project catalyst

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PROJECT CATALYST BRIEF: Financial Architecture[1]

The need for an improved climate finance system

Limiting warming to no more than 2^0C above pre-industrial levels will depend on both developed and developing countries achieving significant abatement of emissions. Some of the abatement in the developing world will save these countries money, primarily through reduced energy use. But a significant share will incur additional costs. These measures will require financial support from the developed world, based on the "agreed incremental cost." This incremental cost is the additional expense associated with a climate-compatible activity, compared to the more carbon-intensive, business-as-usual alternative. Developed countries agreed to provide such support in 1992, in the UN Framework Convention on Climate Change (UNFCCC), and again in 2007, in Bali.

Project Catalyst has previously estimated that the developing world faces an incremental cost financing requirement for mitigation and adaptation activities of €65-100 billion per year over the period 2010-2020. The Copenhagen Accord stated that developed countries would commit to mobilising $100 billion per year by 2020, that both bilateral and multilateral sources would be required, and that a new "Copenhagen Green Climate Fund" should be established. Currently, the UN High-Level Advisory Group on Climate Change Financing (AGF) is looking at ways to scale up international climate finance to deliver the $100 billion, while the UNFCCC's Ad Hoc Working Group on Long-Term Cooperative Action is negotiating the establishment of a new fund and other elements of climate finance.

Given the scale of finance that must be raised and deployed, Project Catalyst believes that a combination of both bilateral and multilateral channels will be required to manage the system. Indeed, while discussions under the UNFCCC focus on a new central fund, the most ambitious climate action now taking place is happening through bilateral partnerships and domestically driven initiatives, such as the Norway-Indonesia REDD partnership and Brazil's Amazon Fund, respectively. Project Catalyst's preliminary analysis on the Fast Start finance pledges has found that two-thirds of the pledged funding is likely to go through bilateral channels and one-third through multilateral channels.[2]

In this paper, we provide a sketch of a climate finance system that would effectively leverage both bilateral and multilateral channels of climate finance.

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[1] This paper is an update to an earlier version released in December 2009 for the Copenhagen conference. See http://www.project-catalyst.info/images/2.%20Climate%20Finance/Publications/2.%20Briefing%20papers%20on%20climate%20finance/20091202%20Financial%20Architecture%20Briefing.pdf

[2] See Project Catalyst's "Making Fast Start Finance Work" paper at http://www.project-catalyst.info/images/publications/2010-06-07_project_catalyst_-_fast_start_finance_-_full_report_-_7_june_version.pdf

Design criteria for the climate finance system

First, it is worth considering what the climate finance system needs to deliver. To be effective, the system must:

- **Be predictable to encourage forward planning**: Many of the climate change challenges in developing countries require transformational changes to entire economies, which developing countries cannot commit to without assurances of future financial support. Norway and Brazil's sizeable pledge to the Amazon Fund, which is contingent upon the delivery of reductions in deforestation, provides a good example for how certainty can be increased through an upfront financial commitment.
- **Boost harmonization:** There is currently little coordination among nations on climate finance. Opportunities are lost to combine funding, avoid duplication, and share learning from each other's successes. This is particularly conspicuous in the current situation with Fast Start finance.
- **Manage for results:** The basis for continued transfer of funding should be the delivery of real results. Performance assessment frameworks need to be developed for specific areas (e.g., REDD, energy efficiency).
- **Create more transparency:** There is no widely shared definition of what Fast Start finance entails, nor is there a solid understanding of how funds are being deployed and how they perform. This creates mistrust among both developing and developed countries. Clear definitions and standards for what constitutes climate finance are needed, including grant equivalence guidelines (how to value loans and risk guarantees) and additionality requirements. At a minimum, donor countries should disclose their working definition for these issues.
- **Ensure efficient disbursement:** From a developing country's perspective, the current, fragmented system of donor funding makes it hard to apply for funding. The system could be enhanced by harmonizing requirements of major funding channels and assessment processes. Efforts should be made to minimize approval time and multiplication of administrative procedures, thereby ensuring efficient access to funding.

A proposed climate finance system

A climate finance system that would deliver on the above requirements would require the following national institutions, finance mechanisms, and global institutions, as shown in Exhibit 1.

