



european network on  
debt and development

# Cashing in on climate change?

Assessing whether private funds can be leveraged to help the poorest countries respond to climate challenges



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## Acronyms

AGF	High Level Advisory Group on Climate Finance
BCCSAP	Bangladesh Climate Change Strategy and Action Plan
BCCRF	Bangladesh Climate Change Resilience fund
BCCTF	Bangladesh Climate Change Trust Fund
CDM	Clean Development Mechanism
CER	Certified Emission Reduction
CIF	Climate Investment Fund
CTF	Clean Technology Fund
DFIs	Development Finance Institutions
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Export Credit Agency
EDFI	European Development Finance Institutions
EFIC	Export Finance and Insurance Corporation
EIB	European Investment Bank
FIs	Financial Intermediaries
GCPF	Global Climate Partnership Fund
GEF	Global Environment Facility
GIIF	Global Index Insurance Facility
IATI	International Aid Transparency Initiative
IFC	International Finance Corporation
IMF	International Monetary Fund
KfW	KfW Bankengruppe
LICs	Low Income Countries
LMICs	Lower-middle Income countries
MIGA	Multilateral Investment Guarantee Agency
NAMA	Nationally Appropriate Mitigation Action
NAP	National Adaptation Programme
NAPA	National Adaptation Programmes of Action
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private investment Corporation
SCF	Strategic Climate Fund
SCCF	Special Climate Change Fund
SMEs	Small and medium sized enterprises
UN	United Nations
UNDP	United Nations Development Programme
UNFCCC	United Nations Framework Convention on Climate Change
WB	World Bank
WRI	World Resources Institute

The effects of climate change on developing countries have created a huge financial burden. Policymakers aim to limit global warming to a rise of 2°C in this century.<sup>1</sup> In this scenario, the cost of adapting to and mitigating the impact of climate change would be in the range of USD 110-275 billion (€79-198 billion) per year for developing countries.<sup>2</sup> Given their historical responsibility, accumulated climate debt<sup>3</sup> and the principle of common but differentiated responsibility, developed countries will have to shoulder most of the cost.

Rich countries have pledged to make available USD 100 billion (€72 billion) per year by 2020, most of which will presumably be channelled through the Green Climate Fund.<sup>4</sup> Although originally this money was expected to come from public sources, developed countries have begun to rely on mobilising large amounts of private money.

As the discussion about mobilising private resources is mainstreamed, financial intermediaries (FIs) are placing themselves at the forefront of the debate. They are receiving a great deal of attention due to their perceived ability to use public money to overcome the barriers to private investment in developing countries. Estimates suggest that through the use of FIs, it may be possible to raise in the range of USD 100-200 billion (€72-144 billion) per year of private flows from developed to developing countries.<sup>5</sup>

While climate finance is vital for both mitigation and adaptation, this report focuses on the latter. It looks at some of the main instruments that can be used to leverage private climate finance through financial intermediaries and analyses data from some major development finance institutions (DFIs). It specifically assesses the role of financial intermediaries in low-income countries (LICs) and in supporting small and medium sized enterprises (SMEs) and looks into the main monitoring and accountability constraints when using financial intermediaries.

## **This report finds that:**

- Important gaps exist in the knowledge of how money is leveraged through financial intermediaries. These gaps should be filled before channelling any significant amounts of climate finance through FIs.
- Financial intermediaries and existing investment instruments are very limited when it comes to targeting LICs and SMEs in sectors which are particularly vulnerable to climate change.
- Developed countries are looking at financial intermediaries as isolated actors without paying attention to the policy and institutional environments in which they operate.
- Monitoring financial intermediaries is extremely difficult and there are no mechanisms to ensure private climate finance is aligned with developing countries' priorities.

These shortcomings underscore the importance of direct public finance. Leveraging money through financial intermediaries cannot be used as a substitute for directing sufficient public resources directly to the poorest. Given the gaps, a strong reliance on FIs and the private sector could spell disaster for many citizens in developing countries.



Developed countries should consider financial intermediaries as a very specific tool among many others rather than as one-size-fits-all solution to climate change and take ambitious steps towards making them more effective.

This report does not suggest that developed countries and international organisations should stop using financial intermediaries. The core message is that developed countries should consider financial intermediaries as a very specific tool among many others rather than as one-size-fits-all solution to climate change and take ambitious steps towards making them more effective. These are our recommendations to them:

- **Develop a coherent framework that is based on the primacy of the national strategies of developing countries.** This framework should consist of clear guidelines that align financial intermediaries' investments with the priorities stated by developing countries, including governments, civil society, local communities and other stakeholders. They should also respect key development effectiveness principles such as recipient country ownership and the use of country systems.
- **Ensure financial intermediaries that receive public support are transparent and accountable to local stakeholders:**
  - Improve reporting so that money channelled through financial intermediaries can be better tracked and coordinated.
  - Increase overall transparency as a means to improve monitoring and accountability to local stakeholders.
  - Implement effective systems to ensure adherence to international social, environmental and human rights standards.
  - Observe high corporate social responsibility standards and do not engage in tax dodging practices.
- **Actively work to identify best practices and instruments that can help to make climate funds more effective, particularly how to reach the most vulnerable countries and sectors:**
  - Understand the limitations of financial intermediaries and investment instruments.
  - Identify and create a public register of pro-poor FIs.
  - Make sure that public investors put in place the right instruments to target LICs and SMEs in sectors particularly vulnerable to climate change such as agriculture.
  - Develop stricter standards and independent methods for assessing the additionality of climate projects

Climate change is possibly the greatest challenge the world will face in our lifetime. It has an impact on people’s lives and livelihoods, on the economy and nature. The UN warns that “billions of people, particularly those in developing countries, face shortages of water and food and greater risks to health and life as a result of climate change.”<sup>6</sup> If no actions are taken, developing countries will bear the brunt of climate change, as they do not have sufficient social, technological and financial resources to adapt to the challenges they are starting to face.<sup>7</sup>

Climate finance needs in developing countries are staggering. Policymakers are currently aiming to limit global warming to a rise of 2°C in this century.<sup>8</sup> In this scenario, the cost of adapting to and mitigating the impact of climate change is still estimated to be in the range of USD 110–275 billion (€79–198 billion) per year for developing countries.<sup>9</sup> Given their historical responsibility, accumulated climate debt<sup>10</sup> and the principle of common but differentiated responsibility, developed countries will have to shoulder most of the cost.

Rich countries have pledged to make available USD 100 billion (€72 billion) per year by 2020, most of which will presumably be channelled through the Green Climate Fund (see Box on next page).<sup>11</sup> Although originally this money was expected to come from public sources, developed countries have begun to rely on mobilising large amounts of private money by auctioning emissions rights as well as leveraging money through financial intermediaries, among other options.

As the discussion about mobilising private resources is mainstreamed, financial intermediaries (FIs) are placing themselves at the forefront of the debate. Broadly defined, a financial intermediary is an institution that connects economic agents who want to lend money with those who want to borrow it. Among other institutions, they include banks, credit unions, insurance companies, stock exchanges, private equity funds and investment and pension funds. Although technically speaking, development finance institutions (DFIs), export credit agencies (ECAs) and other sources of public finance could be considered as intermediaries, in this report we consider them as the sources of public funds –often referred as public investors- that are used to leverage additional finance by supporting financial intermediaries.

Financial intermediaries are receiving so much attention because of their perceived ability to use public money to overcome the barriers to private investment in developing countries. The idea is that public money can be



Some of the main limitations of financial intermediaries concern the type of private actors financial intermediaries can target, as well as the weakness of existing tracking, reporting and monitoring mechanisms.<sup>14</sup>

used, for instance, to provide a line of credit to financial intermediaries in developing countries or to guarantee private investments. These actions will lower private investment risks, hence encouraging or leveraging additional private investments.

