Innovative climate finance

Examples from the UNEP Bilateral Finance Institutions Climate Change Working Group

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Executive summary

In 2010-2011, the subject of 'Climate Finance' has become a key focus of government policy makers and the many non-government research institutes and organisations that advise them. Two key parallel streams of work have been on **policy** (e.g. what constitutes 'investment grade policy') and identifying and **tracking** international flows of funds and investments for what might be described as climate finance.

This report integrates some of these two streams of information, as it applies to Bilateral Finance Institutions (BFIs). But it also has a more practical and specific intent. For years already, BFIs such as AFD, EIB, JICA, KfW and NEFCO,[1] have been providing a major portion of climate finance flowing to developing countries in all regions, and for both mitigation and adaptation. The recently published tracking report by the Climate Policy Initiative **The Landscape of Climate Finance**, for example, identified that BFIs provided about 25% of climate finance in 2010. By contrast, multilateral development banks (MDBs) provided about 13% and private finance about 56%.

These figures may come as a surprise to many in the climate policy community who most often hear about efforts by multilateral banks and agencies to disburse public finance provided by donor governments. By contrast the efforts by BFIs and the private sector are less recognised. This is one of the reasons for efforts by UNEP on three integrated fronts in the finance area: the UNEP Sustainable Energy Finance (SEF) Alliance engaging the public sector (mostly governments); the UNEP-Finance Initiative engaging private sector finance institutions; and the UNEP BFI Climate Change Working Group (CCWG) engaging the BFIs – the subject of this report.

A key point is that BFIs have been active in such finance for many years, so have built up an important body of experience about what works well (and doesn't) and which innovations they have tried have been most successful. **The purpose of this report is to communicate this BFI experience**, in particular to policy makers who are developing international and domestic architectures for expanded levels of international climate finance. In the years while this is being done, it also will be crucial to continue and expand the practice of, and learnings from, finance flows and investment that can be made through these bilateral finance channels. It will be important for both the supplier and recipient sides to continue and **increase outcomes on the ground**, not just build administrative frameworks for this to happen in the future. Tangible investments in climate change mitigation and adaptation are needed that make a difference and provide an evidence base of success that can be replicated at scale. BFIs are, and will continue to be, key players in this success.

Like any development banks, and some commercial banks, BFIs can offer a mix of what might be described as 'classical' finance instruments for project and program investments – e.g. grants, concessional loans, equity and debt finance. BFIs also have experience with what can be described as **innovative finance instruments** and facilities. In some cases, these can be innovative mixes of classical instruments. In other cases they can provide instruments that are seen as innovative in their individual use, or in mixes of other innovative and/or classical instruments.

An important insight is that these existing practices of BFIs are serving to provide an early evidence base for some of the ways to help address the essential conundrum for achieving the needed 'trillions of dollars' scale of climate investment in the coming decade, in particular in zero and low carbon infrastructure. This conundrum centres around the **need for large amounts of low cost-of-capital finance** for such investments, which typically are for long-lived investments with high upfront capital requirements.

At the scale needed, this implies attracting **institutional investor** capital, mostly private sector (e.g. pension funds, insurance funds). These are the primary investors that have such amounts of capital. But, the major current deterrent to such investors is that the risks that could negatively impact the returns of such investments (e.g. policy risk, foreign exchange risk, technology application risk) are too high. The managers of this institutional capital have fiduciary duties to stay within specific risk bounds. Fundamentally therefore, getting past this conundrum is about addressing risk. Solutions can not only provide capital at scale, but also the low(er) cost of capital crucially needed.

