CRITICAL ISSUES FOR CHANNELLING CLIMATE FINANCE VIA PRIVATE SECTOR ACTORS

“It is vital that adequate and reliable climate finance reaches the poorest and most vulnerable people.”

Author: Oscar Reyes

Commissioned by the Bond Development and Environment Group
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About the author

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Governments and multilateral development institutions are showing interest in engaging the private sector to deliver development assistance. This has spawned initiatives to channel development finance through the private sector by, for example, using public funds to ‘leverage’ additional finance from institutional investors.

**RECOMMENDATIONS**

**CLIMATE FINANCE FROM ALL SOURCES, PUBLIC AND PRIVATE, SHOULD BE FOCUSED ON OUTCOMES AND IMPACTS.**

This requires transparent and meaningful disclosure of data, adequate monitoring and evaluation, and appropriate safeguards.

**BETTER DATA ON IMPACTS IS NEEDED, PARTICULARLY TO SUPPORT CLAIMS MADE ABOUT THE ADDITIONAL FINANCIAL, POVERTY REDUCTION OR CLIMATE PROTECTION BENEFITS OF USING PUBLIC FUNDS TO LEVERAGE PRIVATE INVESTMENT.**

Climate benefits should be broken down according to the Rio Markers: the relative proportions of finance allocated for mitigation and adaptation should be recorded.

**PRIORITY SHOULD BE GIVEN TO THE POOREST AND MOST VULNERABLE COUNTRIES AND REGIONS.**

UK climate finance and the Green Climate Fund should prioritise financial and technical support for integrated, country-driven development. This should include strengthening the capacity of developing country governments to engage with climate finance mechanisms and initiatives.

**AT LEAST 50 PER CENT OF OVERALL CLIMATE FINANCE SHOULD BE DIRECTED TOWARDS ADAPTATION.**

This requires provision of public finance. Current measures to leverage private finance are mostly geared to supporting mitigation activities in middle-income countries and are “a poor fit” for adaptation.

**PUBLIC CLIMATE FINANCE SHOULD BE DISBURSED IN THE FORM OF GRANTS NOT LOANS.**

Climate financing should not add to the debt burden of poor countries that are not responsible for climate change. Equally, it is not a good use of scarce public funds to channel them through private equity funds or use them to provide loan guarantees for commercial and near-commercial mitigation projects.

**BEST PRACTICE TRANSPARENCY AND ACCOUNTABILITY STANDARDS FOR DIRECT PUBLIC INVESTMENTS SHOULD APPLY WHEN PUBLIC FINANCE IS PASSED THROUGH PRIVATE SECTOR INSTRUMENTS.**

Financial intermediaries should be held to the same environmental, social and financial reporting standards and transparency requirements as public institutions. If private sector fund managers are not resourced to comply with such standards, then efforts to channel development and climate investment via such private equity funds should be curtailed.

**ENSURE ALL PUBLIC SUBSIDIES AND POLICIES ARE CLIMATE SMART**

Public investment overall should support low carbon investment and climate protection. One crucial international effort the UK should actively support is to shift subsidies away from fossil fuels.

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2 Critical issues for channelling climate finance via private sector actors
Developed countries have not yet agreed any clear plans for meeting their UN Framework Convention on Climate Change (UNFCCC) commitment to provide US$100 billion annually by 2020 for climate change action in developing countries. Furthermore, there is likely to be a need for far more than US$100 billion per year. Government budgets in industrialised countries are constrained by the financial crisis and austerity policies, and there is little clarity about industrialised countries are constrained by the financial crisis and austerity policies, and there is little clarity about when and how public financial flows will be scaled up to meet the challenge posed by climate change. Through this lens, attracting more private sector finance is seen as a way to plug the public financing gap.

Some governments have proposed using public climate finance to leverage, and thereby scale up, private finance for climate action from institutional investors, such as pension, insurance and mutual funds. These investors have large pools of capital to deploy and a longer-term investment outlook that could be suited to low-carbon infrastructure financing in particular. Despite the interest in this approach, there is insufficient evidence that using public finance in this way provides additional financial, developmental or climate protection benefits or that it encourages change in private investment patterns to the extent that is sometimes claimed.

High leverage ratios can be exaggerated

Leveraging is generally measured in terms of ratios. The International Finance Corporation is the World Bank’s private sector arm and one of the main bodies using leveraging for delivering development assistance. If the International Finance Corporation were to claim that, for every US$1 it puts towards a particular investment, private companies have put US$10; this would be a 1:10 leverage ratio. According to Stadelmann, in practice ‘most independent assessments clearly give lower leverage factors than the self-reported ones’. Claims about leveraging are often inflated descriptions of subsidies for private activities that would have happened anyway, without public involvement.