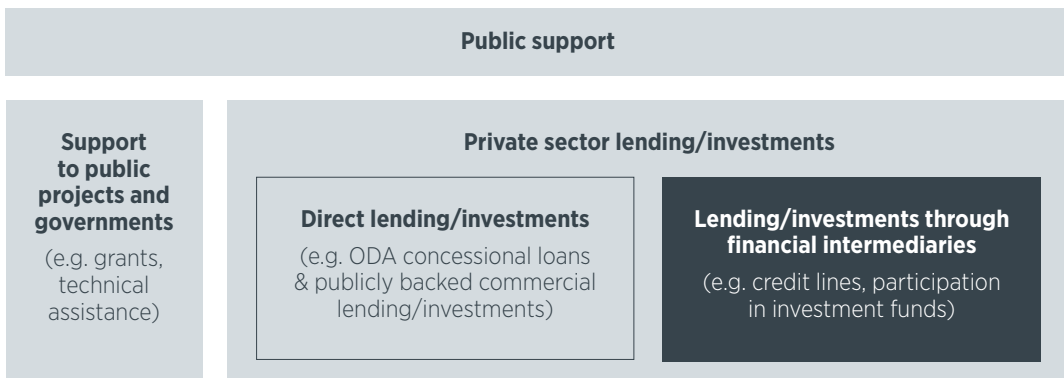
Estimates suggest that it may be possible to raise substantial amounts of private climate finance this way. The High-Level Advisory Group on

Climate Change Financing calculates that using financial intermediaries, USD 35–60 billion (€25–43 billion) per year of public money together with USD 30–50 billion (€22–35 billion) per year from carbon offset flows could leverage in the range of USD 100–200 (€72–144 billion) billion per year of private flows from developed to developing countries.<sup>12</sup>

However, it is not clear that financial intermediaries can indeed raise such an amount of money. More importantly, it is not clear that financial intermediaries are the best option to address the climate needs of developing countries. Some of the main limitations of financial intermediaries concern the type of private actors financial intermediaries can target, as well as the weakness of existing tracking, reporting and monitoring mechanisms. For instance, financial intermediaries have been criticised for using tax havens that render their investments opaque and obstruct accountability to beneficiaries, other stakeholders and also taxpayers whose money is backing FI investments.

**Figure 1: A diagram showing ways in which public funds are distributed.**

The channel that this report focuses on is shown in dark grey.



## The Green Climate Fund and other relevant climate finance initiatives

### Green Climate Fund

This instrument was created in the 2010 Copenhagen Accord where it was decided “that the Copenhagen Green Climate Fund shall be established as an operating entity of the financial mechanism of the Convention to support projects, programme, policies and other activities in developing countries related to mitigation including REDD-plus, adaptation, capacity-building, technology development and transfer.” The governing instrument of the fund was formally approved in Durban in 2011 and the Fund is in the process of being formally constituted. The objective is to raise USD 100 billion (€72 billion) per year by 2020.

### World Bank Climate Investment Funds

The Climate Investment Funds (CIF), including the Clean Technology Fund (CTF) and the Strategic Climate Fund (SCF) were approved by the Board of

Directors of the World Bank in 2008. G8 members have thus far pledged approximately USD 5.7 billion (€4.1 billion) to the funds.

The aim of the Clean Technology Fund is to promote low-carbon economies by helping to finance the deployment of commercially available cleaner energy technologies in developing countries. The Strategic Climate Fund will help more vulnerable countries develop climate-resilient economies and take actions to prevent deforestation.

It should be noted that these funds operate mainly with loans, not grants.

### The Global Environmental Facility

Since 1991, the Global Environment Facility (GEF) has been a major climate fund that has provided over USD 7.4 billion (€5.3 billion) in grants. GEF funds receive contributions from donor countries. In 2006, 32 donor countries pledged USD 3.1 billion

(€2.2 billion) to fund operations between 2006 and 2010.

The GEF also manages two special funds under the UNFCCC (United Nations Framework Convention on Climate Change) -the Least Developed Countries Fund and the Special Climate Change Fund (SCCF).

### The Adaptation Fund

The Adaptation Fund was established by the Parties to the Kyoto Protocol of the UN Framework Convention on Climate Change to finance concrete adaptation projects and programmes in developing countries that are Parties to the Kyoto Protocol.

The Fund will be financed with 2% of the Certified Emission Reduction (CER) issued for projects of the Clean Development Mechanism (CDM) and with funds from other sources.

Adapted from ClimateFund.info

Climate finance is vital for helping developing countries mitigate their climate impacts and allowing them to adopt greener development paths, and also to help them adapt to the impacts of climate change. The main focus of the report, however, is finance for adaptation purposes. The poorest countries and the poorest people across developing countries contribute very little to global emissions, yet are likely to be among the most severely affected. As a consequence, it is finance for adaptation purposes that is likely to be most relevant for them.

This report looks at some of the main instruments that can be used to leverage private climate finance through financial intermediaries and analyses data from some major development finance institutions (DFIs). It specifically assesses the role of financial intermediaries in

low-income countries (LICs) and in supporting small and medium enterprises (SMEs) and looks into the main monitoring and accountability constraints when using financial intermediaries. When relevant, different types of finance have been explored independently.

The report starts by introducing the different types of instruments for leveraging private climate finance through financial intermediaries using public money as well as some of their key features. It focuses on three main types of instruments: equity (e.g. private equity funds), debt (e.g. credit lines) and risk-related finance (e.g. guarantees). Part 2 discusses the main weaknesses when leveraging private climate finance through financial intermediaries. Finally, Part 3 presents the main conclusions of the research and puts forward some recommendations for policymakers.



Due to climate change, countries in Sub-Saharan Africa could experience catastrophic declines in crop yields of 20–30 % by 2080, rising as high as 50 % in Sudan and Senegal, according to Oxfam.<sup>14</sup>



The World Health Organisation has estimated that the moderate global warming (approximately 0.6° C) experienced since 1970 was causing an additional 140,000 deaths a year by 2004.<sup>13</sup>

# Part 1:

# Leveraging private climate finance: the complex network of financial intermediaries

The prominence of financial intermediaries in climate finance is due to their perceived capacity to use public money to lower investment barriers for the private sector and facilitate access to finance. Before moving into a more detailed analysis of the different instruments that can be used to achieve this, it is important to examine why this is possible.

There are two key factors that determine investment decisions: profit potential and the level of risk. Risk is a complex concept that encompasses all those elements that are difficult to control and could prevent the success of the investment

by incurring losses or lower revenues. Some of the main types of risks include: political risks (e.g. unstable governments, policy and regulatory changes), currency risks (e.g. fluctuations in currency values) and technology risks (e.g. untried technologies and solutions).

For an investment to happen, the profit potential usually has to compensate the risk. An informed investor is only likely to engage in a high-risk investment (e.g. a green start-up company) if the profit potential is also high. Another investor, however, may prefer to invest in lower risk assets (e.g. equity

in a large company) even though the profits are likely to be slim. Risk also plays a crucial role in the availability of credit for private actors in developing countries.

Private sector investments are especially sensitive to these two factors in the sense that for a given risk level, private investors will usually require greater profit potential than a public one or, in other words, at a given profit potential the risk tolerance of private investors is lower. For instance, an insurance company is unlikely to roll-out a micro-insurance scheme for small farmers in a developing country as a consequence

of the high upfront costs of creating the necessary infrastructure and the fact that profits can only be expected in the medium/long-term. This behaviour is illustrated in Figure 2 and is motivated not only by different risk and profit appetite, but also by the ability of public investors to take into account positive social and environmental outcomes (externalities) that are difficult to measure in economic terms.

In order to leverage private climate finance, developed countries use development finance institutions (DFIs) and,<sup>15</sup> to a lesser extent, other institutions that are backed and/or funded by governments such as export credit agencies (ECAs). DFI's are extremely powerful investors. DFIs that are members of the European Development Finance Institutions (EDFI) group have an aggregated portfolio of €21.7 billion.<sup>16</sup> According to the datasets used in this research (see Methodology section), the International Finance Corporation (IFC) has a portfolio of over €9.4 billion in low income and lower-middle income countries and the European Investment Bank has investments of €36.8 billion outside the European Union (see Methodology section for further information).

