

STARTING WITH GREEN AND ENDING WITH SUSTAINABLE

Rationale for a phased approach to developing South Africa's Sustainable Finance Taxonomy

Starting with a voluntary green tool focused on climate change, and expanding and deepening for coherent ecosystem development

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BRIEFING PAPER



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About

A green finance taxonomy is an official classification or catalogue that defines a minimum set of assets, projects and sectors that are eligible to be defined as "green" in line with international best practice and national priorities. It can be used by investors, issuers and other financial sector participants to track, monitor and demonstrate the credentials of their green activities in a more confident and efficient way.

The development of the first South African Green Finance Taxonomy was overseen by the Taxonomy Working Group, a multi-representative group drawing from national government, financial sector regulators and the financial services sector, and chaired by National Treasury. This initial phase of work for the Taxonomy Working Group is supported by IFC, part of the World Bank Group, through IFC's Green Bond Market Development program in partnership with SECO (Swiss State Secretariat for Economic Affairs) and Sida (Swedish International Development Cooperation Agency). It also benefits from global support from the IFC-facilitated Sustainable Banking Network (SBN).

The National Business Initiative (NBI) and the Carbon Trust were selected to carry out research, stakeholder consultation and drafting on behalf of the Taxonomy Working Group for the first phase to (i) establish a governance structure and principles for the development and ongoing maintenance of a national sustainable finance taxonomy, and (ii) to develop an initial draft taxonomy for green and climate finance activities, leveraging existing international frameworks.

This briefing note provides the context behind starting with the development of "green" first, including developing criteria for economic activities that define substantial contribution to climate change mitigation and climate change adaptation as a starting point. The basis and merit for this approach is unpacked and contextualised within the realm of other pertinent socio-economic challenges that also required capital re-orientation.

This briefing note then further explores the three directions needed for continued taxonomy development – expanding coverage, deepening the regulatory environment, and developing market capacity. Each area is important and different actors will have varying priorities. The level of technical effort required, user learning rates and process related challenges will each need to be considered in deciding priorities for further phases of work.

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Introduction

With mounting pressure from investors, authorities and society, sustainable finance has rapidly and rightfully risen to prominence as a strategic priority for global economic and financial systems. Sustainable finance is that which is aligned to and finances sustainable development.

The International Capital Market Association (ICMA, 2020) provides the following definition of sustainable finance:

‘Sustainable finance incorporates climate, green and social finance while also adding wider considerations concerning the longer term economic sustainability of the organisations that are being funded, as well as the role and stability of the overall financial system in which they operate’

This definition acknowledges that sustainable finance is inclusive of financing that advances positive impact in both the environmental and social spheres. It also identifies the need for robust governance with regard environmental and social management.

The South African National Treasury definition in the Technical Paper *Financing a sustainable Economy* (National Treasury, 2021) defines sustainable finance as encompassing:

“financial models, services, products, markets and ethical practices to deliver resilience and long-term value in each of the economic, environmental and social aspects and thereby contributing to the delivery of the sustainable development goals and climate resilience.”

With this definition, the emphasis is drawn to the multifaceted nature of sustainable finance, being a holistic pursuit of multiple objectives, as well as a combination of risk management and opportunity pursuit. The South African National Treasury definition especially offers a platform for conducive

frameworks for investing and policy making towards the UN SDGs. It is also significant in its holistic recognition of mechanisms, and the role and expectations of actors in affecting sustainable finance.

The categorisation of sustainable finance is depicted (at its highest level) in the same frame as sustainable development, classically as in

Figure 1 below.

