POLICY BRIEF

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Key messages

- Despite international fiscal austerity, public funding for and private sector investment in low-carbon and climate-resilient development is on the increase. But it still falls far short of the volumes required to limit a global temperature rise to below two degrees Celsius.
- Least developed countries, small island developing states and other vulnerable groups need to be heard in the design of the emerging international climate finance architecture, including the Green Climate Fund.
- Securing an effective Private Sector Facility of the Green Climate Fund will require private sector engagement from the outset.
- Climate change needs to be seen primarily as a 'crisis multiplier' – an economic concern that warrants the attention of national ministries of finance and planning.
- Local government plays an important part in the national response to climate change and this will require strengthened flows of funding to sub-national bodies.

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Climate Finance: Challenges and Responses

Introduction

Embarking on a climate compatible development pathway now has a price tag. The cost of tackling climate change in developing countries could reach some hundreds of billions of dollars annually over the coming decades.[i] Low-emission and climate-resilient development options often require upfront investments that can be costlier than conventional solutions.

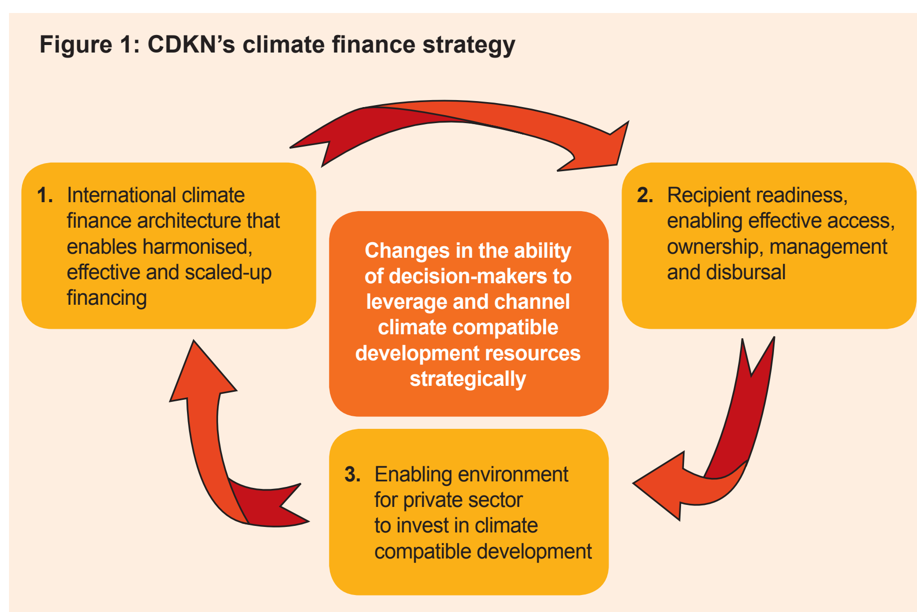
It will require tremendous efforts and ingenuity to mobilise resources at scale, coordinate their delivery through a combination of policy and finance instruments, and maximise their leverage on much larger amounts of public and private investments. At the same time, it is important that climate finance should be mobilised and delivered so as to complement – and not erode – development policy and finance, in order to sustain and further development gains in a changing climate.

The United Nations Framework Convention on Climate Change (UNFCCC) conferences in Copenhagen and Cancún in 2009 and 2010 resulted in an agreement to mobilise US$100 billion annually by 2020, but it is not entirely clear how this figure will be constituted. Does it mean dedicated funds mobilised by donors and in the carbon market, or public and private funds actually used for mitigation and adaptation action, or something else? There is a vibrant discussion on these issues in the international community and progress towards clarification is being made. Donors and Multilateral Development Banks are making efforts to improve tracking and reporting, and an increasing body of evidence of best practices is emerging.[ii]

Currently, a comprehensive global climate finance approach is missing. The Green Climate Fund (GCF) has been established, but will take some time to be operationalised. Developing countries face considerable challenges in planning climate change agendas and coordinating the proliferation of financing instruments and widening variety of national agencies with a climate finance mandate.

Developing countries require support in their efforts towards climate compatible development through the use of climate finance, both public and private, that enables equitable access, national ownership, and effective management and monitoring. In line with CDKN's strategy for climate finance, this can be done by engaging in three priority areas (see Figure 1).

This policy brief provides CDKN's assessment of the gaps in global knowledge and the immediate challenges for the international community in all three of these strategic priorities for climate finance.