2011 figures show that climate finance only represents a small part of these investments, €461 million in the case of the IFC and €3.3bn in the case of the European Investment Bank (EIB). Nonetheless, climate finance is growing at a fast pace: 70% of the combined climate related projects of the IFC and the EIB we looked at have been approved since 2009.

This section starts by looking at the main investment instrument donors use to engage with FIs. In this report, the term 'public investor' will be used to refer to any institution providing finance for the private sector that is supported by a government (mainly DFIs, but also ECAs). For greater clarity the different instruments have been divided into three main groups: equity, debt and risk-related finance.

**Figure 2: Stylistic comparison of positive investment decisions**





No examples have been found of direct equity investments with a clear climate remit being channelled through financial intermediaries.

## Equity

Equity investments are all those investments that involve the ownership of shares in a company. There are two main types of equity investment instruments available to DFIs- direct equity investments and investment funds. The first option entails making a direct equity investment in the financial intermediary, for instance a local bank. Sometimes this investment is made by two or more DFIs at the same time and it may be open to private capital. In its most simple form, a direct equity investment provides additional capital that the financial intermediary can use to expand operations. In some instances, the direct equity investment grants the public investor access to the intermediary's management, where it can work to make the company grow usually with a view to selling its stake at a profit at a later stage.

Private finance can be leveraged at two different stages. When the investment is open to other investors, private capital may flow in as a result of lower risks, greater profitability and the confidence induced by the DFI's investments. When the public investor engages in the management of the company, private capital may also be leveraged at a later stage as a result of the company's greater value.

Direct equity investments are not very common in the portfolios of large DFIs in developing countries. For instance, they represent less than 1% of the EIB's portfolio assessed by Eurodad. No examples have been found of direct equity investments with a clear climate remit being channelled through financial intermediaries.

The second instrument DFIs can use is the investment fund, a collective investment instrument which acts as a financial intermediary and makes

direct equity investments in other companies or banks. Investment funds make investment choices according to specific criteria or following a strategy and are a very common investment instrument because they diversify risk and share it among a larger number of shareholders. When DFIs use investment funds to channel climate finance, they can either set up their own funds or participate in existing ones.

Investment funds represent approximately 20% of the IFC's portfolio in low and lower-middle income countries. In the case of Norfund, Norway's DFI, the figure reaches 26% of the total portfolio. In contrast, the EIB only uses investment funds for around 13% of its total investments outside Europe, but the EIB reporting is not very clear and the figure could be higher. Among investment funds, private equity funds seem to be

the preferred type of instrument. Private equity funds usually purchase equity of the company and engage in its management with views to increasing its value. In the case of the IFC, private equity funds account for €1.3 billion of the examined portfolio (13%). The EIB channels through private equity funds approximately 6% of its portfolio outside the EU (€2.1 billion).

In general, funds leverage money in the same way as direct equity investments: by attracting private capital when the fund is created and, in the case of private equity funds, by increasing the value of the companies that the funds invest in. In addition, when the fund is open to private investors, the public investor can take a subordinated equity stake in order to incentivise private investment. In practice, this means that private investors will be repaid first. This model is generally used for riskier projects.

DFIs also have other equity instruments such as mezzanine loans and quasi-equity investments. These are complex instruments between equity and debt, which require advanced financial markets and are best suited to large companies and financial intermediaries. This report does not examine these instruments because of their complexity and because many of their key features are shared by some of the instruments examined in these pages.

**Table 1. Equity instruments - Key features**

Equity instrument	Regulatory and financial framework	Investors/Investees	Monitoring mechanisms
Direct equity	Do not require highly developed financial markets, but do require a relatively stable and clear legal framework for investors to buy equity and be able to get involved in the companies' management.	Seeking high economic returns on their investments, often up to 50%-60% in developing countries. <sup>17</sup> Equity investors are biased towards larger companies or start-up green or technological companies with significant innovation and growth potential in developing countries.	Direct monitoring based on DFI guidelines. However, direct equity investments are governed by private law and very little information is usually made available, on the grounds that it is commercially sensitive.
Investment funds			Usually through self-reporting by FIs. It is often impossible to know the exact portfolio of a given fund and whether corporate, environmental and social standards are being implemented.





Credits lines represent 25% of the EIB's portfolio (€9.2 billion). Of these credit lines only twelve projects with an aggregated value of €560 million are related to climate.



Out of a total of 189 loans analysed in their portfolio, only 2 were for an amount under USD 1 million (€0.72 million).

**Debt**

The debt instrument DFIs use to provide finance through financial intermediaries is the credit line. It is basically a loan extended to financial intermediaries with the purpose of providing finance to sub-projects, thereby facilitating access to capital. DFIs use credit lines because they do not usually have a strong presence in developing countries and without branches it is difficult to reach SMEs and companies in specific regions. In addition, there are important language, currency and economic barriers that make direct loans from DFIs only suitable for financing large companies. For instance, the average size of a loan operation for the IFC is USD 21.7 million (€15.6 million) Out of a total of 189 loans analysed in their portfolio, only 2 were for an amount under USD 1 million (€0.72 million).

Credits lines represent 25% of the EIB's portfolio (€9.2 billion). Of these credit lines only twelve projects with an aggregated value of €560 million are related to climate. Figures for other DFIs are difficult to estimate because information is not adequately disaggregated. Despite this, examples such as the Global Climate Partnership Fund (GCPF), set up in December 2009 and managed by KfW (grant component €22.5 million) indicate that it is likely to see growth in this area.<sup>19</sup>

### Credit lines have important limitations

The use of credit lines by the World Bank has decreased steadily from the 1980s. An evaluation conducted by the World Bank helps to explain why this has happened and identifies some of the main problems with this instrument. The evaluation found that only 52 % of the loans were satisfactory, representing 45 % of the net commitments, and concluded that the “outcome ratings are unacceptably low.” Credit lines were most successful in the rural sector (62% of loans were satisfactory) and particularly ineffective when it comes to private sector development (10%). Better results were achieved in countries with stable and developed financial sectors.

In general, smaller loans also achieved better results.

Monitoring was also raised as one of the main areas of concern. The evaluation found that the world Bank used credit lines “with little concern for the soundness or viability of the financial intermediaries” and that “information is available in only a minority of LOC [lines of credit] on the quality of the PFIs, on monitoring their overall performance throughout the disbursement of the LOC, and on reporting these findings.”

Based on an evaluation conducted by the World Bank's Independent Evaluation Group<sup>20</sup>

**Table 2. Debt instruments - Key features**

Debt instrument	Regulatory and financial framework	Investors/Investees	Monitoring mechanisms
Credit lines	In general better results are associated with stable macroeconomic conditions and stronger financial sectors, including satisfactory competition policies and good legal and regulatory regimes. <sup>18</sup>	It is possible, by targeting microfinance institutions, for instance, to incentivise lending to SMEs and smallholders. In this case, technical assistance may be needed as the financial intermediaries in developing countries do not always have the capacity to target private actors effectively.	Financial intermediaries are eligible only if they fulfil a number of criteria stipulated by public investors, including the obligations to monitor and report on their projects. However, little information is usually available about the final use of the credit lines.

## Risk-related finance

Risk is a decisive factor when it comes to investment decisions. Using tools that address the risk exposure of investors can therefore be an effective way of triggering additional investments and leveraging money. It is possible to identify three main types of risk-related instruments.