NATIONAL INSTITUTIONS

Developed Country International Climate Funds

These funds would manage a developed country's international climate funding. They would receive funding on a long-term basis, either from direct public sources, auction revenues from an emissions trading system, concessional debt with government guarantees, or from other sources. These funds

would work with their counterparts in developing countries (see below) to provide the finance required for mitigation and adaptation programmes in those countries.

The advantage of separating International Climate Funds from other parts of developed country governments, such as their finance or development ministries, would be to improve transparency of financial commitments from developed countries and to increase the stability of funding provided by them. These funds would be better shielded from annual budget decisions.

Developing Country Climate Trust Funds

These funds, managed by developing countries themselves or, if requested, by a third party (such as an international financial institution), would blend domestic funding, funding from developed country International Climate Funds, and other sources. They would use that funding to deliver programmatic or sectoral abatement and adaptation measures. Brazil's Amazon Fund, which is managed domestically, and Guyana's REDD+ Investment Fund, which is managed by the World Bank, provide examples for how such funds could be structured. National trust funds have a number of advantages: they offer countries ownership, they increase the transparency of the domestic contribution, they complement international funding, and they potentially optimise the use of the various sources of funding.

If offset markets are scaled up significantly, these Climate Trust Funds could also act as market intermediaries that issue credits for sectoral abatement programmes. However, under current mitigation pledge proposals, Project Catalyst estimates that only limited offset demand will be created, reducing the ability for offset markets to deliver much of the needed climate finance.

MECHANISMS TO SUPPORT CLIMATE FINANCE

Low-Carbon Growth Plans

Developing country governments would be responsible for developing Low-Carbon Growth Plans (LCGPs),[3] which provide credible pathways for moving their economies onto a low-carbon trajectory. They would specify the incremental costs of implementing the programmes on top of self-financing commitments and outline the total abatement to be measured and accounted for under a global oversight function. These plans would be subject to oversight from a technical body.

Importantly, developed countries would also be responsible for developing their own LCGPs. Indeed, the sharing of best practices and lessons learned through these plans will be critical for ensuring that these ambitious plans are realized. However, developed country LCGPs will not form an integral part of the international climate finance system because they are not expected to receive funding from international sources.

Developed country finance packages

Developed countries would put together financing packages for programmes of action in developing countries, in line with their overall financing commitments and subject to monitoring, reporting, and verification (MRV) by the global oversight mechanism. These packages would be managed by their

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[3] For more, see the Project Catalyst "Low-Carbon Growth Plan" paper at http://www.project-catalyst.info/index.php?option=com_content&view=article&id=99&Itemid=79

International Climate Funds and could be constructed either on a bilateral or multilateral basis. They would outline a funding schedule and specify the mix of financial instruments (i.e., grant support for capacity building, low-cost debt for capital investment, and grants or carbon credits for abatement performance). All developed countries would be required to regularly report on these climate finance packages to the global oversight mechanism.

Climate Partnership Agreements

Bilateral partnerships between developed country International Climate Funds and developing country Climate Trust Funds would then be negotiated between countries to agree upon the required finance for the supported part of the LCGP. These Climate Partnership Agreements could cover the full plans or parts of them; they could be purely bilateral or involve numerous funders, or even multiple recipients for cross-border or regional initiatives. The partnerships would then be registered within the global system according to a consistent framework of rules.

Developing countries would implement the Nationally Appropriate Mitigation Actions (NAMA) and National Adaptation Programmes of Actions (NAPA) identified in the LCGP over an agreed timeframe and receive funding via national climate trust funds that would be responsible for overall programme orchestration, deployment of funds, and compliance with MRV requirements. An initial set of funding commitments would be drawn down over time as the developing country Climate Trust Fund met an agreed set of milestones. Although shorter-term or more ad hoc arrangements could also exist, using Climate Partnership Agreements would have the advantage of providing stability and reducing transaction costs. The developed country International Climate Funds are needed to allow partnerships to develop between countries and to provide developing countries with the predictability of funding required to develop ambitious and transformative LCGPs that are commensurate with the climate change challenge.

As with any partnership, the specifics of each Climate Partnership Agreements would need to be revised over time, in light of implementation barriers, technological innovation shifts, changes in relative prices, and other factors. Revised Climate Partnership Agreements would be re-registered in the global system, which would also provide a process for resolving disputes.

