MOIRA MUKUKA

LEGAL PRACTITIONERS

# Green and Sustainable Finance in Zambia

## Part 3: Green Bonds: The Chicken & Egg Problem

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Green and sustainable finance in Zambia are still nascent. Several initiatives have been introduced to support Zambia's sustainable development, including the Zambian National Policy on Climate Change 2016, National Policy on Wetlands 2018-2028, National Biodiversity Strategy and Action Plan 2015-2025, the issuance of the SEC Green Bond Guidelines, accreditation of the Development Bank of Zambia as National Implementing Entity for direct access under the Green Climate Fund and the establishment of a new Ministry of Green Economy and Environment to spearhead Zambia's sustainability agenda.

As the deadline for the achievement of the UN Sustainable Development Goals approaches, green finance, and green bonds, in particular, can play a key role in financing their achievement and that of the commitments under Zambia's Nationally Determined Contribution to the Paris Agreement on climate change.

A conceptual overview of the trends and developments in green finance and an examination of Zambia's green bonds regulatory regime were covered in Parts I and II of our series of articles. While green bonds assist both issuers and investors to, among other things, achieve ESG objectives, their issuance is not without challenges and this final Part III of the series examines the problem of incentivising green bonds.

To date, there have been no green bond issuances in Zambia, since the publication of the SEC Green Bond Guidelines in 2020, an indication of the inherent challenges that exist. So far, only one corporate issuer has publicly expressed intent to issue a debut green bond to finance the development of a renewable energy project. There must be deliberate regulatory and government policy measures taken to promote green bonds and the growth of capital markets in Zambia.

## REDUCING COSTS

The issuance of Green Bonds comes with attendant costs such as the cost of developing a framework of the green bond's environmental objectives, engaging an Independent External Reviewer ("IER") pre-issuance and post-issuance for periodic reporting throughout the life of the bond, the cost of implementing internal processes and controls to track management of proceeds and internal systems to measure and track the impact of the project. Given that green bonds are price neutral, market players assert that, there must be additional incentives or benefits over and above an enhanced sustainability reputation to justify these additional costs. The reduction of regulatory fees for the issuance of green bonds would be one such incentive.

Another positive step in incentivizing green finance is the announcement by the Government in the 2022 national budget that the fee structure for environmental impact assessments is to be revised downwards. This will reduce the cost of developing and implementing environmentally beneficial projects and will encourage compliance with environmental obligations. The necessary statutory instrument implementing this policy change is yet to be issued and therefore it is unclear how significant the reduction will be and how much impact it will have.

## CREATING LOCAL INSTITUTIONAL INVESTOR APPETITE

Local institutional investors could play a key role in the green bond market. There is need for clear legal guidance for local asset managers to be conscious of ESG in their investment review processes and decisions. The regulations governing the investment criteria of local asset managers such as the pension fund managers remain focused on financial return as the key metric in evaluating performance. There is need to reframe the statutory fiduciary duties of asset managers to provide fund managers with the flexibility to consider ESG objectives in addition to financial return. This will give asset managers the impetus to incorporate sustainability objectives in their investment policies and investment criteria.

Further, the lack of disclosure requirements for local asset managers to reveal environmental information about their asset holdings in the current regulatory framework, do not provide asset owners with sufficient information to scrutinize the ESG integration processes of local asset managers.

## CREDIT ENHANCEMENT

Credit risk plays a key role in the pricing of debt. The availability of first-loss capital or partial credit guarantees by development finance institutions ("DFI's") could play a key role in catalysing the issuance of green bonds. For instance, in Kenya, GuarrantCo provided a 50 per cent partial credit guarantee for the green bond issued by Acorn Holdings Plc. This serves the purpose of enhancing the creditworthiness of the issuer and would enable an issuer to raise capital at a lower cost. This approach is unlikely to be feasible for every green project, but if some projects are financed using the proceeds of green bond issuance and successfully completed, it could assist activate the green bond market.

## DEVELOPING LOCAL CAPACITY FOR THIRD-PARTY REVIEW

To qualify for an appointment as an IER, an entity must be specialized in assessing the framework of the green bond's environmental objectives. The IER must possess sufficient environmental, financial and market-specific expertise to perform a comprehensive assessment of the use of proceeds. In addition, the IER must be compliant with the International Capital Market Association's Guidelines for External Reviewers or accredited under the Climate Standards and Certification Scheme or any industry body acceptable to the SEC.

There are no local certification schemes for accrediting IER's. This expertise will need to be developed over time. In the meantime, issuers will have to engage foreign firms, at a cost. There is a need to develop capacity locally to assist reduce this cost.

## FISCAL INCENTIVES FOR GREEN ISSUANCE

The lack of bankable green projects to be financed or refinanced through green bonds remains a challenge. There is need for an enabling policy and regulatory environment to facilitate the development of green projects at scale. Alignment of national priority areas that attract incentives under the Zambia Development Agency Act, with eligible projects under the green bond principles has been identified as a potential solution[1], and perhaps a key issue to consider as the country's eighth national development plan is developed.

Tax incentives for both issuers and investors would also be an effective form of incentivization. To encourage the growth of the green bond market, the Minister of Finance could exempt green bonds from taxes such as withholding taxes on interest for the benefit of investors. Corporate tax could also be reduced for the benefit of green bond issuers.

According to the Ministry of Green Economy and Environment, the Government is working on and may introduce incentives such as 'zero-rating withholding tax on interest' from green bond-financed projects and tax-deductibility of costs associated with the issuance of green bonds. Details on the extent of these proposed fiscal incentives and how they will be implemented are yet to be pronounced.

To sum it up, the green bond market offers both large enterprises and SMEs access to a wider pool of capital that is not tied to traditional financial and lending institutions. Regulators, issuers and investors alike will benefit from Zambia's new green bond market in terms of revenue generation. Businesses that lead the charge will reap the greatest rewards.

We can guide you through the maze of rules and regulations that govern the green bond market in Zambia.

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