When the intermediary is a financial institution that acts as a lender, for instance a bank, we generally talk of loan guarantees. A loan guarantee is a commitment by a public institution to repay the loan provided by the financial intermediary -the lender- to a third party -the borrower- if the latter cannot meet the payments. Effectively, this instrument transfers risks from the private lender to the loan guarantor. It is commonly used to encourage loans that a private lender would not usually provide due to their risk profile. DFIs do not use loan guarantees to support financial intermediaries very often. This instrument only represents 2% of the joint portfolio of EDFI (€380 million). The figure is 1% in the case of the IFC (€70 million) and under 1% for the EIB (€80 million).<sup>21</sup>

A second option is export credit guarantees. They are intended to support foreign investment by underwriting loans for projects, mainly large ones, conducted in foreign countries by providing insurance against non-payment (default). Guarantees are mainly provided by export credit agencies in donor countries whose remit is to help donor economies by promoting the investments of domestic companies in other countries. Financial intermediaries can be targeted directly or be used to target SMEs that are not large enough to directly apply to the export credit agency. According to the Berne Union, USD 1.36 trillion (€0.98 trillion) in export credit guarantees were issued in 2010.<sup>22</sup> The amount going through financial intermediaries is not very clear and only some ECAs disclose a breakdown of their operations by sector, but the information available suggest that the figure could be somewhere in the range of 10%-20%. For instance, the financial sector represents 43% of the portfolio the World Bank's Multilateral Investment Guarantee Agency (MIGA) and 89% of the guarantees approved in 2011.<sup>23</sup> Figures are lower in the case of bilateral ECAs. The

financial sector accounted for 13% of Korea's Eximbank total invested amount in 2010 and 18% of CDC's portfolio exposure in 2010.<sup>24</sup>

A third option public investors can use to reduce risk are public insurance schemes that work as financial intermediaries. Most relevant initiatives focus on sectors that are particularly vulnerable to climate change such as agriculture and are based on the parametric insurance model. Parametric insurance offers a payout, which is determined upfront and is conditional on an exogenous variable reaching a pre-set threshold, for instance rain not reaching the yearly average. In some cases, such as the IFC's Global Index Insurance Facility (GIIF), the insurance can be

linked to loans, for instance for high-yield seeds. In this case the insurance also reduces the risks for the lender and increases the farmer's access to loans. Parametric insurance simplifies risk evaluation and administrative costs, making it easier to deploy in developing countries and, in cases such as the GIIF, can also help to leverage additional finance.

Parametric insurance is relatively new. Pilot projects only started in the early 2000s. In the last few years they have expanded, but total funding remains low. The GIIF, for instance, has a total funding of just under €27 million.<sup>25</sup> In total, there are about 20 parametric insurance programmes of this type in developing countries.<sup>26</sup>

**Other types of parametric insurance**

Some types of parametric insurance can be applied at national level to protect countries against natural disasters (e.g. the Caribbean Catastrophe Risk Insurance Facility). However, since this type of insurance aims to protect countries against specific risks rather than to incentivise private sector investments, it will not be explored in this report.

**Table 3. Risk instruments - Key features**

Risk instrument	Regulatory and financial framework	Investors/Investees	Monitoring mechanisms
Loan guarantees	Relatively developed and mature regulatory and financial frameworks are required.	Can be applied to different types of financial intermediaries, from large banks to small microfinance institutions. However, capacity constraints can limit its deployment, especially among microfinance institutions.	Self-monitoring. In order to incentivise better monitoring, public investors usually limit the amount of the guarantee, so that FIs share part of the risk.
Export credit guarantees	Usually applies to large investments in countries with strong policy and regulatory frameworks. <sup>27</sup>	Mainly targeted at private companies wanting to invest in developing countries. The aim is to promote exports and help national companies rather than climate adaptation and mitigation.	Issuers of these guarantees usually assess projects on the basis of social and environmental standards. Unfortunately, most agencies rely on self-monitoring and self-reporting, while only a handful of them conduct some sort of on-site monitoring (EFIC, OPIC and MIGA).
Parametric insurance	The use of an indicator to trigger payments simplifies and reduces administrative needs, making it possible to deploy this type of insurance in rural areas and low income countries.	Parametric insurance has the potential to reach farmers and other small holders in developing countries. Nonetheless, it has faced some problems in LDCs and farmers still need to be able to afford the payment.	Parametric insurance has proven relatively easier to monitor than traditional insurance. It also reduces the costs of dealing with individual and fraudulent claims, valuing goods and other insured property, etc. In addition, since payment is not related to damage, the insured have an incentive to prevent, thereby reducing moral hazard.

# Can financial intermediaries deliver effective climate finance?

The urgent need of additional climate funding was recognised in the UNFCCC process through the associated Copenhagen Accord in 2009<sup>29</sup> - in which rich countries pledged to mobilise USD 100 billion (€72 billion) a year by 2020 and USD 30 billion (€21.6 billion) in fast start finance for 2010-2012 - a decision which was brought under the formal process through the Cancun Agreements in 2010. Furthermore, it was agreed that a Green Climate Fund would be set up, however, it is yet to reach the stage where it can distribute funds. Moreover, donors are not meeting their commitments: according to the World Resources Institute (WRI) preliminary analysis of the Fast Start pledges, only USD 16.2 billion (€11.6 billion) of the 30 billion (€21.6 billion) promised has been accounted for, and it is not clear how much of this money has been or will be delivered.<sup>28</sup>

Under the UNFCCC, countries have committed to providing “scaled up, new and additional, predictable and adequate funding,” “from a wide variety of sources, public and private, bilateral and multilateral, including alternative sources.”<sup>30</sup> However, a number of rich countries simply added these pledges to existing climate commitments. For instance, the UK’s fast start pledge of USD 2.4 billion (€1.7 billion) includes its previous commitments to Climate Investment Funds of USD 1.4 billion (€1 billion).<sup>31</sup> Moreover, rich country donors tend to include climate figures in their Official Development Assistance (ODA) commitments.<sup>32</sup>

Faced with bleak prospects and the urgent need of more finance to avoid disastrous consequences in developing countries, DFIs are looking at the possibility of using public money to leverage private climate investments as an alternative source of funding. Despite their theoretical potential to leverage private climate money and their ability to access markets, which may otherwise be difficult to reach by DFIs, it is yet not very clear how financial intermediaries can contribute to advancing the global fight against climate change. There are several concerns regarding

the suitability of different financing instruments to channel climate funds. This section addresses these concerns and assesses whether financial intermediaries are up to the climate challenge.



## Leverage potential - too good to be true?

The IFC estimates that “within two decades the cost of addressing global warming in developing countries could reach USD 275 billion (€198 billion) per year, an investment that will not be possible without the private sector, which is expected to pay for more than 80 %.”<sup>33</sup> Indeed the UN’s High Level Advisory Group (AGF) estimates that by 2020 it should be possible to raise between USD 100 billion (€72 billion) and USD 200 billion (€144 billion) per year according to what they called a conservative leverage ratio of 1:3.<sup>35</sup> This estimate was obtained from papers suggesting significantly

The use of credit lines to support the work of national institutions and development banks seem a much more reasonable strategy for long-term engagement, than the use of direct investment instruments.

**Table 4. Leverage ratios suggested in existing literature<sup>34</sup>**

Instrument	Claimed Leverage ratio	Comments
<b>Equity</b>		
direct equity	1:10	Important differences from one investment to another
investment funds/private equity	1:10	
subordinated equity	1:2	Usually linked with higher risk investments
<b>Debt</b>		
credit lines	Low, under 1:1?	Difficult to estimate, figures for some European Bank for Reconstruction and Development (EBRD) investments range from 1:0.1 to 1:1.5
<b>Risk related</b>		
guarantees	1:6-1:10	
policy insurance	1:10 or more	
parametric insurance	N/A	Figures not available, likely to be low



If developed countries seek to maximise their investment instead of their impact and significance, they may be tempted to focus on investments which are neither additional nor the best option to address developing countries' adaptation needs.

higher ratios for some investment instruments (see table 4 for some of the most commonly used ratios). However, a more detailed analysis of these figures reveals important inconsistencies and questions whether such ratios can actually be achieved.

The first concern is that "there is not one singular definition of financial leverage and thus it is almost impossible to compare different instruments to understand their effectiveness as evidenced by their ability to leverage public and private finance."<sup>36</sup> Problems related to the lack of a clear methodology also include double-counting in the sense that two separate DFIs often claim to have raised each other's money.<sup>37</sup> DFIs also tend to count or estimate the leverage ratios of projects that aim to create a behavioural change (e.g. demonstration and pilot projects on new technologies), but their impact is very difficult to quantify. Moreover, the aim of these so called catalytic projects is not to leverage money.