High leverage ratios can mean low developmental and climate protection impacts

In addition, the assumption that high leveraging ratios are always a good thing may be misplaced. In fact, they may simply mean that the public sector is taking on a high level of risk, although it is often assumed that, on the contrary, a high leverage ratio means lower public risk. Moreover, significant leveraging means that the private sector has a greater influence over the project or programme being funded, which is likely to result in trade-offs between commercial objectives, such as maximising profits, and other objectives such as climate protection, poverty reduction and building the adaptive capacity of host governments. Also, a high leverage ratio is no indication of how effective projects and programmes are at reducing greenhouse gas emissions. In fact, ‘there is often an inverse relationship between the two, since low-cost options, such as energy efficiency, generally do not require significant additional investment to achieve their aims.’

Types of additionality/leverage

- Financial: is this new money or is the private investment likely to have happened anyway? If this is probable, then the argument can be made that in fact the private investors have leveraged the public sector finance to support existing plans.
- Operational and institutional: have there been improvements in the design of the investment as a result of public sector involvement? Have there been improvements in social and environmental standards, corporate governance, or institutional management as a result of the public-private partnership?
- Development: will the total investment contribute to sustainable development, or climate adaptation and mitigation objectives? If not then it can be argued that the public funds have been wasted or would have been better directed.

Leveraged private finance fails to reach the poorest and most vulnerable people

UK climate finance is classified as Official Development Assistance (ODA), meaning that it should adhere to principles of accountability and transparency, as well as targeting ‘poorer and fragile states’. Furthermore, in the UK, the International Development Act 2002 specifies that aid must be used for poverty reduction. The purpose of the International Climate Fund is to support international poverty reduction by helping developing countries to adapt to climate change, take up low carbon growth, and tackle deforestation. It also states: ‘All spending from the International Climate Fund must be consistent with the DAC definition of ODA and [the] overall purpose of UK development assistance is poverty reduction.’ Experience with existing climate finance initiatives demonstrates that using public finance to leverage private investment is not ‘a good fit’ in terms of meeting the needs of the poorest and most vulnerable people in relation to the effects of climate change.

For example, 75 per cent of current Clean Development Mechanism registered projects are in China, India, Brazil and Mexico; only one per cent of projects are in Least Developed Countries. Furthermore, an ODI study of the UK’s private climate finance support for 2010–2012 found that only seven per cent was spent on activities in low-income countries. Similarly, only 13 per cent of International Financial Corporation projects channel support to low-income countries.

In fact, without any public financing element, Foreign Direct Investment and international bank lending show fairly similar distributions. Most finance goes to a handful of ‘emerging economies’ (China, Brazil, Mexico and India) and only three per cent goes to Least Developed Countries. Thus, mechanisms to use public finance for leveraging are highly likely to reproduce the distribution of existing private finance flows. At best, they may ‘tip the balance’ to make some non-commercial projects more viable – although such projects are finite in number, so the extensive use of such ‘de-risking’ tools would have diminishing returns. In other words, a focus on leveraging could substitute, and crowd out, private sector investment in projects that would happen anyway because such a venture would be profitable without public assistance.
Ultimately, the evidence shows that leveraging tools do not offer incentives for initiating projects in areas where there is market failure and a lack of existing commercial incentives. Finally, there is arguably a kind of ‘free-riding’ effect in using public climate finance to strengthen existing patterns of commercial investment. This risks undermining taxpayer support for providing additional public climate finance. The risk is high at a time when development assistance is already under attack from some sections of the media on the grounds that it is subsidising commercial ventures in countries perceived as trade rivals. Overall, there is mismatch between using scarce public funds for leveraging and achieving proven developmental and climate protection aims.

Transparency and accountability concerns

The UNFCCC Work Programme on Long-Term Climate Finance has called for greater disclosure on private flows so governments can apply lessons learnt to improve future interventions.19 The governments can apply lessons learnt to improve greater disclosure and accountability reporting standards.19 The CDI’s recent review of US$8.5 billion in climate finance identifies 17 private financial intermediaries channeling climate finance. The review states that there is no clarity on the extent to which both the UK’s new Climate Public Private Partnership initiative and the US Overseas Private Investment Corporation (OPIC) are attracting additional climate finance, due in part to a lack of information and transparency. The cited barriers to disclosure in such schemes include commercial confidentiality, regulatory requirements and the fact that many interventions are in their early phases of implementation.20

