

Climate finance

Background

What is climate finance and what is its purpose?

In the broadest sense, climate finance refers to all financial flows that help reduce greenhouse gas emissions, support adaptation to the negative consequences of climate change, and bolster resilience to climate change. From an economic point of view, a stable climate is a global public good. Greenhouse gas emissions, which are responsible for anthropogenic climate change, can be understood as a byproduct (negative external effect) of economic activities such as power generation, manufacturing, transport and land use. The market, however, does not allocate resources optimally (“market failure”) because the negative environmental impacts of greenhouse gas emissions do not have to be paid for by the emitters and are suffered by third parties – typically the most vulnerable population groups in developing countries. The influential report by British economist Nicholas Stern (“Stern Review”) from 2006 therefore calls climate change ‘the greatest market failure the world has ever seen’. In the absence of a reasonable carbon price that would account for the costs of the negative environmental impacts of economic activity, climate finance remains an indispensable tool for the promotion of climate-friendly development.

Total investment requirements exceed currently available climate finance resources, and at present there are no adequate investment and market structures for redirecting existing capital from (institutional) investors to climate-friendly and resilient projects (‘shifting the trillions’). Besides, many developing countries have only limited capacity to access international climate finance and make use of it efficiently and transparently.

Financing requirements according to various estimates:

- Achieving the <2°C target: USD 37.9 trillion (International Energy Agency 2015)
- Adaptation costs: On a scale of USD 140-300 billion by 2030, or USD 280-500 billion by 2050 (UNEP 2016)
- Costs of designing climate-friendly infrastructure: USD 90 trillion between 2016 and 2030 (New Climate Economy 2016)
- Requirements for climate-relevant investment in the fields of buildings, transport and energy in several selected emerging economies by 2030: USD 23 billion (IFC 2016)

The most important categories of climate finance sources can be summed up as follows:

- Partner countries can finance climate investment directly with public funds from their own budgets or indirectly by improving the environment for investment. Fiscal policy measures such as environmental tax reform, carbon taxes or (fossil) fuel subsidy reforms can increase the financial scope for climate-friendly incentive systems in the national budget.
- The international community provides public climate finance through multilateral or bilateral channels.
- Numerous private sector actors invest in or provide capital from their own funds for climate change mitigation and adaptation measures.

They can be divided into two groups: enterprises in the real economy (such as national or international industrial enterprises, small and medium-sized enterprises and project developers) and financiers (such as banks, leasing firms, equity funds, microfinance institutions, institutional investors, foundations and insurers).

Climate finance plays a key role in the global fight against climate change. With the signing of the Paris Agreement in 2015, a milestone was reached in the international climate negotiations under the Framework Convention on Climate Change (UNFCCC). The agreement proposes to limit global warming to well below 2°C (if possible 1.5°C) compared with pre-industrial levels. Achieving this target requires a transition towards a decarbonised, climate-resilient global economy and the redirection of global financial flows.

National contributions to the achievement of global climate objectives, known as Nationally Determined Contributions (NDCs), are a key element of the Paris Agreement. All signatory states have committed to developing national contributions in which they define their climate action targets and measures. NDCs may also contain an adaptation component. Implementing the Paris climate targets and NDCs requires enormous volumes of investment and financing (see box), so the mobilisation and effective use of substantial additional climate finance resources is indispensable.

International climate finance can be made available in the context of technical or financial cooperation. Financial cooperation comprises various financial instruments such as grants, loans on concessional terms, project finance, equity, guarantees and insurance products.

Technical cooperation is usually financed on a grant basis and involves, among other things, policy advice, capacity building, technology transfer, project preparation and support in the implementation of projects.

In the context of the climate negotiations, the expression international climate finance is used in a narrower sense to describe the transfer of public financial resources and (private) funds thereby mobilised from donor countries to developing countries and emerging economies to support adaptation and mitigation measures.

An internationally accepted definition of climate finance has not yet been agreed upon, so it is measured in different ways. This is due to controversies that have emerged in international climate negotiations, such as the question whether climate finance should refer only to public or also to private financial flows, or only to financial flows from industrial nations to emerging or developing nations, or also to South-South transfers, for example. A further particularly contentious issue relates to what is referred to as ‘additionality’. Some developing countries demand that climate finance be provided in addition to official development assistance (ODA). Whether climate finance will be provided additionally to development

finance is a contentious issue among policy-makers. Setting the quantity and quality of climate finance is a key element of international climate negotiations and gives rise time and again to differences between industrialised and developing countries and, thus, slows down the negotiation processes.

The definition of climate finance is therefore an object of political controversy and intense negotiation processes at international level. In addition to the expression ‘climate finance’, other terms such as ‘green finance’ or ‘sustainability finance’ have become established and are sometimes used as synonyms. ‘Green finance’, however, is a more comprehensive generic term that encompasses all financial flows for a broad range of environmental projects.