Leverage ratios have also been contested in some case studies. For instance, a paper found that the USD 100 million (€72 million) invested by the World Bank's Clean Technology Fund in Turkey did not leverage significant amounts of private finance despite initial documents suggesting a leverage ratio of more than 1:10.<sup>38</sup> The figure is even more

relevant given that Turkey has all the necessary ingredients to make equity investments successful (e.g. strong financial institutions and regulatory framework, political stability, etc.) Another project based on credit lines implemented in Sri Lanka also failed to meet leverage expectations. The expected figure is not mentioned, but the case study acknowledges that at 1:0.53, the final leverage ratio was less than half the predicted level.<sup>39</sup>

Leverage ratios are also misleading because high ratios indicate that investments are more attractive to the private sector and more likely to happen without public support. The reason for this is that leverage potential is just a measure of how attractive the investment is for the private sector which, as we have seen, is motivated by the balance between risk and profit potential.

In relation to this, instruments with high leverage ratios are not necessarily better suited to meet the needs of developing countries. Investments are likely to work better when they are in line with government policies and spent on national priorities. In addition, governments are in a better position to take into account broader issues such as the global public goods, which private actors often cannot internalise. In this context, the use of credit lines to support the work of national institutions and development banks seem a much more reasonable



Middle and high-income countries are still more likely to access climate funds. The concern is that the use of financial intermediaries is likely to make things worse.

strategy for long-term engagement, than the use of direct investment instruments. However, as shown on table 4, this type of finance has much lower leverage ratios than other investment instruments.

The AGF did not provide detailed information about the basket of investments it used to work out its 'conservative' estimate of 1:3 and it is not possible to conduct a more detailed analysis. Nonetheless, previous paragraphs make clear that the figure can be questioned not only in terms of its reliability –whether it is possible to achieve such a figure on average– but also on grounds of significance –whether a high leverage ratio means anything at all in terms of climate effectiveness.

Unfortunately, it looks like the main concern of developed countries is to raise and report as much money as possible, including using instruments created to promote developed countries' companies, such as export credits. However, this does not stop the OECD from claiming that export credits in the form of guarantees or loans are an "important opportunity to stimulate private investment in developing countries in low-carbon development" and calling on members to improve their reporting.<sup>40</sup> The problem is that if developed countries seek to maximise their investment instead of their impact and significance, they may be tempted to focus

on investments which are neither additional nor the best option to address developing countries' adaptation needs.

### Can financial intermediaries address the needs of LICs and SMEs?

#### Financial intermediaries in LICs

Climate change is having dire consequences on the world's poorest communities. According to Oxfam, countries in Sub-Saharan Africa could experience catastrophic declines in crop yields of 20-30 % by 2080 due to climate change. The figures could reach 50 % in countries such as Sudan and Senegal.<sup>41</sup> It is a tragic paradox that those who barely contributed to climate change have to bear its brunt. Under the principle of common but differentiated responsibility set out by the UNFCCC in 1992,<sup>42</sup> as well as the wider historical responsibility of developed countries and the accumulated climate debt, developed countries agreed to shoulder most of the costs associated with climate change. It is only fair that those with the fewest resources to cope with climate change, such as low-income countries, should be prioritised.

Despite the fact that several countries are channelling their climate money

**Table 5. DFI investments for selected years in € million\***

	IFC		EIB		Norfund		FMO		Bio	
	€m	%	€m	%	€m	%	€m	%	€m	%
<b>Total</b>	9360.2	100.0%	36827.2	100.0%	750.5	100.0%	4820.3	100.0%	317.6	100.0%
SMEs	1038.9	11.1%	12630.7	34.3%	187.9	25.0%	1640.4	34.1%	165.2	52.0%
Climate	460.8	4.9%	3256.3	8.8%						
Climate and SMEs	22.6	0.2%	0.0	0.0%						
<b>Total LICs</b>	780.3	8.3%	1396.5	3.8%	183.4	24.4%	587.5	12.2%	30.1	9.5%
Climate	0.0	0.0%	127.3	0.3%						
SMEs	225.7	2.4%	129.5	0.4%	39.2	5.2%	141.8	2.9%	13.2	4.2%
and SMEs	0.0	0.0%	0.0	0.0						
<b>Total FIs</b>	3417.5	36.5%	12247.5	33.3%	339.4	45.2%	2941.5	61.0%	267.6	84.3%
LICs	276.1	2.9%	162.0	0.4%	102.1	13.6%	240.6	5.0%	13.3	4.2%
SMEs and LICs	225.7	2.4%	129.5	0.4%	39.2	5.2%	141.8	2.9%	6.9	2.2%
Climate	291.2	3.1%	2627.0	7.1%						

\*See methodology note on page 21 for further information on these figures. Regional investments have not been taken into account when looking and distribution by income group as they cannot be allocated.

“ Of all examined projects, investments in LICs vary from 24% in the case of Norfund, to 3.8% in the case of the EIB.

“ Climate investments account for 4.9% of IFC and 8.8% of EIB assessed portfolios, but almost no money reaches low-income countries.

#### Additional concerns about development finance to the private sector

Providing public funds to private companies and financial institutions raises a number of fundamental questions that go beyond the remit of this report, and which concern both support by public institutions to private investments in developing countries and the expansion of financial markets in these countries. These questions range from whether state aid should subsidise profit-seeking activities, to whether the improvement of financial and private capital markets contribute to the development of LICs. The question is not only whether this is the best development strategy, but also whether there is a positive and necessary correlation between the two issues (financial markets and development).

This report, however, has a much narrower remit, focusing on whether private funds can be leveraged to help the poorest countries in the fight against climate change.



If donors and other public investors go ahead with their plans to use public money to leverage additional funds, there is a clear risk that low-income countries will be by-passed unless significant efforts are made to fill this gap.

through specific instruments to target the poorest countries, such as the Least Developed Countries Fund, middle and high-income countries are still more likely to access climate funds. The concern is that the use of financial intermediaries is likely to make things worse.

Eurodad has examined the portfolio of six DFIs, five of which were detailed enough to study the distribution of projects (see the Methodology section for further details). The figures in Table 1 show that, of all examined projects, investments in LICs vary from 24% in the case of Norfund, to 3.8% in the case of the EIB. In the case of the IFC, where only projects in LICs and Lower-middle income countries (LMIC) have been examined, only 8.3% of the portfolio went to LICs. When only money channeled through financial intermediaries is taken into account the figures are much lower: ranging from 13.6% in the case of Norfund to 0.4 % in the case of the EIB.

When looking at climate finance in general, we found that climate investments account for 4.9% of IFC and 8.8% of EIB assessed portfolios, but that almost no money reaches low-income countries. With three projects (total value of €125m), the EIB is the only one of the two DFIs to have climate projects in LICs, although none of the projects use financial intermediaries. This figure may be slightly biased downwards given that regional instruments were not classified by income group, but in their portfolio there are few of these regional instruments that focus on climate finance. The amount of climate related regional instruments adds up to a total of €320 million. Only a fraction of them is likely to target LICs and therefore the argument remains valid.

These figures beg the question of

whether it is possible to leverage private climate finance through financial intermediaries in LICs. The problem with using financial intermediaries is that these actors often rely on the existence of well-developed financial markets and stable legal systems in recipient countries. These conditions are often missing in low-income countries. In addition, investment costs and risks are usually higher in these countries. When these circumstances are added to investments with lower profit potential, such as small-scale projects, it becomes difficult to incentivise international investments in these countries. A project promoting the use of solar home systems in Bangladesh illustrates this point. According to a United Nations Environment Programme, it was not possible to raise funds from the private sector because “technologies and investments with no or limited immediate commercial market prospects [...] retain a requirement for patient capital that is willing to accept low risk-adjusted returns, or even the possibility of no return.”<sup>43</sup>

If donors and other public investors go ahead with their plans to use public money to leverage additional funds, there is a clear risk that low-income countries will be by-passed unless significant efforts are made to fill this gap. It is important that public money is allocated to specifically tackle the challenges these countries and citizens face.