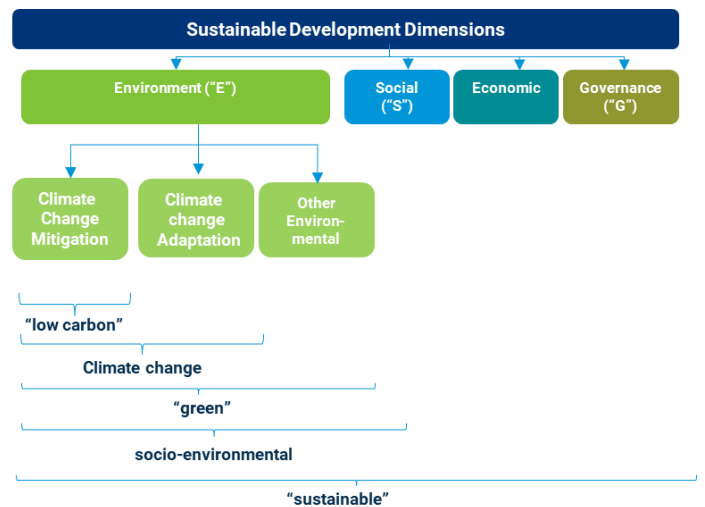


Figure 1: The breadth of sustainable development and environmental, social, economic and governance foci for sustainable finance

There is a widespread need expressed by the financial sector for greater clarity on the environmental and social performance required to qualify sectors, assets, projects and activities as genuinely sustainable. Conversely, there is also a need to identify those projects and activities that are detrimental or present unreasonable risk from an ESG perspective.

Sustainable finance classification, coverage and traction

The development of finance classifications is a step towards the certainty that is desired by financial actors. Also referred to as finance taxonomies, these are a comparatively new

mechanism in sustainable financing, with the aim to assist in defining and monitoring sectors, assets and projects with required characteristics.

As depicted in Error! Reference source not found. below, the utility of finance taxonomies includes applications that standardise approaches for individual actors, as well as supporting greater standardisation between actors and the wider enabling environment.

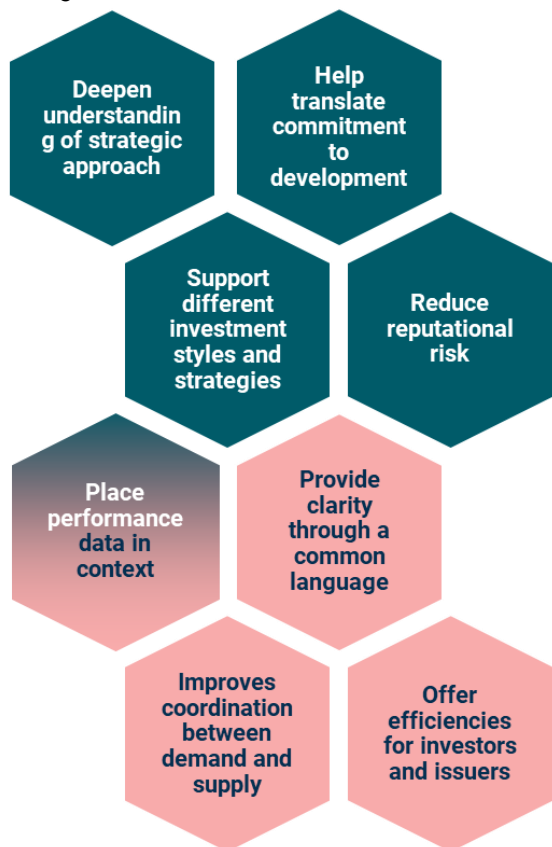


Figure 2: The utility and applications of finance taxonomies

Many market-based finance taxonomies have been developed for a relatively targeted purpose. For example, for defining sustainable infrastructure or specifying climate change mitigation assets and projects. These taxonomies have assisted in the development of identifiable asset classes, applied for debt and equity transactions.

These taxonomies, put forward by independent organisations or developed by industry bodies, are applied by actors on a voluntary basis.

For finance taxonomies to realise their potential to support sustainable development and a sustainable finance ecosystem, the following needs have been articulated by different stakeholders:

1. Develop increasing taxonomic coverage of ESG aspects (leading to a universe of definitional certainty, with the necessary interconnectivity between aspects).
2. Induce more widespread and comprehensive adoption across the financial sector and beyond (stimulating adoption beyond first movers).
3. Demonstrate the relevance and the links between a finance taxonomy and financial sector practices and methods (clarifying the relationships and creating technical understanding).