The global climate finance goal

At the 15th Conference of the Parties (COP 15) to the Framework Convention on Climate Change held in December 2009 in Copenhagen, the international community committed to jointly make available and mobilise USD 100 billion annually for the fight against climate change in developing countries from 2020 onwards. This sum is to be provided from public and private sources – although the scope and origin of private funds is the subject of controversial debate. According to an analysis conducted by the OECD, such funds already amounted to USD 61.8 billion in 2014.

The Paris Agreement reiterates the USD 100 billion target. In October 2016 the industrialised countries submitted a roadmap for achieving the target and took initial steps. The move was based on climate finance pledges made by several industrial countries for 2020, climate finance commitments made by multilateral development banks (MDBs), and the work of climate funds such as the Green Climate Fund (GCF). In 2016, the latter had already received funding pledges slightly exceeding USD 10 billion.

International climate finance architecture

The global climate finance architecture is diverse and constantly evolving. The most important elements of global climate finance architecture financed from public resources comprise:

- **Bilateral channels:** The bulk of public climate finance is made available through bilateral channels. Governments make financial resources available from their budgets. This is done either in the form of governmental commitments or dedicated climate funds such as the International Climate Initiative (IKI) in Germany or the

International Climate Fund in the United Kingdom. This funding is mainly deployed by national implementing organisations such as GIZ or KfW. Other examples of such bilateral channels include the EU Global Climate Change Alliance (GCCA) and the multi-donor fund NAMA Facility.

■ **Multilateral channels:** Governments also make budget resources available through UN organisations, multilateral development banks (MDBs) and specific funds:

› The financial mechanism of the Framework Convention on Climate Change comprises the Global Environment Facility (GEF) and the Least Developed Countries Fund (LDCF) and Special Climate Change Fund (SCCF), both of which it manages, as well as the GCF.

› Other climate funds, such as the Adaptation Fund enshrined in the Kyoto Protocol, as well as funds outside the Framework Convention on Climate Change such as the World Bank's Climate Investment Funds (CIFs).

› Multilateral development banks provide a large number of financing and advisory instruments and sometimes act as implementing organisations for international climate finance funds. They can also blend their own funding which they raise in the international capital market with public climate finance contributions.

■ **Regional and national institutions in partner countries:** Some developing and emerging countries have established climate finance institutions of their own through which they access and manage international climate finance. Examples include the Amazon Fund in Brazil, the Indonesia Climate Change Trust Fund (ICCTF), the National Environment Fund of Benin, the Rwanda Climate Change and Environment Fund (FONERWA), the South African Green Fund and the CDM Fund in China. Many developing countries find it a considerable challenge to identify and make use of suitable international climate finance sources because there are so many widely differing means of accessing them. Besides, planning, managing and accounting for funds from various donors ties up scarce resources in developing countries, placing a strain on national administrations.

The relationship between the GCF and GIZ

GIZ has been accredited with the GCF since October 2016 and can submit and implement projects of its own. At the same time, GIZ provides needs-oriented advisory services to some partner countries to help them gain direct access to the GCF themselves. That is why GIZ does not compete for projects with national institutions

that seek to gain direct access (national implementing entities – NIEs).

Our position

In this context, GIZ takes the following positions:

■ **Climate finance comprises all public and private financial flows for climate projects.** As no internationally accepted uniform definition of climate finance has been established yet, GIZ is taking a pragmatic approach by defining climate finance as all public and private financial flows for climate projects in developing countries and emerging economies. Climate projects comprise measures or strategies that pursue the overarching goal of mitigating greenhouse gas emissions and/or adapting to the consequences of climate change (based on the OECD DAC Rio markers) and thereby contribute to achieving national and international climate objectives and implementing the Paris Agreement. A system for measuring results is also a fundamental component of climate projects.

■ **Climate change mitigation and climate change adaptation require not just additional funds but also a high degree of ownership and sufficient capacities in the partner countries and their national implementing organisations.** Given that international climate finance is growing continuously, issues of good governance are also becoming increasingly relevant. Partner countries can make a significant contribution to ensuring the effectiveness and efficiency of climate finance at national level by assuming strong ownership, ensuring high transparency in the use of funds and adopting anti-corruption strategies. The international principles on the effectiveness of development cooperation such as mutual accountability (Busan Partnership for Effective Development Cooperation, 2011) are relevant to climate finance in this context. GIZ therefore supports partner countries in establishing effective national institutions that coordinate, manage and implement climate finance resources.

■ **The benefits and drawbacks of establishing national climate funds or similar institutions must be carefully assessed.** It is important to use existing partner systems as much as possible to implement climate finance resources at national level. This ensures compliance with national public budgeting and procurement rules. National climate funds can generally be a suitable method for obtaining direct access to international climate finance

sources (through accreditation with the Adaptation Fund or the GCF, for example) and for using climate finance in a targeted manner and in accordance with national priorities. That said, establishing climate funds is very time-consuming and puts a great strain on resources and capacities, so the benefits and drawbacks must first be thoroughly assessed. When managing climate finance, it is often more efficient to make use of national institutions that adhere to proven standards in the use of funds on a fiduciary basis and in accounting procedures, such as national development banks. One example of this is the Brazilian Amazon Fund, which is managed by Brazil's national development bank BNDES.