Specific examples of innovative instruments described in this report include:

- **Blending facilities**, e.g. where BFIs provide 'zero cost' grant finance into a finance package involving

1 Agence Francaise de Developpement (AFD), European Investment Bank (EIB), Japan International Cooperation Agency (JICA), KfW Entwicklungsbank (Germany's development bank), Nordic Environment Finance Corporation (NEFCO) with UNEP constitute the **UNEP BFI Climate Change Working Group (CCWG)**

loans at more commercial rates provided by other finance groups – with the overall effect of helping to lower the total cost of capital down to a level sufficient to make the project or program financially viable;

- **Support for policy development**, where grants or loans are provided to help countries develop and implement policies that help establish a policy environment that will be attractive for needed private sector investment;
- **Green Credit Lines**, where finance is provided to local financial institutions to on-lend to 'green' projects and programs that otherwise would struggle to get finance;
- **Risk sharing instruments**, where a range of finance tools are available that help take on and share some of the risks that otherwise would prevent projects and programs to be 'bankable';
- **Support for carbon markets**, where, for example, BFIs have provided some unique assistance to support the access of project investments to the CDM or JI;
- **Financing forest protection and REDD**; and
- **Support for small and medium size projects and programs**

In addition to the big picture policy point about risk and the cost of capital, other criteria that are used to elaborate these examples of innovative instruments by BFIs are those that can also describe finance approaches that are **effective** (e.g. scale of finance and results, timeliness, leverage of co-finance, flexibility, scalability, replicability, localisation) and **efficient** (e.g. least or low economic cost, and low transaction costs). Notably, a point in the "Draft governing instrument for the Green Climate Fund" by the Transitional Committee in its 18 October 2011 report is that

> "**Monitoring** ..... The programmes and projects, as well as other activities, funded by the Fund, will be regularly monitored for impact, efficiency and effectiveness **(underlining added)** in line with rules and procedures established by the Board...."

The attention of the international climate finance community in 2011-12 is on the development of the institutional settings and working modalities of this **UNFCCC Green Climate Fund (GCF)**. The ability of BFIs to quickly package and target climate finance interventions suggests they should have an important and growing role in multilateral finance affairs, especially given the current situation where developing countries are expressing frustration at the pace of the delivery of finance for adaptation and mitigation.

With respect to the **GCF and the role of BFIs**, the examples of innovative instruments set out in the report suggest that:

- GCF fundings ideally should make the best use of and leverage the existing capacities of a wide range of national and international development finance institutions (DFIs). This suggests the GCF being designed on the principle of a fund providing complementary resources to those of existing financial actors, using blending approaches
- Grants or grant-elements could be allocated to a full range of eligible implementing agencies, i.e.
    - financial institutions: MDBs, and regional, bilateral and national development banks
    - specialized and/or technical assistance bodies: UN agencies, bilateral, national, NGOs
- The fund ideally should also provide complementary/additional resources for assistance mechanisms that help developing countries to elaborate high quality public policies that would be likely to attract private investments.
- Should the money from the GCF be available to blend loans from DFIs with grants and for project preparation work, this would allow BFIs to step up activity levels considerably. An important value added by BFIs to the GCF then would be in streamlining, harmonising, speeding up and simplifying paperwork.

Some **final key insights** about the experience and role of BFIs are that:

- Because on the funding 'provider side' BFIs are connected to countries' development and climate policy agencies, they will often have a bigger picture perspective than other financial institutions, but also can focus on outcomes they are mandated to achieve.

- BFIs have many years of experience in those subjects especially at the sector level – in energy, transport, industry, urban development, water supply and solid waste and waste water treatment and forests. The technical assistance packages that complement finance packages draw from, and add to, this deep body of knowledge.

- BFIs also have a deep knowledge of, and history with, local institutions, in particular with national development banks. The experience with **blending facilities** and **credit lines** increasingly seeks to reach through to local banks, local private sector capital and the promoters of projects and programs on the ground.

- BFIs have proven experience with both the financial instruments and policy-side support interventions needed to crowd in critical private investor groups using smart public sector side interventions that work to get the risk-reward ratio in the 'right' zone.

- BFIs provide a wide range and diversity of financial tools and technical assistance services, individually and collectively. In addition they are able to work with other international and domestic financial institutions, public and private, to craft finance packages that address the local needs and issues.

- Among international financial institutions, BFIs typically have easier and faster modalities for disbursements, and higher flexibility to decide and close on innovative financing solutions.