This briefing note explores these three taxonomic developments areas, and provides insight to the rationale for the starting point of the South African Green Finance Taxonomy (focusing on environmental impact and climate change in particular; serving as a voluntary tool), and options and possible priorities for continued development in each area.

Unpacking sustainable finance definitional coverage needs for South Africa, and the first Edition of the South African Green Finance Taxonomy

The South African Green Finance Taxonomy (SA GFT) and the EU Sustainable Finance Taxonomy, which is its precedent, recognises that an economic activity cannot be considered truly sustainable independent of the wider system in which it operates.

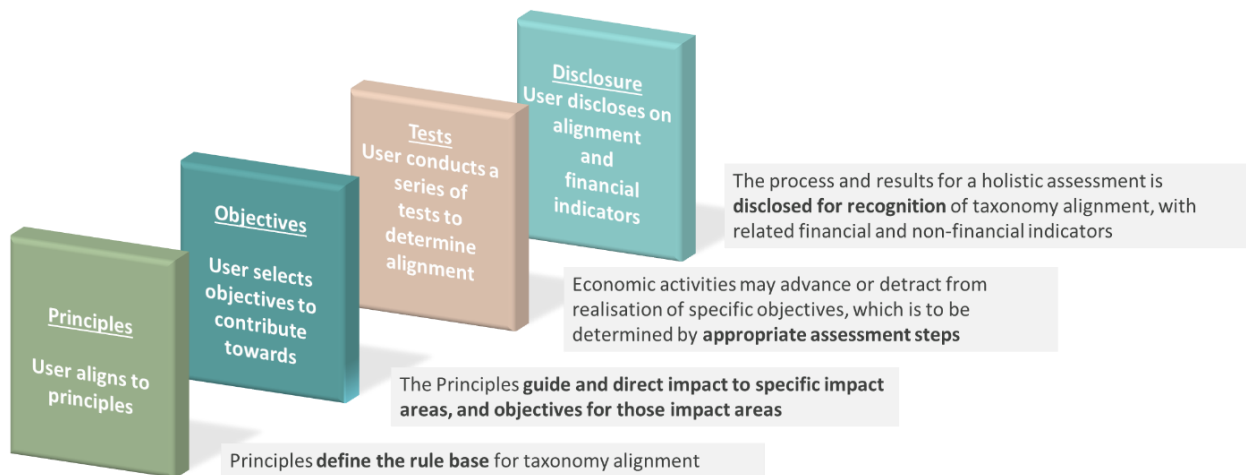


Figure 3: The essential structure of detailed sustainable finance taxonomy design followed in the SA GFT

Furthermore, it is possible – hypothetically – that a project, asset etc. can and should make optimal positive contributions along multiple dimensions of environmental and social impact areas. The SA GFT requires that no detrimental impact is borne, which is an important evolution in evaluation processes that do not allow for performance trade-offs between ESG aspects.

Unpacking the domestically relevant environmental and social impact areas into distinct objectives and mechanics is an important contribution of a South African taxonomy design. These objectives are often already distinctly expressed in national policy and plans – such as the National Development Plan (NDP).

Processes are also unfolding in critical areas wherein unstructured aspirations and obstacles to sustainable development progress are being studied and considered by a broad range of stakeholders, with a rough consensus forming around objectives, such as defining the just transition for South Africa.

The taxonomy serves to confirm and articulate these objectives, underpinned with technical standards and disclosure to support granular detailed assessment. Therefore, the first Edition GFT (and the structure advised for subsequent developments to replicate) is shown in **above**.

above.