■ **A large portion of climate finance for Least Developed Countries (LDCs) and Small Island Developing States (SIDS) should be made available in the form of grants.** Although they have contributed less than one per cent to global greenhouse gas emissions, these countries are hit particularly hard by the consequences of climate change. Grants, especially for adaptation measures, are justified because while these measures may save costs (for example through reduced water consumption or long-term macroeconomic cost savings) they usually do not generate any long-term revenues and are therefore not very attractive for private investors. Besides, LDCs and SIDS have limited public funds and particularly limited capacities for accessing climate finance sources.

■ **Public climate finance should be used as efficiently and effectively as possible and take into account cost trends and market developments in technologies.** Support through public climate finance should trigger private investment and not crowd it out. Climate finance therefore not only supports individual investments, it also improves the enabling conditions for private-sector investments.

■ **The limited availability of public climate finance resources makes it more important to adopt measures aimed at mobilising or redirecting financial flows and direct investments.** In addition to well-tested measures such as feed-in tariffs (FiT), emissions trading systems and subsidy reforms, regulatory measures adopted by financial regulators, such as the creation of favourable conditions for green bond markets, can also make an important contribution.

Our recommended actions

GIZ considers the following the most important recommendations for action:

■ **The partner countries' ownership and capacities for accessing and transparently managing public climate finance resources (climate finance readiness) must be strengthened further.** Accessing international climate finance resources and using them effectively is a challenge for many of GIZ's partner countries. The capacities of institutions that plan, coordinate and implement climate finance should therefore be reinforced in order to ensure that climate finance resources are verifiably used in a sound, efficient and corruption-free manner. Concrete examples of this include measures aimed at strengthening the capacities of National Designated Authorities (NDAs), developing national climate finance strategies or programmes, and supporting national institutions in obtaining accreditation with the GCF. In addition, it is important to build capacities in the field of good financial governance, including integrating climate-relevant aspects into international planning and budgeting processes, as well as sharing experience of climate finance among actors from developing and emerging countries.

■ **Climate finance instruments that are based on the use of public funds must be used in a targeted and needs-based manner.** Public or public-private financing instruments should be used where private providers make no suitable offers, not even for economically sustainable investments, as a result of inadequate conditions. Possible instruments range from grants, concessional loans with various maturities and terms of repayment, guarantees, structured funds and insurance schemes to equity capital with a high risk tolerance. Each of these instruments has benefits and drawbacks and must be assessed on the basis of the overall conditions of the project and sector, the individual project risk and the phase of project development in each case. Proven development finance methods such as market analyses and barrier analyses should be applied. Public finance instruments should also contribute to mobilising (crowding in) private investments because public funds alone will not be sufficient to meet the investment needs. For example, low-interest loans are being extended to project developers through local partner banks under a NAMA programme jointly implemented by GIZ and KfW in the building sector in Mexico.

■ **The use of climate finance resources should be aligned with national climate priorities and the 2030 Agenda.** Such priorities include Nationally Determined Contributions (NDCs), the Sustainable Development Goals (SDGs), national climate policies and the process of national adaptation plans (NAPs), Nationally Appropriate Mitigation Actions (NAMAs), low emission strategies (LEDs) or similar strategy documents. Overarching national climate action targets often have to be translated into specific investment and financing plans. The use of climate finance resources must be well prepared and should be taken into account at an early stage, when the policies mentioned above are developed. The absorptive capacity of the country in question also needs to be taken into consideration. A national climate finance strategy can be a suitable instrument for this purpose.

■ **Support should be provided to establish a project pipeline consisting of ambitious, feasible and investment-ready climate projects in partner countries.** In order to actually achieve national climate targets, they must be translated into specific investment and financing plans. The establishment of a project pipeline also contributes to strengthening absorptive capacities for climate finance at national and sub-national level. GIZ's partner countries need support in building the relevant capacities. Specific measures include building local project developers' capacities, providing support in preparing feasibility studies and business plans, prioritising project proposals, and promoting a structured dialogue between project developers and investors (matchmaking). Under the Africa-EU Renewable Energy Cooperation Programme, for example, GIZ supports project developers with advisory services on the development of structured finance-ready project proposals.

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Registered offices
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Address
Dag-Hammarskjöld-Weg 1-5
65760 Eschborn, Deutschland
T +49 61 96 79-0
F +49 61 96 79-11 15
E info@giz.de
I www.giz.de

Responsible/Contact:
Alexander Linke
GIZ Section 'Climate Change and Environmental Policy'
E Alexander.Linke@giz.de

In collaboration with:
Gwendolin Aschmann, Roman Roehrl, Marius Kaiser, Sebastian Sommer,
Sascha Oppowa, Steffen Menzel, Frederic Wils, Paula Rolffs, David Ryfisch,
Hauke Broecker und Sonny Syahril

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