Equitable international climate finance architecture

Developing countries are increasingly demanding a fair and effective international climate finance architecture that gives them a stronger role in decision-making and is more responsive to their investment needs. However, they – especially the most vulnerable and least developed countries – also recognise a lack of institutional and technical capacity to plan, programme and manage climate finance effectively and accountably.

The lack of comprehensive information on all climate finance elements impedes the negotiation, analysis and improvement of financing instruments. Transparent, harmonised approaches to tracking and reporting on international climate financial flows help to identify where existing practices can be improved to promote equitable access, effective management and private sector leverage.

The GCF has been established and its Board had its first meeting in August 2012. Its Transitional Committee has done a considerable amount of work in reviewing practices in others funds and in developing ideas about various windows for direct access to capital, delivery through international partners and participation by the private sector. Developing countries will play an important role in shaping the GCF through their representatives on the Board. However, it will take time before the GCF's capitalisation, programme and project development and disbursement can start at a significant scale. There are also a significant number of other sources of climate finance, with a wide variety of volumes and eligibility criteria.[iii]

While the GCF is being operationalised and the international climate finance architecture streamlined, developing countries need immediate support to ensure their contribution to reducing greenhouse gas emissions (and subsequent slowing of global warming) and adaptation to the impacts of climate change. The gaps in global knowledge related to the international climate finance architecture include:

- limited knowledge in developing countries of the different sources of climate finance, and their applicability for different investment contexts and/or actions
- limited awareness of the accessibility potential and requirements of different sources of climate finance, and how to optimise fundraising, harmonisation and blending of these sources while streamlining local management requirements
- uncertainty over optimal fund management and accountability modalities (including monitoring and evaluation) to ensure local relevance within a country, and international harmonisation and effectiveness of climate finance (at international, including GCF, levels)
- uncertainty over the design and operational principles of the GCF, including the Private Sector Facility, and over the voice of developing countries in the design process
- uncertainty over the optimal international governance and safeguards structures for the GCF, including the required national-level safeguards and the capacity of developing countries to comply with them.

CDKN suggests that policy-makers in developing countries and their development partners consider three immediate challenges:

- How can transparency and effectiveness of international climate finance be improved (and confidence in the UNFCCC and GFC process increased) through systematic tracking and reporting of public and private climate finance flows?
- How can developing countries optimally develop the institutional capacity to access, deploy and track climate finance in alignment with national plans and priorities, while ensuring accountability and anticipating international requirements around transparency, monitoring and evaluation, and safeguards?
- How can least developed countries (LDCs), small island developing states and other vulnerable groups have an increasingly strong influence in designing and operationalising the emerging climate finance architecture, including the GCF?

Improved readiness for climate finance at the national level

The UNFCCC has raised global awareness that climate change represents a new and different challenge for national policy-makers. While responding to the vagaries of the climate is a continual demand made on public administrations, the shift in climate conditions that are now beginning to be observed raises a different set of questions for public policy and its funding. National planning often looks back in time to help guide decision-making for the future. Such an approach will no longer be reliable under changing

climatic conditions; policy development will have to move in a direction that addresses risk and uncertainty. This is already placing a strain on public finance management (PFM) systems that are not particularly robust in many developing countries.

Climate change has the potential to constrain economic development, undermining the efforts made by low-income countries to graduate to higher-income status. Years of investment may be put at risk. Although we are only beginning to appreciate the costs associated with responding to climate change, additional financial resources will clearly be necessary, at local and national levels, for countries to build a climate-resilient future.

As such, climate change needs to be seen primarily as an economic concern that warrants attention by national ministries of finance and planning. Local government will also play an important part in the national response to climate change, which will require strengthened national-to-local flows of public funding.[iv]

Different countries will respond differently to climate change. In middle-income countries, an immediate concern is to identify mitigation actions that will reduce carbon emissions, both in the industrial and land-use sectors. These actions will require tailored funding strategies to secure private sector investment. In contrast, in low-income countries, public expenditure is required to fund adaptation strategies, particularly to address the needs of poor and vulnerable people.

Existing international sources of concessional finance are not well developed to meet these needs. Much of this funding continues to be directed at project interventions. This misses the opportunity to support more programmatic approaches that can catalyse larger amounts of funding from both public and private sources.