Through study of the South African context and policy landscape and extensive stakeholder engagement for the SA GFT development during 2020-21, key national impact areas and objectives have been confirmed and validated, for which taxonomic definition is sought by the market, comprising of:

> **Environmental ('green') activities**, that make substantial positive contribution to environmental sustainability. The process of SA GFT development has enabled articulation of the six environmental objectives, that the taxonomy should cover, namely:

- Climate change mitigation
- Climate change adaptation
- Sustainable use of water and marine resources
- Ecosystem protection and restoration
- Pollution prevention
- Sustainable resource use and circularity

- > **Climate transition activities**, being those activities that have a detrimental or inadequate impact in terms of the climate change mitigation objective, but for which the operators can demonstrate a credible route to performance levels that would be sufficient and make a significant contribution.

Climate transition is an environmental objective but is identified distinctly from the above 'green' objectives because of its circumstantial nature, complexity in determination (as it requires a combination of 'flow' and 'stock' performance evaluation and contextual assessment), as well as a moral argument to clearly signal the difference.

Climate transition is a necessity for South Africa's economy, and it has been suggested that centralised specification of economic activities' role in that transition is needed, to provide certainty of the timeframes in which particular economic activities will continue to be part or enter into relevance, and then phase out or cease to be supported.

- > **Social and socio-economic advancement activities**, those that have substantial positive social contribution. In South Africa, this impact area is a crucial element, given continued social disparities and diverse interconnected socio-economic development challenges faced.

As has been the case internationally, the approach for identifying relevant impact areas and sufficient impact have tended to remain conceptual and principles-based, allowing individual actors to decide. Social impact can be highly situational and complex, which makes centralised specification extraordinarily difficult and has always been considered as disempowering for actors seeking to advance social impacts from their own perspectives. However, there are national sustainable development priorities that must be addressed, and so there is an argument for a national

finance taxonomy that provides greater definitional certainty – starting at impact focus areas. The ability to define taxonomic specifications beyond that (i.e., minimum performance requirements for individual economic activities in regional and situational contexts) would be a complex task to undertake. Market actors have also indicated a preference for remaining as principles-based as possible, whilst refining the specification of impact evaluation methods.

- > **Just transition activities**, that have a substantial positive social contribution in areas that advance the transition to a low-carbon economy. This includes materially advancing climate justice through that transition.

This area combines social advancement alongside environmental advancement. Just transition demands considerations in multiple dimensions: combined localised and systems thinking; multiple temporal horizons; and anticipating economic and social displacement and reallocation/development opportunities.

Systems modelling to provide definitional certainty in all instances will be extraordinarily complex and not especially useful, as system dynamics emerge. However, mobilising the just transition is critical and its incorporation taxonomically is essential. At writing, there are well-progressed parallel projects defining just transition impact areas, routes for equitable climate transition with socio-economic considerations, and assessment and disclosure practice for just transition contribution. These provide greater certainty and may be translated to taxonomic definitions. However, as with social aspects, maintaining a principles-based (but somewhat delineated) process will likely be optimal and most practical for the diversity of market actors.

- > **Non-compatible activities**, that do not form part of the sustainable development future. This category is for defining activities and performance that distinctly detract from, hold back or harm sustainable development. Various actors have expressed an interest in this taxonomic coverage, as a definite means of identifying activities to which a negative filter or investment penalty might be applied.

There are differing views as to whether social and environmental contribution should both be in place for any activity to be recognised (narrowing the field radically but emphasising the optimising potential that many activities have), or whether each aspect should be recognised independently. These same questions extend to optimising multiple objectives within social and environmental impact areas (objectives), although for the time being an activity need only Make Substantial Contribution (MSC) to one dimension and one objective, in order to qualify.

With that said, it has been established clearly that there should be governing coordination between social and environmental aspects. This is enabled through the likes of the Do No Significant Harm (DNSH) and meet Minimum Social Safeguards (MSS) principles.

Why environmental classification (and climate change) has developed ahead of other dimensions and objectives

A taxonomy can have a wide-reaching scope that stretches across multiple economic sectors and thereby has influence on various stakeholders. Therefore, its development is a complex undertaking that requires enormous amounts of engagement and national buy-in, as well as technical, economic, market and technology appropriateness evaluation. A key learning from the development of the first Edition SA GFT is that awareness raising, technical understanding and practical implementation considerations should not be rushed. It should, however, also be recognised and anticipated that without pushing forward and

challenging actors' perceptions and expectations, the system will experience inertia.

