liabilities to GDP has increased from 20 per cent to

31 per cent over the decade to 2012, while that for deposits to GDP increased from 12 per cent to 22 per cent over the same period. However, these figures remain weak compared to non-African developing countries, with the comparable figure for deposits to GDP being 38 per cent.

- **Stock markets** provide a growing source of finance, but Sub-Saharan Africa's combined value of publicly listed companies remains comparatively small, with about 1,100 companies listed on 19 stock exchanges supporting a combined market capitalization US\$1.4 trillion as of September 2013. Of this, South Africa accounts for close to 70 per cent of the total market capitalization and 388 of the listed companies.
- **Pension funds** play a critical role by mobilizing and allocating long-term savings to support investment. Recent reforms in many African countries have created private pension systems, which are rapidly accumulating assets under management. South Africa's pension funds have over US\$300 billion under management, and the Nigerian pension industry grew from US\$7 billion in December 2008 to US\$25 billion in 2013. Similarly, Ghana's pension industry is expected to expand fourfold from 2014 to 2018. Pension assets now equate to some 80 per cent of GDP in Namibia and 40 per cent in Botswana.
- **International private capital flows** to sub-Saharan Africa—foreign direct investment (FDI), portfolio flows and loan flows — reached US\$67 billion in 2012, up from US\$14 billion in 2002. In comparison, official development assistance (ODA) increased to US\$42.5 billion in 2012 from US\$18.1 billion in 2002. Since 2002, private capital flows to sub-Saharan Africa have grown at a robust pace of almost 20 per cent per year in spite of the global financial crisis. Interestingly, the share of FDI from the BRICS countries increased to about 25 per cent in 2010 and this trend is strengthening.

Whilst these developments follow fairly traditional paths, Africa has also witnessed significant innovations in its financial system, including:

- **Bank-less payment services**, with sub-Saharan penetration rates of mobile financial services exceeding 25%, as compared to 15% in North Africa and the Middle East and a global average of 4%, which offer the potential to extend financial services and access to credit over the critical 'last mile' to households and SMEs.
- **Remittances** from Africans in the diaspora rising rapidly, with transfers in 2013 valued at US\$32 billion, or about 2% of the region's GDP. Projections to 2016 suggest that remittances could rise to US\$40 billion.

FINANCING OUT OF STEP WITH SUSTAINABLE DEVELOPMENT

While Africa's financial system has developed rapidly, it can often seem disconnected from the continent's financing needs. These disconnects are well known—often stemming from under-developed physical, institutional and human capital—and can present barriers to meeting key financing needs:

- **Weak project preparation and execution capacity.** This problem is often accompanied by under-developed investment climates, including challenging public administration and governance.
- **Weak financial inclusion.** Two-thirds of adult Africans do not have a bank account, let alone access to savings, credit or insurance. Less than one-quarter of African businesses hold a loan or line of credit, and the majority of loans are short-term rather than the long-term credit needed to finance investment.⁷

- **Underdeveloped banking systems.** While banking dominates the financial system it remains characterized by inefficient intermediation and limited competition. A large share of assets are held in the form of government securities and liquid assets. Lending is mainly short-term in nature. Banks enjoy comparatively high profits, well in excess of their counterparts in other countries, which raises the cost of borrowing. Weak banking supervision is often balanced with high capital requirements, a rather inefficient safeguard to financial stability.⁸
- **Illicit outbound financial flows.** Estimated to be at least US\$50 billion annually (roughly the same as ODA), these outbound flows damage tax revenues and weaken the recycling of profits into the continent's further development.⁹
- **Continued weaknesses in capital markets.** Notably, there is an almost complete absence of local currency debt markets, which is reinforced by a tendency of asset managers to invest outside of Africa while little flows in, particularly into Africa-focused private equity vehicles.

Because of these gaps in the financial system, and because of continued need for additional resources, governments in Africa still depend on high levels of ODA, at some \$48 per capita (compared to a developing country average of \$23).¹⁰ This can be seen as both a symptom of, and through weak execution and wider effects can be an unintentional contributing factor to, the challenges facing Africa's financial system.