In the short term, countries countries will likely need to rely on domestic resources to fund a significant portion of their national response to climate change. However, such finance is in short supply. An early focus is therefore needed to strengthen national systems that ensure effective and efficient management of both public and private capital. This mirrors the many years of efforts to improve PFM and, in particular, the national budgetary system. Climate change puts extra urgency on these reforms.

Gaps in present global knowledge about climate finance at the national level include:

- limited knowledge of the policy, institutional, accountability and budgetary requirements to ensure the effective flow of climate finance
- limited awareness by national policymakers on the financing mechanisms that exist
- a scarcity of demonstrable, tested models on climate finance delivery, including budget support, direct access through national implementing entities, and national execution of funds managed by multilateral or bilateral agencies
- limited capability at the national level to develop and package bankable

Box 1: CDKN activities and outputs related to international climate finance

- Briefs and reports on implications of the recommendations of the United Nations Secretary-General's High-Level Advisory Group on Climate Finance
- Support to the LDC Group on sources of long-term climate finance in the UNFCCC process and GCF Transitional Committee discussions, and to the GCF Board and Standing Committee
- Support to LDCs in understanding the impact of the suggested international air passenger levy
- Research on national and local payments for ecosystem services
- Support to Kenya's innovative national financial mechanisms and implementation plans for nationally appropriate mitigation actions
- Support to Mozambique's Adaptation Fund National Implementing Entity
- Design of Rwanda's national climate fund
- Indonesia/Vietnam public and private climate finance roadmap
- National strategies for climate finance for food security
- Research on Kenya's and Sri Lanka's coastal zone fiscal regulatory mechanisms
- Inside Story publications in 2012: Distributing the benefits of REDD+: The case of Vietnam; Comparison of Jamaica and Senegal Adaptation Fund National Implementing Entities; Ecuador Socio Bosque Programme; Market mechanisms in China
- Finance component of the Low-Emission Development Global Partnership
- Briefing Paper on 'The Green Climate Fund: Options for mobilizing the private sector'
- Risk insurance for disaster-prone communities in Pakistan
- Exploring local access to the Green Climate Fund
- Strategy on Gender and Climate Finance
- Model for secure safe water through credits in Uganda
- National Financing Strategies for Implementation of Low Carbon Development

climate compatible investments that would make effective use of climate and other concessional funds, making core public and private funds available at a large scale.

Much needs to be learned from the experience of PFM reform, particularly as the early demand for innovative national climate finance mechanisms is driving a move toward the use of extra budgetary funds. The institutional costs associated with such new structures can be high and may lead to fragmentation of policy oversight and coherence. Optimising national funding arrangements will depend on country circumstances, and there are obvious dangers in rolling out one preferred route to secure an effective national institutional architecture for funding climate change actions. More research is needed to map all the options.

With a new phenomenon such as climate change, it is not surprising that the analysis of national financing mechanisms and their associated expenditures is only developing. There are difficult conceptual and definitional ambiguities associated with the term 'climate finance' that hinder the policy debate. These need to be addressed to reach a national consensus in each country over what constitutes spending relevant to climate change. Learning lessons from other countries will be enhanced through developing such national perspectives.

Much research on climate finance delivery has focused on public expenditure and the need to ensure that financial resources are available, both domestically and internationally, to support actions that reduce carbon emissions or allow societies to adapt. The debate on fiscal measures has lagged behind, yet taxation and subsidy policies have a marked influence on a country's climate change trajectory. For example, fiscal measures may be prominent in supporting economic activities that increase carbon emissions rather than promoting climate compatible development. Research is required to understand the political economy surrounding the use of fiscal instruments available to governments.

All such efforts have a major shortcoming: the significant capacity constraint in many countries to analyse climate change spending. Very few academic centres have given this theme any attention. As a result, the pool of analytical skills is confined to the multilateral agencies and academic centres in the north (even there, climate finance is not a well-researched theme). More needs to be done to support national and regional centres of excellence to provide governments with the evidence they need to build robust climate change strategies and funded action plans.

Increased scale of climate finance

While many developing countries focus on public finance and believe it needs to flow efficiently first, private finance is critical and also must materialise at scale. Both sources are essential, with public finance needed to unlock the full potential of private finance. The reality check behind mobilising the US$100 billion a year that was pledged at the UNFCCC talks in Copenhagen is that the private sector will be responsible for the bulk of the investment needed. The UNFCCC recently estimated that more than 85% of all finance to address climate change will need to come from the private sector.[v] In the context of a global economic slow-down and increasing pressure for austerity, the need to look beyond aid towards wider development finance, including private investment and trade, has never been greater. Innovative solutions are required to stimulate private sector action and investment to support low-carbon and climate-resilient development.