#### **Can financial intermediaries target SMEs and other vulnerable groups?**

Climate finance projects backed with public money should focus on the most vulnerable. In addition to low-income countries, this includes SMEs and smallholders in developing countries. Whilst among the most vulnerable, they also generate a great deal of capital and employment: “SMEs and informal enterprises



The amount of funds, however, is much lower when we look at support to SMEs in low-income countries. Figures drop across all DFIs and reach a minimum for the IFC and the EIB at 2.4% and 0.4% of the portfolio respectively.

account for over 60% of GDP and over 70% of total employment in low-income countries, while they contribute over 95% of total employment and about 70% of GDP in middle-income countries.”<sup>44</sup> The economic relevance of SMEs and the vulnerability of those working in the agriculture sector in particular make them a key target of adaptation efforts. Given that donors are counting on leveraging private finance to respond to most of their needs, it is important to assess whether financial intermediaries leverage effective support for these private sector actors.

Table 5 shows that in principle, DFIs do provide a substantial amount of support to SMEs. In the case of Bio, the smallest DFI, the figure reaches 52% of its portfolio. The EIB provides significant support to SMEs (34%) compared to 11% of the IFC portfolio examined, this may be due to the fact that the sample only includes investments in LMICs and LICs.

The amount of funds, however, is much lower when we look at support to SMEs in low-income countries. Figures drop across all DFIs and reach a minimum for the IFC and the EIB at 2.4% and 0.4% of the portfolio respectively. Most of the money for SMEs in LICs is channelled through financial intermediaries.

Data suggests that SMEs are not the target of climate related projects. Climate information is available for both the IFC and the EIB, but projects fulfilling both conditions have only been identified in the portfolio of the IFC. The total amount is €22.5 million or barely 0.2% of the total portfolio.

In order to assess these figures it is important to consider that there is no official definition of SMEs. For instance, the World Bank’s classification of SMEs

includes companies with up to 300 employees and total assets and sales of up to USD 15 million (€11 million). In some cases, such as that of the IFC it seems that the size of the investment can also be used to determine whether support to SMEs or not.<sup>45</sup> In our sample, most projects supporting SMEs were not direct investments, but larger contributions to financial institutions and funds and therefore we assume that the former definition was being used. According to the EU definition an SME has up to 250 employees (main criterion) or either having a turnover of up to €50 million or a balance sheet of up to €43 million.<sup>46</sup> It is clear that both classifications include companies that are very sizeable, especially in low-income countries.

In view of this, the relatively significant support by DFIs of SMEs needs to be qualified. In reality, figures hide a bias towards larger companies such as medium sized enterprises. The analysis of a sample of projects also suggests a tendency to support companies in the energy, transport and technology sectors. The relatively higher concentration of companies with such features in middle and, at least in the case of the EIB, high-income countries also explains the lack of support for SMEs in LICs. In reality very little money reaches companies that should actually be considered small by developing country standards-including smallholders. The fact that climate finance for SMEs is so low confirms this analysis and suggests that most climate projects currently focus on large-scale projects.

The analysis of DFI support to SMEs confirms the concerns raised in the previous section about the real potential of using public money to leverage private climate finance to address the needs of the poorest.

**Table 6. Investment instruments and their performance when targeting LICs and SMEs**

**Equity instruments**

Barely any flow into LICs, especially in the case of climate finance

Financial intermediaries often rely on stable legal systems and companies with significant growth potential, pre-conditions which are often absent in developing countries

Investments usually have an expiry date. For instance, in the case of the IFC, ten-year investments seem to be the norm. This explains the preference for larger companies and also raises doubts about the focus on long-term sustainable results.

**Debt instruments**

Credit lines can reach SMEs in low-income countries when provided to microfinance institutions. The approach has proven successful in many countries including some LICs

Microfinance institutions are concentrated in a few countries with developed financial systems,<sup>47</sup> suggesting such systems need to be in place for debt instruments to be deployed effectively in the short-term.

It is possible to develop the required infrastructure, legal framework and skills, but the process is slow and can take years.

**Risk related instruments**

**a) Loan guarantees**

Potential to lower collateral requirements for SME borrowers, which in developing countries usually exceeds 150%

Can target SMEs and other vulnerable groups in LICs when working with microfinance institutions

Face the same limitations as credit lines.

**b) Export credit guarantees**

The mandate of public export credit agencies and specialised insurance companies is to help the national economy by promoting national investments abroad

They have been severely criticised for the lack of sufficient environmental and social standards and increasing developing country debt.<sup>48</sup>

**c) Parametric insurance**

May be suitable for farmers and other small enterprises to help them cope with climate change

The use of indicators makes the risk evaluation easier and reduces administrative costs, making this instrument easier to deploy in rural areas and LICs

Not enough information to draw reliable conclusions. The amount of money channelled through parametric insurance is still relatively small (only about 20 pilot projects are running to date).



Figures hide a bias towards larger companies such as medium sized enterprises. The analysis of a sample of projects also suggests a tendency to support companies in the energy, transport and technology sectors.



In reality, very little money reaches what could be considered small companies for developing country standards – including smallholders.

## Tracking flows and monitoring their impact

### Tracking and coordination of private climate finance flows

Leveraging private climate finance through financial intermediaries will involve several different instruments and dozens of organisations and governments, not to mention the diversity of intermediaries. It is obvious we are looking at a very complex picture, which raises several concerns when it comes to coordination.

Firstly, there is the problem of how to count money that is leveraged. As seen in Part II, section 1, there is not a clear methodology to calculate leverage ratios, a view which is also supported in a report commissioned by the European Commission.<sup>49</sup> Then there is the reporting mechanism itself. Several options are being discussed, but no decisions have been taken to date.<sup>50</sup> The first step in the process would be to use a common set of guidelines. However, reporting on the Fast Start initiative shows that donors are still far apart (see Part II, introduction). As recognised by the OECD, the truth is that donors have yet “to define what flows are of relevance, how they will be accounted, and how data will be collected and reported. There is also the question of what kind of private-sector financial data can realistically be monitored and reported on, and how it will be obtained.”<sup>51</sup>

Once it is clear how much money is flowing where, it should be possible to start working on some type of coordination initiative. The Green Climate Fund could perform such a role to a certain extent, but it has yet to be deployed and funded. In any case, and even if it attracts a significant share of climate finance for developing countries, it will remain just one of many instruments.

The challenge is huge and the risk enormous. Aid, which is relatively simpler since the management usually remains in the hand of donors themselves, is a clear example of this. Aid fragmentation, as the phenomenon of having several donors working on in too many countries or sectors is known, increases transactions costs.<sup>52</sup> Moreover, it can result “in inability of government to impose order upon project portfolio or even obtain an overview of aid-funded investments and activities, lack of effective planning, geographical patchiness, etc.”<sup>53</sup> This problem is persistent despite the long-standing existence of clear reporting mechanisms to track aid flows and global initiatives such as the Aid Effectiveness Agenda.

If climate finance reaches the level that is expected, we will be looking

at an even more complex scenario involving even larger amounts of money. Unless donors start taking measures to address the problem of coordination, it is hard to see how private climate finance leveraged through FIs will be directed towards specific goals and objectives. The OECD has already warned that the lack of clear reporting mechanisms “renders a proper evaluation of the effectiveness and productivity of climate support programmes difficult and hinders countries from learning about effective ways of spending their money wisely.”<sup>54</sup>