Mini glossary

– of finance terms used in the case examples in this report

Direct investment	Investments (normally equity finance) made directly in projects – as compared with via investment funds
Equity fund	A type of investment fund that invests in equity positions in companies, including project 'special purpose vehicles'
First-loss	A tranche of finance that, in the event of a default, takes the first loss before other tranches of finance (equity or debt). Where debt, sometimes called 'junior debt'.
Grant	Provision of funds without expectation of repayment
Investment fund	General term for a fund that pools investors' capital, is managed by a fund manager and invests in given types of opportunities to achieve returns for the investors
Loan- Market conditions	A form of debt finance, commonly provided by banks. Loan agreements typically include an interest rate and a repayment period (initial tenor)
Loan - Concessionary (or subsidized)	A loan with (very) favourable terms for interest rate and/or tenor compared with normal market condition loans
Local currency guarantee scheme	A form of guarantee (or insurance) that minimises the risk of foreign exchange fluctuations for investors in projects
Mezzanine fund	A type of investment fund that provides mezzanine debt to companies, including project 'special purpose vehicles' – mezzanine debt is a form of finance that in terms of its security position in the circumstance of a company wind-up, sits behind 'senior debt' (e.g. bank loans) but before equity providers
Project Finance	Financing structured around a project's own operating cash flows and assets, without requiring additional guarantees by the project sponsors.
Technical Assistance	Provision of technical services, and/or funds (usually grants) for technical services, e.g. feasibility studies for projects or capacity building of local actors, including local financial institutions
Blending mechanisms	Blend facilities add grant funds to a blend of debt instruments from a number of financial institutions to provide a package of finance with attractive terms to meet project finance needs
Climate change program loans	Loans to governments to support the development of policies and programs that support investments in given sectors (by the loan provider and other investors)
First loss guarantees	Provided in equity or debt funds
Green credit lines	Lines of credit (debt finance) provided to local banks for investing in projects that meet specified 'green' criteria
Risk sharing instruments	Instruments often involving public and private finance that have elements that share risks, so place the risks for individual investment groups within acceptable bounds

'Classical' instruments

'Innovative' instruments[a]

[a]Note that 'innovative finance' can also be a mix of these specific innovative instruments (that are discussed in this report) with 'classical' instruments – and also a new mix of classical instruments.

1

Introduction and background context

1.1 Objective – beyond just climate finance policy and tracking

In 2010 and 2011, the subject of 'climate finance' has become a key focus of government policy makers active in the UNFCCC process and the many non-government research institutes and organisations that advise them. Two parallel streams of major analytical work and initiatives have been on **policy** (e.g. what constitutes so-called 'investment grade policy') and identifying and **tracking** international flows of funds and investments for what might be described as climate finance.[2]

Section 1.2 below provides some data about the flows of climate finance provided by bilateral finance institutions (BFIs) and the private sector, among others. This data may come as a surprise to many in the climate policy community who most often hear about efforts by multilateral banks and agencies to disburse public finance provided by donor governments. By contrast, the much higher levels of finance by BFIs and the private sector are less known and recognised.

This is one of the reasons for the efforts by UNEP on three integrated fronts in the finance area, the UNEP Sustainable Energy Finance (SEF) Alliance engaging the public sector (mostly governments); the UNEP-Finance Initiative engaging private sector finance institutions; and the **UNEP BFI Climate Change Working Group** (CCWG) engaging the BFIs. This last group is the subject of this report, which covers finance provided by five BFIs:

While this report integrates some of these two streams of information on climate finance policy and tracking flows, as it applies to BFIs, it also has a more practical and specific intent. The main objectives of this report are to (1) provide a structured view of what constitutes innovative climate finance and (2) describe the key role that these BFIs are playing already to deliver it.

1.2 Background data on contribution by BFIs

BFIs provide a very substantial portion of the public sector finance currently flowing to developing countries to support investments in climate change mitigation and adaptation. It is noteworthy that the October 2011 Climate Policy Initiative report **The Landscape of Climate Finance**[3] drew out the point

> "**Bilateral institutions distribute a greater share of finance than multilateral agencies.** While there has been a lot of attention recently on the development of a global 'green fund' to catalyze international climate finance, the reality is that most of public climate finance is currently provided by bilateral institutions (those sponsored by one nation)[4] rather than multilateral institutions."

Data derived from this Climate Policy Initiative report is provided in Figure 1.