The potential public finance gap should be regarded as a private sector opportunity, enabling public funds to go further and ensure greater impact. There are, however, few examples of public finance being used to unlock private finance for low-carbon and climate-resilient investment in developing economies. There are several barriers to private sector investment.

- Domestic policy barriers: there is often a lack of investment-grade public policy that offers transparency, longevity and certainty to investors, when climate investments require commitment over a longer term.
- Domestic market risks: there are various domestic market barriers, including costs of operation, limited human capital, insufficient infrastructure, and political and economic risks (including inflation and currency risks) which make the decision to invest less attractive in developing countries.
- Lack of 'investment ready' low-carbon/climate-resilient projects: there are few visible 'investment ready' projects, with many opportunities requiring further development, due diligence, new financing solutions and changes in regulatory or institutional barriers.
- The current very low price of carbon and uncertainty in the commercial attractiveness of carbon markets are also major barriers to private sector investment.

National governments need to focus on implementing a clear and stable investment framework to enable the scaling up of investments. This includes long, loud and legal policies; targeted subsidy regimes with sunset clauses;[vi] national measurement, reporting and verification systems; and regulation and standards, including feed-in tariffs and potentially a carbon price. Such frameworks can limit political risks, level the playing field for new technologies and help overcome administrative barriers. Private sector engagement is a critical part of the process of developing 'private sector readiness', to avoid policy reforms or programmes that might crowd out private investments, cause distortions of local markets and result in unnecessary subsidies.

International public finance can generate private capital through a variety of mechanisms. Public finance instruments could take risks that the private sector is not ready to take, support early movers, and pool increased private capital in developing countries. Examples include those that de-risk finance using risk guarantees to underpin credit worthiness, funding incentive mechanisms such as price guarantees, and concessional finance to complement early-stage risk

capital. These different instruments will not eliminate the costs and risks, but can improve the risk–return ratios to a more acceptable level.

In addition, more indirect public finance mechanisms are being proposed, from green or climate bonds to technical support for governments to develop climate compatible, investment-grade policies, and challenge or innovation funds aimed at catalysing the development and investment readiness of climate change projects. Some of these mechanisms are already being employed in the wider finance or development sectors, but need adjustments to the climate-finance context (e.g. bonds, risk guarantees). Other instruments, such as technical assistance funds, are ready for up-scaling. In many cases, governments and donors will need to pilot some of these financial instruments before they can be refined and adopted by the private sector at scale.

There are several gaps in global knowledge:

- Considering the heterogeneous nature of the private sector, there is limited knowledge of the 'real barriers' concerning the incentive structures and mechanisms required to support its private sector investment in mitigation and adaptation activities in developing countries, on a country-by-country basis.
- There is limited understanding of the effectiveness of certain policy interventions.
- There is a lack of visibility of existing and potential public–private initiatives and wider private sector engagement with climate change activities within recipient countries.
- There is a limited evidence base around which the different financial mechanisms work best according to different national contexts and/or different sectors and climate challenges: in each case, the heterogeneity of the private sector must be considered when employing and packaging different financial instruments.

CDKN suggests policy-makers in developing countries and their development partners consider the following immediate challenges.

The first issue to be addressed is how communication between the public and private sectors in developing countries can be increased as part of national planning and investment prioritisation processes. This is needed in order to make the financial instruments work effectively and to build trust in the public sector regarding private sector involvement. And how can an active role for the local private sector be supported during national policy and programme development and reform processes?

A second challenge relates to how we can determine which types of public–private collaborative arrangements, financing instruments, business models and pilots have proven effective in mobilising private finance for development challenges. Questions that need answering include: Which instruments work in which contexts? Which models have proved ineffective, creating market distortions and/or crowding out the private sector? This relates to the more practical question of how best to collaborate with key actors (donors, investors, public and private banks, financial intermediaries, project developers, implementers and governments) to develop, refine and scale up innovative and successful existing financial mechanisms that are already familiar to mainstream investors.