ALIGNING THE FINANCIAL SYSTEM WITH SUSTAINABLE DEVELOPMENT

The financial system's value lies in its role in enabling a dynamic and efficient real economy which delivers inclusive sustainable development (see box 1). Financial capital, according to the latest Inclusive Wealth Report developed by the UN University and UNEP, only accounts for 27 per cent of the global productive base, while human capital (skills and health) contributes 61 per cent and natural capital (including forests, agricultural land and fossil fuels) contributes 12 per cent. The study finds that while produced capital and human capital are rising in most countries, natural capital stocks are falling in 116 out of 140 countries, including across the entire of the African continent.¹¹

Internationally, the financial system is significantly out of step with the needs of the real economy. Externalities are a useful starting point for understanding the need to redesign our financial systems.

BOX 1: AFRICA'S REAL ECONOMY AND THE PURPOSE OF THE FINANCIAL SYSTEM

The 'real' economy is the part of the economy concerned with actually producing and distributing goods and services, as opposed to the financial system whose goal is to serve and support the real economy by facilitating transactions, intermediating capital, transferring risk, transforming maturity, providing liquidity and governing assets.

In other words, the purpose of the financial system is to enable capital to be allocated more efficiently to where it can best be used.

Source: UNEP Inquiry (2015) *Aligning the Financial System to Sustainable Development: Pathways to Scale*. Geneva: UNEP

Negative, uncounted environmental costs amount to an estimated US\$7 trillion a year.¹² Clearly the factors that drive environmental regeneration will need to be valued so that they are accounted for by the real economy. For Jaime Caruana, Managing Director of the Bank of International Settlements, "it is such negative externalities and the significant spillovers to the real economy that are the essence of systemic risk and which make a case for policy intervention".¹³

Growing concerns about rising inequality have opened another front in the debate about the impact of the financial system on sustainable development. Short termism and misaligned incentives, have contributed to comparatively high

levels of value added accruing to parts of the financial sector, whilst increasing volatility with negative effects on long term financing.¹⁴

Furthermore, such patterns tend to leave many potentially profitable enterprises under-financed, notably small and medium-sized businesses, which creates a drag on economic growth and productivity. Research by the International Monetary Fund and others have pointed to a further downward effect on the success of the non-financial economy—namely the size of the financial sector itself, if it goes beyond an optimal level relative to the size of the real economy.¹⁵

In this light, the UNEP Inquiry has identified a growing number of innovative approaches to financial and monetary policy, as well as financial regulations and standards, including individual and collective voluntary standards, codes and principles. Focusing on country-level innovation, the Inquiry has explored practices in over 15 countries, including Bangladesh, Brazil, China, Colombia, Europe, India, Indonesia, Kenya, South Africa and the US. Many of these innovations have been championed by developing countries, particularly those with rapidly evolving financial and capital markets.¹⁶ Many are still at an early stage and largely ad hoc; that is, not part of a systematic policy framework focused on the alignment of financial markets with sustainable development. Nonetheless, China's Green Finance Task Force¹⁷ and Indonesia's Roadmap for Sustainable Finance¹⁸ indicate a rapid maturing of the field as more integrated, longer-term designs and plans begin to emerge.

FINANCING AFRICA'S SUSTAINABLE DEVELOPMENT

Africa's financial system, as it evolves in scale and sophistication, can be better aligned to the continent's sustainable development needs. Drawing from international experience, including in Africa (see Box 2) the UNEP Inquiry highlights a number of interventions that could be usefully adapted and deployed in Africa.¹⁹