Acknowledging these complexities, the development of the SA GFT focused on addressing climate change related issues first, as these challenges have been recognised as a substantial global risk to economic stability and socio-economic wellbeing, and there is growing understanding of the issues. Addressing climate change challenges as a priority is anticipated not only to provide co-benefits for multiple sectors, but also address national imperatives for economic transition and development.

Until recently, climate change considerations and widespread understanding of the risk and opportunities posed have been relatively limited. However today, significant strides in buy-in, technical understanding and tools for progress have been achieved and developed, especially for the financial sector. Through this work, fiscal and economic benefits and needs have been made clear, as has fiduciary responsibility.

Simply put – internationally and in South Africa – we are furthest along the process of widespread understanding and consensus on climate change related issues and responses. This reduces the stakeholder learning rates in this area (i.e., for intended users of the taxonomy).

Furthermore, the SA GFT leverages international examples, specifically the EU Sustainable Finance Taxonomy, which also began its development with climate change adaptation and mitigation environmental objectives, while acknowledging continued development needs, and which is expected to have a significant global influence on capital markets. The EU Sustainable Finance Taxonomy provides a comprehensive technical foundation with extensive stakeholder engagement and specialist development inputs. Thereby the foundational SA GFT development takes advantage by expediting the taxonomy development processes, focusing efforts on the domestication process as needed.

This practice and taxonomic development route does not intend to communicate a lesser concern for the urgent need for effective development and impact in other areas. Continuing development of taxonomic coverage for further economic activities, definitions for other environmental objectives, and taxonomic response for other impact areas, should follow as a priority. It is encouraging that rapid advancements are being made domestically in defining just transition pathways for instance, which carves the way for capturing these through the taxonomy over time. This is where the proposed SA GFT governance mechanism is essential, given its role in overseeing the refinement and advancement of the national taxonomy over time (please refer to the associated *Briefing Note* on this topic).

Figure 4 below illustrates the SA GFT in the context of a wider sustainable finance taxonomy and provides a graphical representation of the 'building blocks' discussed above, that should arguably be developed going forward.

The figure makes clear the substantial work already undertaken, where the project has begun to "take bites out of the elephant", but also the significance of impact areas and criteria that are still to be developed.

Coverage prioritisation – what next?

Further taxonomy chapters

The foundation of the SA GFT is that it is aligned to the national green economy opportunity and recognises climate change as inextricably linked to this development imperative. Yet, it is also acknowledged that South Africa's defining context is framed in terms of untenable social challenges and a dire need to transition the economy. Given this context, key areas of taxonomic development require attention, but also further coordination, as follows:

- > In the case of a transition taxonomy, to allow for the development of the necessary

underpinning technical and economic modelling, so that this component has quantitative substance.

- > In the case of a just transition taxonomy, to incorporate the results from landmark parallel projects defining South Africa's just transition pathways and financing practice.
- > In the case of a social taxonomy, to consider a comprehensive approach and the interwoven development landscape and national actors that would need to be involved in this process.

These different elements will take time to coalesce.

Completing technical criteria for all environmental objectives

There are also calls for the development of criteria for making substantial contribution to the four additional environmental objectives, thereby establishing a process of holistic assessment. This approach has been advocated by different actors depending on their activities and investment focus and/or national priorities. Sustainable use of water has been emphasised for earliest development amongst the other objectives.