The issue is not only one of disclosure, but also relates to how such investments are structured. For example, equity funds claim significant leverage on the grounds that the public sector investor takes only a small stake alongside a number of private investors. However, the presence of private investors can severely dilute or even compromise the climate and developmental objectives of the proposed project. Most funds that have Development Finance Institution (DFI) involvement require the application of environmental and social safeguards and management systems, but do not require reporting against environmental and social outcomes.21

In addition, the majority of equity funds that DFIs invest in are domiciled in offshore financial centres, also known as ‘secrecy jurisdictions’.20 This makes it even harder to ensure that public officials have transparent oversight of social, human rights and environmental safeguarding. It also inhibits DFIs’ ability to carry out adequate due diligence (including anti-corruption) checks on their co-investors.20

Lack of evidence on the impacts of leveraging private finance

The lack of adequate data on the developmental and climate protection impacts of finance channelled through private sector mechanisms means that it is currently difficult to evaluate whether leveraging represents value for money. In particular, data that simply measures leverage ratios is unhelpful, since it can easily be manipulated (as noted above) and because it can distract financing priorities. Improved data collection might look at the impacts of private sector leveraging by breaking down the different types of additional benefits or ‘additionality’ with which it is credited:

I. Financial additionality: namely, whether the investment has attracted additional finance or have happened anyway without the involvement of public finance bodies; and

II. Operational and institutional additionality: whether public finance leads to improvements in the social, environmental or corporate governance standards adopted by the project or those of the company receiving investment; and

III. Developmental additionality: whether the total investment has sustainable development benefits.20

In the case of climate finance, it is also crucial to report on the ‘climate-additionality’ of such investment flows. The OECD-DAC Rio Markers provide a useful starting point, classifying finance according to whether climate policy goals are a ‘principal objective’ or a ‘significant objective’, or whether projects are ‘not targeted’ towards climate goals at all.20 Any measures of climate financing should also specify the relative proportions allocated to adaptation and mitigation.

Increased political ambition for a robust multilateral climate change framework

Cost assessments for mitigation and adaptation and for compensating developing countries for ‘loss and damage’ are spiralling in the absence of ambitious emissions reductions, particularly on the part of industrialised countries. They will continue to rise until a more robust multilateral mitigation framework is in place.20 This also raises the question of where the public investment priorities of industrialised economies lie. For instance, financing for climate action is still dwarfed by the scale of fossil fuel subsidies, financial sector bail-outs and global military budgets.20

Shifting public subsidies should be a greater priority than leveraging private finance

There is a lack of coherence in the fact that decision-makers are focusing on leveraging finance from institutional investors for climate action and low-carbon development while at the same time maintaining high levels of public investment and subsidy in fossil fuel portfolios. A climate-smart regulatory framework is required to shift investment away from fossil fuels and promote greater investment at home and abroad in energy efficiency and the development of low-carbon forms of energy and infrastructure. There also needs to be a strong focus on energy access and an integrated approach to adaptation.20

Governments, including the UK’s, could do more to make climate financing a similar or greater priority, as well as engaging domestic and international efforts to redirect fossil fuel subsidies. This also makes long-term economic sense, as many economists have argued, most notably Lord Nicholas Stern in the UK context: the longer governments delay in addressing climate change, the greater the economic costs will be.20

In this context, fiscal measures, such as scrapping fossil fuel production subsidies, as well as household and industrial energy-saving measures, feed-in tariffs and tax exemptions for renewables, can all play a role.20 Arguably, other direct and indirect non-fiscal measures could also support a coherent, low-carbon investment agenda, including: addressing secrecy jurisdictions, bolstering the international legal liability of transnational investors for environmental harms in developing countries, or legally mandated resource-efficiency reporting.20
Innovative sources of public finance

Although public financing will necessarily involve significant additional budgetary contributions from developed countries, several ‘innovative’ sources of finance could be mobilised to supplement these. They include, inter alia: financial transaction taxes, special drawing rights, carbon pricing of shipping and aviation, and oil export taxes. Considerable pools of public capital also exist in the form of public pension funds and, in many countries, sovereign wealth funds. A proportion of these could be invested in climate action – providing that the appropriate enabling framework, incentives and safeguards were in place.

**Targeting the right financial flows**

The rationale for the focus on leveraging private finance from institutional investors rests upon global assessments that these actors are sitting on US$100 trillion or more in assets. Redirecting even a small fraction of this amount presents a ‘manageable opportunity’ to plug the climate finance gap. A more nuanced assessment of financial flows shows that most financing for development investment comes from domestic public and private resources. This implies that leveraging instruments, as currently conceived, are focused on the wrong target. Domestic expenditure in developing countries is already larger than both ODA and Foreign Direct Investment. Greater emphasis should be placed on helping domestic actors, including governments, to target their investment towards renewable energy and low-carbon infrastructure, including by building the capacity of developing country governments. Country-driven approaches that bolster domestic expenditure should be encouraged for their ability to grow developing country production capacity in renewables and low-carbon industries. It is also important that such approaches promote social inclusivity and take sufficient account of the developmental needs and wants of local communities, especially the poorest and most marginalised groups.