And finally, given the ongoing and time-critical work needed to capitalise and operationalise the GCF over the coming years, how can lessons be learned and best practices feed into the design of the Private Sector Facility of the GCF, from governance, operations and results perspectives?

Suggestions for action by the development community

The challenge for the international community is to identify strategic support measures that can provide an early return by strengthening developing countries' national efforts. We propose five measures that warrant attention:

Box 2: The Climate Finance Advisory Service for most vulnerable countries

The Climate Finance Advisory Service (CFAS) platform was launched in November 2012. Through this, negotiators, policy-makers and advisors in the poorest and most climate-vulnerable countries can access the bespoke information and guidance they need to effectively participate in complex global climate finance negotiations. CDKN will support the initiative through a partnership between the research, knowledge management and advocacy fund outputs.

The CFAS consists of three related components:

1. An **in situ rapid response service**, which provides bespoke answers to queries from climate finance negotiators and delegates, enabling them to participate more effectively in international negotiations related to climate finance, for example, during GCF and UNFCCC meetings. Responses are provided as concise notes with an explanatory phone call or meeting as required.
2. **Technical policy briefs** will be provided in advance of key climate finance negotiating sessions. These will be short and targeted to the needs of developing country negotiators, policy-makers and advisors. These briefs will provide essential information to assist delegates in preparing their positions.
3. A **knowledge portal** will be created, through which all the information by CFAS can be accessed. This will allow broader dissemination of the advice and information provided and will enhance the usability of information on climate finance. The database of advice will be accessible through the CDKN website and will also be used to disseminate other CDKN publications on climate finance.

In addition to this, the CFAS will be closely linked to CDKN research work and will be used to scope demand for new CDKN research on climate finance.

4. (continued list)

1. The transparency and effectiveness of accessing and disbursing international climate finance needs to be improved, and confidence in the UNFCCC and GCF process increased, through systematic tracking and reporting of public climate finance flows, and through better understanding of private sector flows in adaptation and mitigation actions.
2. While the GCF is being operationalised and capitalised, and the international climate finance architecture streamlined, developing countries need immediate support from their existing development partners in their transition to climate compatible development.
3. An early focus is needed to strengthen national systems to ensure effective and efficient management of public capital. This mirrors the many years of international assistance to improve PFM, and in particular the national budgetary system. Climate finance adds to the necessity of these reforms.
4. Support programmes are needed to stimulate a significant scale-up in incentive structures and mechanisms. These are required to support private sector investment in mitigation and adaptation activities in developing countries. Such programmes need to build, as far as possible, on existing structures and efforts, including National Development Banks.
5. More needs to be done to support national and regional research centres to provide governments with the evidence to build robust climate change strategies and fund investment plans.

Recommended resources

www.cdkn.org for information on CDKN strategies and activities related to climate change, including the CFAS.

www.climatefundsupdate.org for information on trends in dedicated climate finance funds.

www.climatefinanceoptions.org for information on potential sources of catalytic finance for investments in adaptation and mitigation action in developing countries.

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ii. Buchner, B., Falconer, A., Hervé-Mignucci, M. and Trabacchi, C. (2012) *The Landscape of Climate Finance 2012*. San Francisco: Climate Policy Initiative.

iii. www.climatefundsupdate.org; www.climatefinanceoptions.org

iv. An example can be found in: Lofts, K. and Kenny, A. (2012) 'Mainstreaming climate resilience into government: The Philippines Climate Change Act'. CDKN Inside Story. London: CDKN.

v. United Nations Framework Convention on Climate Change. Source: United Nations Environment Programme Finance Initiative (2012) 'Creating the "new normal": Enabling the financial sector to work for sustainable development. Perspectives on financing sustainable development in the wake of Rio+20'. Discussion Paper. Châtelaine, Switzerland: UNEP FI.

vi. Legal clauses that allow the subsidies to expire after a certain period.

About CDKN

The Climate and Development Knowledge Network (CDKN) aims to help decision-makers in developing countries design and deliver climate compatible development. We do this by providing demand-led research and technical assistance, and channeling the best available knowledge on climate change and development to support policy processes at the country level.

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The Overseas Development Institute (ODI) is the UK's leading independent think tank on international development and humanitarian issues.

About PwC

PwC is an international professional services organisation. The firm's sustainability and climate change team work globally with public, private and non-governmental organisations, advising on the implications and opportunities of climate change and sustainable development.

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