### Monitoring of results and accountability

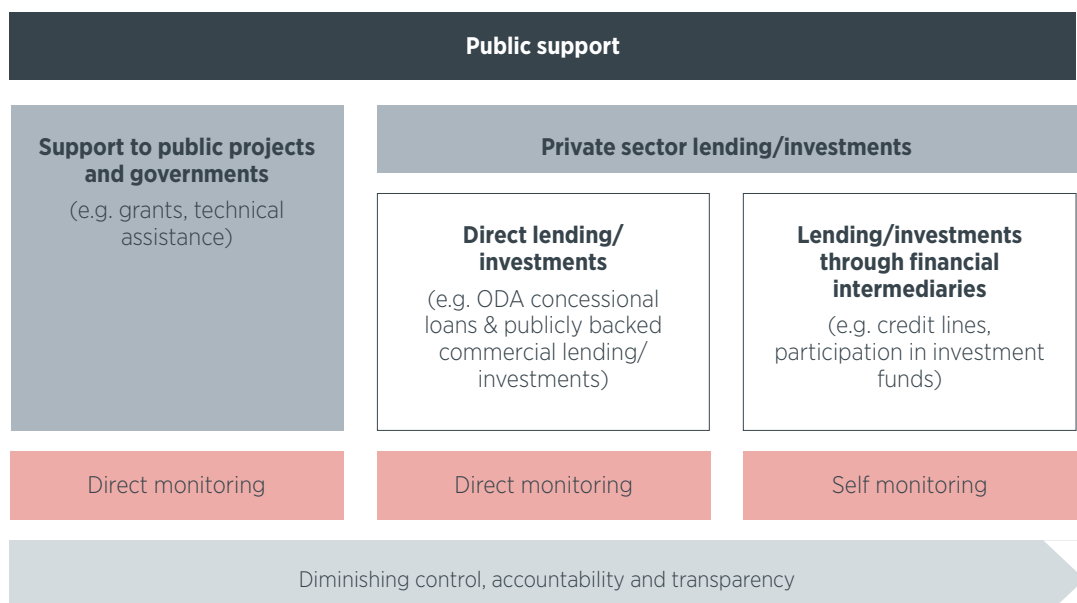
Monitoring the results of climate finance leveraged through FIs is crucial. It is necessary to ensure flows are obtaining the intended results. It is also important to ensure

accountability not only to the intended beneficiaries, but also to tax payers for the public funds being used to leverage those flows.

Monitoring is also important to ensure the financial additionality of funds. Some evaluations have shown that several investment projects supported or facilitated with public funds would have gone ahead with or without public support.<sup>55</sup> Monitoring is therefore necessary to ensure public money is used to leverage funds that make a real additional contribution to the fight against climate change, instead of increasing profitability or reducing the risk of private investments abroad.

Existing monitoring mechanisms are questionable. As discussed in part one, public investors usually have a number of requirements financial intermediaries have to

**Figure 3. Diagram showing main types of publicly supported climate flows and differences in monitoring and accountability**



“ Unless donors start taking measures to address the problem of coordination, it is hard to see how private climate finance leveraged through FIs will be directed towards specific goals and objectives.

“ The poor monitoring of climate finance leverage through FIs has important implications when it comes to holding public investors to account for both the use of taxpayers’ money and delivering results for citizens in developing countries.



meet before the project is approved, but which do not go further down the line. Investment decisions are therefore taken after an assessment of the financial intermediaries. Once approved, monitoring of the implementation of the project is usually based on self-reporting. Public investors have the right to monitor investments much closer, but this is very rare.

The only exception is perhaps the use of parametric insurance instruments. Monitoring their implementation and impact is relatively easy as they are at the core of insurance activity. It could be argued that direct equity investments are another exception. But those made in FIs with the idea of leveraging further private climate finance – the ones we deal with in this report – face the same restrictions that debt and private equity funds experience when it comes to assessing the impact. In addition, information on all types of equity investments tend to be limited for commercial reasons.

The poor monitoring of climate finance leverage through FIs has important implications when it comes to holding public investors to account for both the use of taxpayers' money and delivering results for citizens in developing countries. This is clearly demonstrated by the lack of information available to the public. The transparency of international institutions has improved significantly over the last ten years with the introduction of new information disclosure policies by organizations such as the World Bank that make disclosure the default option unless there are good reasons for not revealing information. However, some of the policies adopted by institutions dealing with the private sector are significantly weaker.<sup>56</sup> A recent Eurodad report looking at six of the major DFIs shows that, in the case of debt instruments, there is no information about the final beneficiaries, the amounts invested in them and the environmental, social and governance standards formulated by the intermediaries.<sup>57</sup> The same is true for equity investments, with the only exceptions being the IFC and Overseas Private Investment Corporation (OPIC), where information on the name of the final beneficiaries can be made available if the managers of equity funds give their consent.

In many cases, monitoring is further obstructed by the fact that many financial intermediaries are registered in tax havens. These jurisdictions “have practically no transparency and information obligations vis-à-vis

the market or regulatory authority in terms of the identity of its owners or debtors, changes in their share capital distribution, their accounts or their level of debt their strategies or their results.”<sup>58</sup> In addition, it is often difficult to access detailed information about corporate structures and the beneficial owners (people who are actually in control of the money). One may think that public investors are less inclined to use tax havens, but this is not true. An analysis of investment portfolio of CDC, the British DFI, showed that 48% of the subsidiaries it invested in are registered in tax havens.<sup>59</sup> Similarly, 29 out of the 35 funds used by Norfund, Norway's DFI, were based in tax havens.<sup>60</sup> The EIB and the IFC also rely on tax havens to a significant extent. Research has shown that the EIB uses several funds based in tax havens and that the IFC also channels funds for projects in Ghana, Nigeria, Uganda and Kenya through these jurisdictions.<sup>61</sup>

### The importance of policies to make climate finance effective

Before looking at financial intermediaries, public investors should make sure the right policies and institutions are in place to make sure climate finance is effective. Using financial intermediaries without the right policies in place will prevent developing countries from harvesting most of the benefits.

Financial intermediaries and the private sector do not work in a vacuum. An important body of research indicates that foreign direct investment alone cannot increase domestic investment or growth, and highlights that the policy, regulatory and institutional environment of the country where they operate has an important impact on their investments.<sup>62</sup> Private climate finance leveraged through financial intermediaries is not different. A paper coordinated by the World Bank looked at the mobilisation of climate finance and concluded that “the extent to which subsidized funds can be used to leverage other flows is likely to depend as much or more on the domestic policy environment as on the financial engineering of the deal.”<sup>63</sup>

All countries have strategies to coordinate and direct investments in areas such as education, infrastructures, environment and many more. Climate change, as a crosscutting issue, should not be an exception. Only by using the right policies can developing countries ensure that investments, especially when they are leveraged with public money, are aligned with and directed towards national priorities, in other words, owned by the country. Since 2008, LDCs have been able to submit to the UNFCCC national adaptation programmes of action (NAPAs). In Durban, it was agreed that they will be replaced by strengthened National Adaptation Plans (NAPs) and include

developing countries in general. The idea is that donors organise their support around developing countries' adaptation needs. A similar initiative exists for mitigation efforts: Nationally Appropriate Mitigation Action (NAMA). However, it is not very clear how these plans were or will be taken into account by DFIs, nor have we been able to find any guidelines asking financial intermediaries to answer to developing countries' climate needs.<sup>64</sup>

But it is not only a matter of alignment and ownership. As seen in Part II, the policy and institutional environment also play an important role when assessing risks. It is therefore possible to use policies to incentivise investments without having to mobilise important amounts of public funds. Discussing the whole range of options is beyond the scope of this paper, but they go from regulatory environmental policies – especially important when it comes to ensuring that the private sector internalises the cost of its activities – to policies that incentivise the desired behaviour through some form of reward, and can also include policies to increase access to credit or improve the business environment. The right set of policies could trigger investments by the private sector, for instance, to reduce pollution. This would shift the burden from taxpayers to the private sector itself and it is especially important in areas such as greenhouse gas emissions.

### Ensuring climate finance ownership-can it work with FIs? A case study in Bangladesh

Over the last five years, Bangladesh has taken important steps to identify its climate needs and make sure funding is coordinated and aligned with national priorities. It is difficult to see how the same model could work with private sector financial intermediaries.

In 2009, the Government of Bangladesh produced, in consultation with civil society groups, the Bangladesh Climate Change Strategy and Action Plan (BCCSAP). Funding for the Plan's implementation will come from two funds: the Bangladesh Climate Change Trust Fund (BCCTF), which uses resources from the national budget (USD 100 million or €72 million a year over the period of 2009-2012); and the USD 125 million (€90 million) Bangladesh Climate Change Resilient Fund (BCCRF - formerly known as the Multi Donor Trust Fund). An interesting feature of the BCCRF is that the governing and managing bodies are led by government officials, who hold the majority of the votes, and include representation from donors and civil society almost on an equal footing.