Can private climate finance meet adaptation needs?

There is limited data on the relative availability of private finance for adaptation and mitigation, although the existing evidence suggests that private financing is heavily concentrated on mitigation activities. This is unsurprising, since the private sector looks for commercial returns on investment and there are relatively few profitable adaptation opportunities available, particularly in the poorest countries. An approach to climate finance that emphasises private investment is unlikely to meet adaptation needs.

How should public finance be delivered, through grants or loans?

The rationale for ‘climate finance’ is based on an acknowledgement in the UNFCCC and elsewhere that developed countries are disproportionately responsible for causing climate change, while developing countries are and will be affected by it disproportionately. This is embodied in the UNFCCC principle of ‘common but differentiated responsibilities and respective capabilities’. To address this ethical imperative, projects that are unlikely to attract commercial investment, including adaptation projects in the poorest and most vulnerable countries, should be financed through grants.

However, to date, more than half of the contributions made towards achieving the Copenhagen Accord’s US$30 billion goal for fast-start finance have been provided in the form of loans; some countries have also counted export credits and other forms of tied aid as fast-start finance. It is unfair to expect poor countries to take on new debts to address climate change-related impacts. Concessional loans should be seen as supplementary to climate finance and reported as such. Non-concessional loans and export credits should also be separated clearly from climate finance reporting.

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Improved data collection and much greater transparency are needed to measure the financial, developmental and climate protection effectiveness of initiatives that leverage private investment. The climate, human rights and developmental benefits of these investments must be accurately measured and reported. The relative proportions of investments flowing towards adaptation and mitigation should also be documented.

However, better disclosure of data is not enough. Public finance provided in support of private climate investments should be subject to the same levels of scrutiny and oversight as direct public investments, adhering to best practice standards. Public finance should not be channelled through financial intermediaries unless there are robust social, human rights and environmental safeguards in place, along with transparent monitoring and reporting mechanisms and adequate public oversight.

Finally, decision-makers should build a coherent approach to climate financing policy. A climate-smart regulatory framework is required to shift investment away from fossil fuels and promote greater investment in energy efficiency and low-carbon development. New York: United Nations Development Programme.

docs/products/investing_in_climate_change_2011.pdf"


"For example, a Wikileaks memo reveals that Indian companies investing in low-carbon development projects are unlikely to rely on revenues from the Clean Development Mechanism (CDM) when making the business case for such projects, although many of these projects subsequently do become CDM-registered. Under these circumstances, carbon revenues cannot claim additivity: http://wikileaks.org/cable/2008/07/ibmukmba0840.html A further example is partial credit guarantee schemes, the true costs of which can be understated; their social benefits are also hard to estimate. See Honohan, P (2009) ‘Partial credit guarantees: principles and practice’, Journal of Financial Stability, 6(1), 1–9. http://www.tara.tcd.ie/handle/2262/31746"


"UK government’s International Development Act 2002, Part 1 Section 1: www.legislation.gov.uk/ukpga/2002/1
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Critical issues for channelling climate finance via private sector actors


The economics of climate change: The Stern Review. Most recently, Lord Stern said that he now realised that he had previously underestimated the risks posed by climate change, and that the effects of global warming were being felt earlier than he had calculated. Interview with Lord Stern at the World Economic Forum, Davos, Saturday, 26 January 2013. In addition, recent analysis by scientists shows the most stringent emissions cuts (which would only give a 50 per cent chance of remaining below 2°C rise) reduces impacts by 20–65 per cent by 2100 relative to a “business-as-usual” pathway which reaches 4°C, and can delay impacts by several decades’. Arnell, Lowe, Brown, Gosling, Gottschalk, Hinkel, Lloyds-Hughes, Nicholls, Osborn, Osborne, Rose, Smith & Warren (2013) ‘A global assessment of the effects of climate policy on the impacts of climate change’, Nature Climate Change, published online in January 2013. According to one of its authors, Professor Nigel Arnell, Walker Institute Director at the University of Reading, the research ‘clearly identifies the benefits of reducing greenhouse gas emissions — less severe impacts on flooding and crops are two areas of particular benefit. Reducing greenhouse gas emissions won’t avoid the impacts of climate change altogether [but] it will buy time to make things like buildings, transport systems and agriculture more resilient to climate change.’ See endnote 33

Notes

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