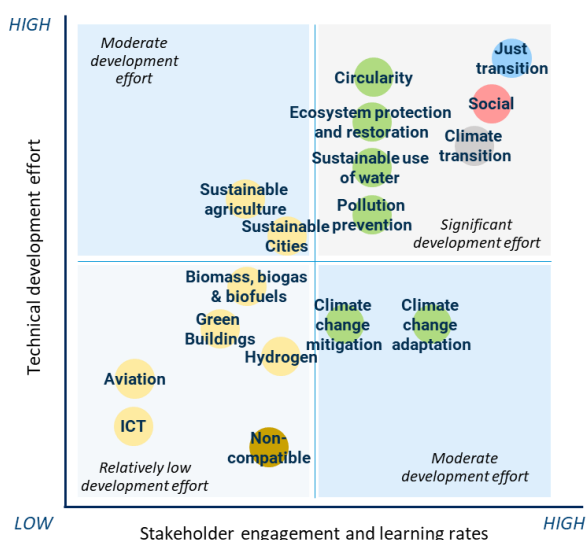
Developing complete technical criteria for key South African sectors

Actors have also emphasised the importance of taxonomic coverage to include qualifying economic activities that:

- > Are existing and impactful, and to which there is already significant capital allocation and/or investor appetite, being sensitive to financial system architecture.
- > Are existing and known to be impactful but under-served, depending on technology readiness levels and market viability.
- > Are emerging, for which capital allocation is vital to grow the supply, through appropriate development interventions and financial instruments.

Understanding that there will be different priorities proposed for next areas of development by different actors, **Figure 5** below provides a perspective on potential development effort and challenges.

Significant development effort is noted for just transition and social taxonomies, because of the technical complexities and level of engagement that would be required to develop all the functional components and technical standards. Furthermore, in the absence of local or international precedent for social and just transition taxonomies or classification systems, South Africa would be stepping ahead in these areas. The learning rates are anticipated as high, as is the effort for requisite and inclusive stakeholder engagement.



- Environmental objective
- Climate transition taxonomy
- Social taxonomy
- Just transition taxonomy
- Individual economic activity
- Non-compatible taxonomy

Figure 5: Development effort anticipated for different taxonomy dimensions

The options to embed the taxonomy, for more rapid ecosystem alignment

An important related consideration is the priority for embedding the SA GFT's use. In other words, testing and mainstreaming the taxonomy in its current form, before launching into expansion development. This has substantial merit, given learning rates and challenges that are yet to be understood and addressed. Advancing widespread implementation on the first Edition SA GFT could provide regulators a more manageable test bed, whereafter expansion could follow and benefit from the insights gained.

With growing understanding and recognition that ESG integration is a fiduciary responsibility, there has been increasing momentum to integrate measures into the enabling environment to encourage uptake of sustainable finance.

For the most part internationally and domestically, regulator approaches have initially been light touch, providing conceptual guidance and indication of the importance of ESG matters, but not being strongly prescriptive or dictating the recognition, evaluation methods or results disclosure. This is, however, beginning to change.

In frontrunner jurisdictions, we see regulators taking the necessary methodical steps to steer and reinforce minimum requirements, including being:

- > Increasingly clear about universal relevance of ESG issues, particularly equitable and timely climate action.
- > Proactive in developing the underpinning technical and economic understanding of the imperative for action across ESG issues, disaggregated suitably for targeted sub-sectoral specific requirements.
- > Increasingly specific about the methods and requirements for disclosure around governance, management and performance concerning these issues.

- > Strengthening the evidence base, linking efficacy of governance and management, to financial performance and long-term value.

The development of the SA GFT was initially conceived as a voluntary tool for the market that could support the financial sector to overcome specific technical obstacles to sustainable finance practice.

Through this development process, diametrically-opposed views have been expressed by stakeholders as to the necessity or appropriateness of the SA GFT being endorsed with a more formal recognition by regulators. Many argue that without a formal status for the tool, either their own organisations would not be induced to use the taxonomy, or that they might but others might not. Some financial institutions might be exposed to internationally derived drivers for adoption, such as through exposure to EU-based investors and development financiers. For those where the drivers for adoption are not evident, market intervention will be needed. This is especially so, given that users' taxonomy application will necessitate more data and enforce greater rigour in transaction evaluations for most than would otherwise be the practice, and that market-based inducements for taxonomy application are not yet widely evident.