- 1 *Green and inclusive credit guidelines and incentives:* Enforced direction of bank credit is often unwieldy and ineffective, but guidelines, transparency, incentives and oversight can offer effective interventions. Examples include the China Banking Regulatory Commission's Green Credit Guidelines, the Brazilian Central Bank's environmental risk management requirements, the financial inclusion disclosure and incentives arrangement embedded in South Africa's Financial Charter, and the use of preferential refinancing terms as an incentive for guided credit by the Bangladesh Central Bank. Based on these experiences, other finance ministries could also consider extending the mandates of their supervisors to sustainability issues.
- 2 *Green bonds:* Growing debt issuance across Africa opens the door to introducing 'use of proceeds' features, such as green bonds and associated certification and oversight processes, as a means of attracting new sources of finance. Over time, these features could potentially lower the cost of capital. Green bond issuance internationally has grown US\$3 billion in 2012 to about US\$40 billion in 2014; the African Development Bank's first green bond in late 2013 attracted a new cadre of asset managers. Green bonds are seen as a way for institutional investors to diversify their portfolio and reduce risks associated with over-weighted investments in fossil fuel and climate-vulnerable assets.
- 3 *Extended fiduciary:* The continent's institutional investors, pension funds and insurance companies, as well as sovereign wealth funds and other state-owned investment vehicles, are a critical source of long-term finance for development. South Africa's adjustment to its pension fund legislation, "Regulation 28", exemplifies how sustainability can be institutionalized in fiduciary

BOX 2: SOME EMERGING POLICY INNOVATIONS TO ALIGN FINANCIAL SYSTEMS WITH SUSTAINABLE DEVELOPMENT

For **China** the challenge of transforming from a resource and pollution-intensive economy to a green economy has become a strategic priority. The People's Bank of China and China's Development Research Centre of the State Council have, in association with the UNEP Inquiry, developed recommendations for advancing green investment and curbing investment in pollution-intensive industries. Focus has been placed on extending China's development of 'green credit' (environmental risk assessment and priority loans for green sectors in banking), 'green securities' (environmental assessment for IPOs and information disclosure requirements for listed companies) and 'green insurance' (through experimentation in compulsory environmental liability insurance), alongside carbon markets. Progressing these areas will need clear rules and frameworks, adequate enabling policies, regulations and standards, and cultural change and capability development within the financial sector itself.

In **Brazil**, the government has taken several steps to align the financial system to sustainable development. In 2011, the Brazilian Central Banks asked banks to demonstrate how they consider exposure to socio- environmental damage in the Internal Capital Adequacy and Assessment Process (ICAAP), and in it established a Resolution which requires all banks operating in Brazil to demonstrate policies and practices for assessing and managing social and economic risks in their portfolio. To date it is estimated that around 12% of bank lending along with 62% of assets under management in the pension system are now covered by policies that require sustainability assessment. There is potential for the development of a Green Bonds market in Brazil. In 2011, the Brazilian government gave tax breaks for those investing in notes ("infrastructure notes") issued to finance infrastructure projects in the transportation, logistics, sewage and water treatment, energy, irrigation and telecommunication sectors. Green Bonds, including potentially 'forest bonds' for conservation, could fit in this class of notes and projects in Brazil with positive environmental externalities could raise demand for these.²⁰

In **Bangladesh**, the Central Bank promotes sustainability objectives as well as the more traditional role of promoting financial stability and broad economic growth. It targets financial inclusion and investment in SMEs, agriculture and renewable energy through measures including concessional refinancing to commercial banks and microfinance institutions at reduced interest rates for loans given to priority areas such as renewable energy. While this is a public subsidy it relies on the private sector as a gatekeeper in the allocation of capital. The Central Bank also sets directed credit requirements which oblige financial institutions to allocate portions of their loan portfolio to key sectors such as agriculture. In September 2014, BB announced that as of 2016 every financial institution will be obliged to allocate at least 5% of its loan portfolio to green finance.²¹

Source: UNEP Inquiry (2014) *Aligning the Financial System to Sustainable Development: Insights from Practice*. Geneva: UNEP Source: UNEP Inquiry (2015) *Aligning the Financial System to Sustainable Development: Pathways to Scale*. Geneva: UNEP

responsibilities. This can be complemented by encouraging internal approaches such as the development of 'beliefs' and associated principles and actions by the US pension fund CalPers, as can more effective accounting and greater transparency of the sustainability aspects of investment portfolios such as South Africa's Code for Responsible Investing principles.

