MOIRA MUKUKA

LEGAL PRACTITIONERS

Green and Sustainable Finance in Zambia

Part 2: Regulation of Green Bonds

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In Part 1 of the series, we discussed the general concept of green financing and the prevailing trends. In this Part II of the series, we narrow down the broader concept of green financing to green bonds and dissect the regulatory framework of the green bond market in Zambia.

INTEGRITY OF THE MARKET

Integrity is key for any capital market, particularly because one of the benefits of investing in, or issuing green bonds is the enhancement of the issuer or investor's reputation for sustainability.

To promote integrity in the development of the green bond market in Zambia, the Securities and Exchange Commission ("SEC"), issued the (Green Bonds) Guidelines, Gazette Notice No. 26 of 2019 (the "Green Bond Guidelines") in January 2020 pursuant to the Securities Act, No. 41 of 2016. The Green Bond Guidelines introduce mandatory rules for green bond labelling in Zambia.

The Lusaka Securities Exchange ("LuSE") has also prescribed rules, mirroring those under the Green Bond Guidelines, regarding the issuance of green bonds, to be used before the bonds can be listed and admitted to trading on the LuSE.

The Green Bond Guidelines are underpinned by the principles of transparency and disclosure which are key for the integrity of the capital market. They provide the necessary clarification by prescribing what steps an issuer needs to take both pre and post issuance and what information is to be disclosed by the issuer, over and above the disclosure obligations applicable to a conventional bond issuance.

This clarification aids investment decisions by promoting the availability of information necessary for an investor to evaluate the environmental impact of their green bond investments.

THE GREEN BOND GUIDELINES ARE ALIGNED WITH THE FOUR CORE COMPONENTS OF THE GREEN BOND PRINCIPLES[1] WHICH ARE:

- Use of proceeds;
- Proccess for project evaluation and selection;
- Management of proceeds; and
- Reporting

THE OPPORTUNITY

For an investor, the Green Bond Guidelines allow an investor to invest capital in projects or business activities in Zambia that are aligned with their ESG objectives. At the same time the investor, secures a stable financial return typical of any bond investment, which meets the investor's ESG investment criteria and enhances their reputation for sustainability.

FOR AN ISSUER OF GREEN BONDS, THE OPPORTUNITY IS TWO FOLD:

- The Green Bond Guidelines assist issuers achieve their environmental sustainability objectives by facilitating access to investors through the debt capital markets, to finance environmentally sound and sustainable projects that foster climate change mitigation and adaptation and protection of the environment; and

- The Green Bond Guidelines also facilitate market integrity required to attract a wider pool of investors with specific ESG objectives who are looking for environmentally friendly assets.

Green bonds may not necessarily offer any financial advantages for issuers in terms of pricing, when compared to conventional bonds whose interest rates, financial covenants, and other financial terms may generally not be any different. Many academic studies however, anticipate that as demand for green assets increases given the growth in ESG funds, a limited availability of sustainable assets, may result in better pricing for issuers.

THE OFFER DOCUMENT

The same offer documents will be used for a green bond issuance as a conventional bond i.e a prospectus or programme memorandum, if they are to be issued under a programme. Similarly the offer documents and other transaction documents, will also contain the same terms such as financial covenants and the issuer will also be subject to the same disclosure obligations under the Securities Registration of Securities Rules or the LuSE Debt Listing Rules, if they are to be listed. However, there will be some modifications specific to the disclosure of information required under the Green Bond Guidelines such as the framework of the green bond's environmental objectives.

CHARACTERISTICS OF A GREEN BOND

The Green Bond Guidelines define a green bond as a listed or unlisted debt security instrument, approved by SEC, whose proceeds are used to finance a new or existing project with environmental benefits. Examples of eligible projects or business are renewable energy, energy efficiency, climate change mitigation, clean transport, sustainable water and waste management, pollution prevention and control, green buildings and bio-diversity conservation. This list is non-exhaustive.

THIRD PARTY REVIEW

An issuer must appoint an independent external reviewer ("IER"). The IER conducts a pre-issuance review to confirm that the bond qualifies to be classified as green and is required to issue a report (the "IER Report"). The Green Bond Guidelines further outline the eligibility criteria necessary for one to be appointed as an IER. The IER must be independent of the prospective issuer, its directors, managers and shareholders.

DISCLOSURE IN THE OFFER DOCUMENT

The issuer is required to disclose in the offer document, the framework of the green bonds i.e. the use of proceeds in achieving the environmental objectives, the management of the proceeds from the bonds and the project selection process.

The offer document should include the IER Report, stating whether the proposed issuance can correctly be classified as 'green' and disclose to investors how the revenues from the green bond are to be managed and utilized. This is meant to promote transparency and credibility. A prospective issuer of a green bond is also required to disclose the criteria to be used in the selection of an eligible project.

REPORTING OBLIGATIONS

Post-issuance, an issuer of green bonds is subject to continuing reporting obligations throughout the life of the bond, over and above those applicable to a conventional bond issuer, to promote the credibility of the green bond post-issuance. For example, in a conventional bond issuance, twenty-one (21) days before an annual general meeting, an issuer must submit a director's report and annual accounts to the SEC and investors. In the case of a green bonds issuer, the annual accounts must include a Green Bond Report reviewed and confirmed by an IER, which describes the project and the amounts disbursed, as well as the expected impact of the project.

RISKS, CONCERNS AND CHALLENGES:

GREENWASHING RISK

There is a risk of abuse of the concept of green bonds to the detriment of investors. The Green Bond Guidelines define 'greenwashing' as the superficial or insincere display of concern for the environment. It involves misrepresenting or overstating the environmental benefits of a project that the proceeds of a green bond will fund. If it is found that greenwashing has occurred, SEC institutes investigations to determine whether the greenwashing constitutes a fraud on the investors. This may pose a risk to the issuer if it is found to have misled investors.Therefore, an issuer must carefully consider the disclosures in the offer documents and the periodic reports post issuance.

ISSUANCE AND COMPLIANCE COSTS

An issuer will incur additional costs of engaging an IER pre and post issuance, which would not be the case in a conventional bond issuance or if a loan facility was procured. In addition, it may also be costly for an issuer to implement internal measures to ensure adequate tracking of the management of the proceeds and measurement of the impact of the environmental objectives. Given the additional costs and absence of financial benefits in terms of the pricing of the bonds at issuance in the primary market, issuers may be reluctant to incur these additional costs.

NON-COMPLIANCE RISK

In the event of breach, SEC informs the issuer of the specific breach and requests that remedial measures be taken within a given period. This is in addition to any other measures that SEC, as regulator, may take. If the breach is not remedied, SEC may reclassify the bonds by directing the removal of the ‘green’ label on the green bond. The SEC may also, in the interests of investors, take other enforcement actions it deems appropriate for the breach.

Contractually, investors may seek contractual protections from greenwashing by demanding that compliance be included as green covenants under the terms and conditions of the bonds or that breach of the guidelines be included as an event of default, triggering certain enforcement action, including accelerating redemption of the bonds. It remains to be seen how this approach will be used as the market develops.

To wrap up the series in Part III, we’ll look at the chicken and egg problem of incentivising the use of green bonds in Zambia.

[1] The Green Bond Principles are voluntary process guidelines for the issuance of green bonds whose development and monitoring is conducted by the International Capital Market Association

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