This is a considerable departure from previous models of piecemeal contributions by developed

countries to support separate stand-alone projects. Shifting decision-making to national institutions consolidates a country-driven approach to project identification, formulation and implementation. In addition to strengthening national ownership – although greater involvement from civil society and affected communities is still needed to achieve true democratic ownership – Bangladesh's approach has the potential to improve transparency and accountability by ensuring better project assessment and monitoring.

In contrast, when climate finance is channelled through FIs, decisions are adopted by the intermediaries' management. As discussed above, it is not very clear how decisions are made and money cannot be traced to the final beneficiaries. Examples have not been found of public investors' guidelines asking financial intermediaries to align investments with developing countries' strategies.

Source: S.M. Munjurul Hannan Khan, Saleemul Huq & Md Shamsuddoha (2011) The Bangladesh National Climate Funds: A brief history and description of the Bangladesh Climate Change Trust Fund and the Bangladesh Climate Change Resilience Fund. IED and ECBI.

# Conclusions and recommendations

This report has looked at some of the main instruments that can be used to leverage private climate finance through financial intermediaries. Important limitations have been found suggesting that although financial intermediaries may work under some circumstances, they offer only limited solutions to developing countries' climate needs.

Important gaps exist in the knowledge of how money is leveraged through financial intermediaries that should be filled before channelling any significant amounts of climate finance through FIs. Their leverage potential is not clear: the methodology used to estimate the figures is not sufficiently explained and the figures show important inconsistencies with the results of case studies. Donors are basing their estimations and climate finance forecasts on figures that cannot be trusted. In addition, mechanisms to report on climate private finance flows are yet to be developed. Without them it is impossible to coordinate flows at a country level, let alone across the developing world.

Donors also seem to be looking at financial intermediaries as isolated actors without paying attention to the policy and institutional environment in which they operate. As discussed above, very often the impact of private actors depends on the environment rather than the instrument of financial intermediary used to channel the funds. More importantly, policy improvements could trigger private investments in many areas without having to recourse to public funds. There are no reasons that support the idea that placing the lion's share of climate finance in the hands of private capital and financial markets, also known as the 'financialisation' of climate finance, should be the priority.

The very nature of financial intermediaries also contradicts some of the principles that should guide donors when facing their common but differentiated responsibilities. Monitoring is extremely difficult and there are no mechanisms to ensure private climate finance is aligned with developing countries' priorities. It is also difficult to target LICs - the most vulnerable countries to climate changes- and support SMEs beyond a very small group of technology or innovative firms. Some instruments such as parametric insurance have the potential to reach smallholders and other vulnerable groups, but they

still are in a pilot stage and funding is scarce.

These shortcomings underscore the importance of direct public finance. Leveraging money through financial intermediaries cannot be used as a substitute for directing sufficient public resources directly to the poorest. Given the gaps, a strong reliance on FIs and the private sector could spell disaster for many citizens in developing countries.

This does not mean that developed countries and international organisations should not work to ensure FIs are effective. The core message is that developed countries should consider financial intermediaries as a very specific tool among many others rather than as one-size-fits-all solution to climate change. These are our recommendations to them:

## Recommendations

- **Develop a coherent framework that is based on the primacy of the national strategies of developing countries.** This framework should consist of clear guidelines that align financial intermediaries' investments with the priorities stated by developing countries, including governments, civil society, local communities and other stakeholders. They should also respect key development effectiveness principles such as recipient country ownership and the use of country systems. In countries where this strategy does not exist, developed countries should support the development of national climate strategies led by the government with full participation of civil society, national parliament and local stakeholders. Respecting national strategies is especially important in the context of the financial sector because of its strategic macro-economic importance. Countries should be able to freely determine the balance between domestic resource mobilisation and foreign investments, based on national strategies developed in consultation with all national stakeholders.
- **Ensure financial intermediaries that receive public support are transparent and accountable to local stakeholders:**

### **Improve reporting so that money channelled through financial intermediaries can be better tracked and coordinated.**

Public investors should support FIs only if they can track where public climate funds are being invested. All project information from different investors should be harmonised and made available to the public and, in particular, to local stakeholders. There should be a presumption of the disclosure of information with a strictly limited regime of exceptions, as detailed in the global Transparency Charter for International Financial Institutions.<sup>65</sup>

### **Increase overall transparency as a means to improve monitoring and accountability to local stakeholders.**

Special efforts need to be made to ensure affected people can actually access information about projects that affect their lives, which includes, for example, translating key documents into local languages, and ensuring effective consultation processes, respecting the internationally agreed principle of free prior and informed consent.<sup>2</sup> All information, including social, environmental and governance standards, contracts, subcontracts, investment and partnership agreements, should be available to the public and, in particular, affected communities.

### **Implement effective systems to ensure adherence to international social, environmental and human rights standards.**

These systems must ensure that sub-projects are also covered and effective monitoring takes place, instead of relying on self-reporting.

**Observe high corporate social responsibility standards and do not engage in tax dodging practices.** Public investors should implement strict guidelines that ensure that the FIs they work with and the companies involved in the transactions observe high corporate social responsibility standards and do not engage in tax dodging practices. At a minimum, financial intermediaries and companies should disclose reliable annual information related to sales, employees, profits made and taxes paid in the country as well as information regarding the beneficial ownership of any legal structure directly or indirectly related to the company (as defined in Eurodad's Responsible Finance Charter).<sup>67</sup>

- **Actively work to identify best practices and instruments that can help to make climate funds more effective, particularly how to reach the most vulnerable countries and sectors:**

**Understand the limitations of financial intermediaries and investment instruments** by undertaking further research on their leverage potential and impact in developing countries. This paper has identified serious shortcomings in their potential to support the poorest countries, for example. The use of financial intermediaries should be looked at as one of the many potential options. Research efforts should be directed at identifying best practices and assessing the strengths and weaknesses of different kinds of financial intermediaries.

**Identify and create a public register of pro-poor FIs.** These should have a substantial local ownership and be equipped to implement a pro-development approach supporting local SMEs in each country.

**Make sure that public investors put in place the right instruments to target LICs and SMEs in sectors particularly vulnerable to climate change such as agriculture.** This is especially important when supporting adaptation activities as many of the existing instruments such as investment and private equity funds, credit lines and many risk-related instruments are inadequate to target these actors.

**Develop stricter and independent methods for assessing the additionality of climate projects.** All investments supported by public money should be accompanied by such an evaluation, indicating why public support is essential for the project's success, as well as the methodology used to reach this conclusion.

# Methodology

Table 5 and most of the discussion in this report is based on the analysis of the project portfolio of the IFC, EIB, Norfund, FMO and Bio. The portfolios include the following information:

All data has been compiled in a single file and classified on a project by project basis according to four independent categories: project related to climate change, support for SMEs, use of financial intermediaries and income level of the host country. In a first stage, raw data and project descriptions were studied. When doubts remained about the classification of the project, further information has been looked up online in order to make a decision. Regional projects have not been

classified by income, but all other categories still apply and they have been included in the calculations.

**Disclaimer:** Due to the exceptionally large number of projects and despite the extreme care in handling the data, the author cannot guarantee the complete accurateness of the figures in this report and they should be considered as indicative. In addition, some DFIs use different definitions and categories. As a consequence, the data presented in this report cannot be used to make a direct comparison between these institutions.

Other sources of data are quoted throughout the report.

DFI	Geographical coverage	Period
IFC	LMICs and LICs	2006-2011
EIB	All countries but Europe	2007-early 2012
Norfund	All countries	1998-2010
FMO	All countries	all active
Bio	All countries	2002-2011

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## **Eurodad**

The European Network on Debt and Development is a specialist network analysing and advocating on official development finance policies. It has 49 member groups in 19 countries. Its roles are to:

- research complex development finance policy issues
- synthesise and exchange NGO and official information and intelligence
- facilitate meetings and processes which improve concerted advocacy action by NGOs across Europe and in the South.

Eurodad pushes for policies that support pro-poor and democratically-defined sustainable development strategies. We support the empowerment of Southern people to chart their own path towards development and ending poverty. We seek appropriate development financing, a lasting and sustainable solution to the debt crisis and a stable international financial system conducive to development.

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