Some stakeholders have also identified and understood that a shift in the ecosystem may come most effectively if the SA GFT is inserted (by reference) into nexus points of the South African financial system architecture. For example, this could include:

- > Guidance and a regulatory supplement to Regulation 43(5)(c) in terms of the Companies Act, concerning taxonomic coverage and alignment.
- > Reference in Regulation 28 under the South African Pension Funds Act, and elaborated guidance expressing utility and applications in which the SA GFT is expected (consider

supplementing the 'Responsible Investment and Ownership Guide' by Batseta).

- > Asset tagging and capital allocation metrics, feeding into annual reporting to the Prudential Authority and Financial Sector Conduct Authority, and incorporated into sectoral stress testing.
- > A Johannesburg Stock Exchange (JSE) and King Committee disclosure supplement to THE King Code of Corporate Governance (King IV) requirements for listed equity.
- > JSE specification in debt listing requirements (across interest rate markets, not limited to the sustainability segment and prospective transition segment).
- > Inclusion in National Treasury capital appraisal guidelines and implementation in national and subnational processes.
- > Application in budget tagging by government, stated-owned entities and public agencies.
- > Coordinated structuring of monitoring and evaluation (M&E) and periodic reporting processes by all related national departments and subsidiary agencies, not least THE Department of Planning, Monitoring and Evaluation (DPME), Department of Forestry, Fisheries and the Environment (DFFE), Department of Trade Industry and Competition (dTIC), Department of Transport (DoT), Department of Public Works (DPW) etc.
- > Endorsement by industry associations, working with their members to adopt. This is especially important for private equity and venture capital, where regulatory coverage and support is not comprehensive.

The priority to demonstrate the SA GFT's interconnection to existing methods¹

In parallel to questions regarding priorities for expansion and regulatory 'deepening', is the evident need to address technical misunderstandings of how the SA GFT complements existing financial sector methods and practices. The following areas would benefit from clarification in this regard:

- > The touchpoints for taxonomic application within implementation of the UN Principles for Responsible Investment (UN PRI), UNEP FI Principles for Responsible Banking (PRB), UNEP FI Principles for Sustainable Insurance and the Equator Principles.
- > How IFC Performance Standards (as standalone and within conformance with the Equator Principles) could underpin or be leveraged for taxonomy alignment evaluation, and where robustness of diligence must be checked.
- > How the MDB-IDFC and the SA GFT map to each other, to support national development banks or those requiring compatibility to both.
- > How assessment and disclosure of taxonomic alignment (in terms of climate change mitigation and adaptation) and aligned financial metrics are relevant within implementation of the Task Force on Climate-Related Financial Disclosures (TCFD) Recommendations, by both financial and non-financial actors.
- > In relation to this, how taxonomic alignment evaluation and disclosure correlates with climate-related risk disclosure emerging from IFRS Foundation and accounting boards.
- > Explaining the touchpoints in data and performance metrics complementary between taxonomy application (for climate change

mitigation) and the Partnership for Carbon Accounting Financials (PCAF) standard and Science Based Targets for Financial Institutions (SBTs for FIs).

- > How international capital markets are incorporating national and jurisdictional taxonomies by reference, as compatible and complementary to voluntary guidance for green and sustainable bonds and loans. I.e., that International Capital Market Association (ICMA) Green Bond Principles encourage heightened transparency including through taxonomies, and that distinct asset classes are being defined in this manner in several jurisdictions.
- > Extending this, clarifying taxonomic relevance in evaluating relevance and ambition for performance-linked instruments.
- > The potential direct links between asset tagging and bottom-up climate-related transition risk evaluation and management methods.
- > Clarifying compatibility with developments under the Taskforce on Nature-related Financial Disclosures (TNFD) and other non-financial guidelines, protocols and standards.

¹ "Methods" being documented practices and practice guidance or requirements of the financial sector, as well as the collection of published principles, frameworks,

methodologies, tools, standards, regulations, laws and codes.

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