- 4 **Sustainable stock exchanges:** These will become an increasingly important mechanism for channeling citizen's savings into the continent's largest companies, which will benefit both the citizens and the African economy. Such benefits will, however, depend on these exchanges not being dominated by potentially over-valued fossil fuel and pollution-intensive companies. The continent's stock exchanges can draw from the growing experience in sustainability-related disclosure, indexes and associated tracker funds in Africa—in Egypt, Nigeria and South Africa—and internationally from Shanghai to Santiago.²² Contributing to the public good, furthermore, will depend on exchanges maintaining a strong public utility function in the face of commercial interests in selling data and other services.
- 5 **Foreign direct investment (FDI):** FDI has grown rapidly and is beginning to be diversified away from natural resource extraction. Unlike other financial flows, FDI operates largely independently of domestic financial and capital markets, often emanating from balance sheets of multinationals. Such flows can, however, be aligned better to sustainable development

outcomes by adjustments through the relevant domestic investment authority.²³ Also helpful are the rules governing originating financial and capital markets, including US regulations such as the Foreign Corrupt Practices Act governing the international operations of US-based corporations, Singapore's new legislation governing trans-boundary haze, and international footprints of financial regulators such as the China Banking Regulatory Commission's Green Credit Guidelines.

- 6 *Liability*: Most countries require lenders and direct investors to ensure that the project owners obtain the relevant environmental certification prior to securing financing, generally from environmental ministries. Too often, however, these certificates are limited at best to desk assessments of the project design. Lenders and investors nevertheless use such environmental certification to justify financing, and rarely undertake design-stage environmental due diligence, let alone ongoing oversight of environmental effects in practice. Lender and investor liability, suitably framed to provide safe-haven when adequate due diligence can be demonstrated, can improve environmental outcomes, as demonstrated in the case of US lender liability for land contamination. Brazil is currently assessing options for introducing such a liability regime, and China's Green Finance task Force has tabled this instrument for further examination.²⁴

International experience illustrates the potential for evolving financial systems to be more closely aligned to serve the need for sustainable development. Several Africa-specific developments in financial and capital markets might also be considered, including :

- *Transfer charges* can lead to significant leakage of finance that might otherwise have positive development outcomes, particularly in relation to remittances, currently averaging 12% across Africa, well above the global average of just under 8%.
- Africa's challenge in stemming *illicit financial outflows* can only be met if it involves financial intermediaries that are in effect, and often unintentionally, party to such flows.
- International experience demonstrates that *incentives*, both micro-level remuneration arrangements and macro-level incentives such as fiscal measures, make a major difference to the time horizons of financial and capital markets.
- *Market composition* makes a major difference, including concentration rates that are high in the African banking context, and similarly high levels of diversity for financial institutions, particularly the degree of localization in geographic scope and knowledge.
- Bankless payment platforms, peer-to-peer lending and crowd sourcing investing, as examples of *technology-driven disruptive innovations*, will raise new opportunities, but also challenges, to ensuring effective alignment.

COMPACTS FOR ALIGNING THE FINANCIAL SYSTEM TO SUSTAINABLE DEVELOPMENT

The UNEP Inquiry's final observation, concerns the *value of building strong, dynamic social compacts* between financial sector actors and other parts of society. Financial institutions, individually and collectively, can become isolated and defensive in the face of criticism and changing societal demands. Other actors, likewise, can make uninformed and often impractical or even counter-productive demands on financial institutions, including those informed by legitimate concerns.