GLOBAL INSTITUTIONS

Global Green Fund or "New Fund"

In addition to these bilateral arrangements, a global "green fund," described by the UNFCCC as a "new fund" would be required to perform three main functions:

1. **Provide backup funding** either for partially funded Climate Partnership Agreements or for robust developing country LCGPs that, for legitimate reasons, cannot secure funding through other bilateral or multilateral channels. This backup funding should focus on adaptation needs of developing countries which may find it more difficult to secure funding through bilateral partnerships than would mitigation programmes.

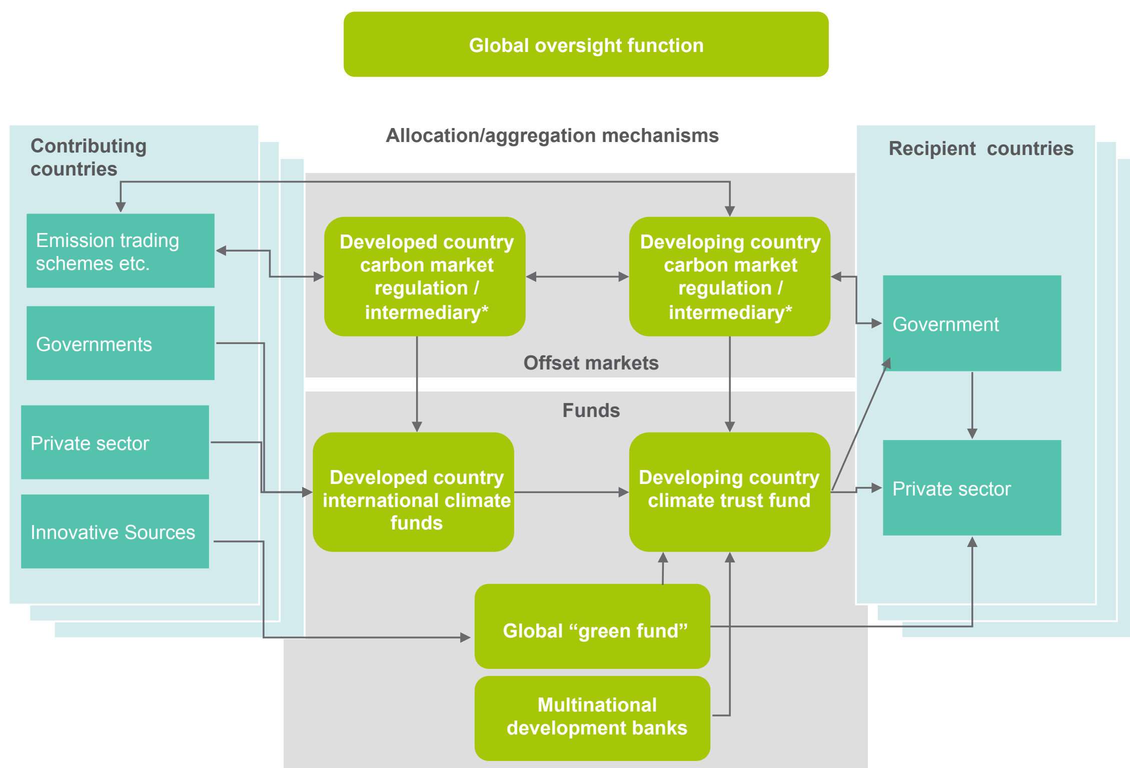
2. **Support investments in global public goods**, such as investments in pre-commercial low-carbon technology (e.g., carbon capture and storage) or early warning systems.
3. **Strengthen global safety nets** in the face of mounting climate risks (e.g., by supporting national-level climate insurance programmes).

The green fund would need to work in close coordination with existing climate funds and development institutions, such as the multilateral development banks, in order to leverage existing funding flows and ensure the portfolios of those institutions take climate change into account.

Global oversight system

Lastly, a global oversight system with equitable governance from developed and developing countries could provide system coordination, account for the contributions of different parties, register the agreed Climate Partnership Agreements, help match sources of funds with potential recipients, develop shared rules of conduct, and spread best practices.

Exhibit 1 – Overview of climate financing system



*Function could be performed by developed and developing country trust funds

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Project Catalyst is an initiative of the ClimateWorks Foundation and the European Climate Foundation. This paper is a summary based on the Project Catalyst publication, "Scaling up climate finance". The full paper is at www.project-catalyst.info