In forming such compacts, it is possible to draw on the experience of South Africa's formal process leading to the Financial Charter, and also on that of many countries, particularly in the developed world, following the financial crisis, such as the Netherlands "Bankers Code" linked upwards to bank licensing conditions and principles, and downwards to remuneration arrangements and retraining. Further insights can be drawn from the recent experience of the People's Bank of China in forming a Green Finance Task force, co-convened with the UNEP Inquiry and comprising public and private actors mandated to develop proposals for advancing green finance in China. There is also relevant experience from Indonesia's financial regulator, Otoritas Jasa Keuangan, in shaping its 'Roadmap for Sustainable Finance'. The key is to have engaged, forward-looking approaches that are inclusive, focused and dynamic. That said, the need for policy makers and regulators to ensure that the required change happens remains critical. For this, a case in point is Kenya's experience in driving through an accelerated growth of bankless payment systems.²⁵

Box 3: COMPACTS FOR FINANCIAL SYSTEM TRANSFORMATION

Indonesia's new Financial Service Authority Otoritas Jasa Keuangan (OJK) in 2015 established a Roadmap for Sustainable Finance. OJK is tasked with preparing a Master Plan for Indonesia's Financial Service Sector for the period of 2015 -2024 which includes requirement for priority allocation to key sectors. Other areas of focus are an environmentally based share index and reporting requirements for listed companies. The Roadmap is aimed at building on these foundations through in the short term; building the basic regulatory framework and reporting system, increasing understanding, knowledge and competences in the financial services industry, provision of incentives and coordination with related agencies. In the Long term the aim is to ensure that financial institutions develop integrated risk management and integrating sustainability into sound corporate governance, establishing a bank rating system and an integrated sustainable finance information system. The Roadmap was developed with the Environment Ministry, National Development Planning Agency, Ministry of Finance and other key ministries and agencies and through consultation with domestic stakeholders including the Indonesian Stock Exchange, the private sector and international donors. The initial Roadmap is a broad statement of direction and ambition and a detailed set of actions which will continue to be refined and developed through implementation. To support this a Sustainable Finance Forum will be organised at least twice a year, with national as well as regional meetings. The Forum will serve both to coordinate strategy and action and to monitor and evaluate the implementation of sustainable finance by the financial institutions.²⁶

In **South Africa** the post-apartheid transition led to the development of a pioneering Financial Sector Charter in a bid to address the country's huge gap in financial inclusion, secure confidence in the South African Banking system and increase its efficiency. A long negotiation between government, business and labour sought to find a practical way forward between stakeholders wanting to "Make the Banks Serve the People" and a financial sector concerned that the government should not "dictate to financial institutions where to invest...". The Financial Sector Charter which emerged was voluntary, and had the aim to enable a "transformed, vibrant, and globally competitive financial sector that reflects the demographics of South Africa, and contributes to the establishment of an equitable society by effectively providing accessible financial services to black people and targeted sectors of the economy". The Charter had mixed impacts, for example leading to the development of low-cost Mzansi accounts which have since been superseded by more commercial entry-level banking products.²⁷

ALIGNMENT IMPROVES AFRICA'S FINANCIAL SYSTEM

Building a financial system suited for the 21st century requires it to be aligned to the financing needs of inclusive, sustainable economic development.

Aligning the financial system with sustainable development through measures such as those set out above is not an 'additional' requirement of an otherwise conventional set of system performance features. Quite the reverse, it centrally concerns the efficiency, effectiveness and resilience, and so stability, of the whole system:

- *Financial exclusion* weakens both the underlying vitality of the economy on which the financial system depends, and negatively impacts the financial system by allowing profitable lending and investment opportunities to remain unfinanced.
- *Under-priced environmental risks* ultimately impact the value of specific financial assets, and damage the capacity of the financial system to perform its functions of effective price discovery and intermediation.
- A growing mismatch between risk management and underlying risks, furthermore, eventually *destabilizes the financial system* as a whole through failing confidence and demonstrable systemic weaknesses.

Aligning a financial system to its purpose in financing sustainable development, therefore, is simultaneously the pathway to developing financial and capital markets across Africa that are efficient, effective and resilient.

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