Sources of Climate Finance in Asset Recycling

Full Description

Public Sources

Traditionally, public sources have been the main source of capital available for climate finance, including financial resources from multilateral and bilateral DFIs, other types of multilateral and bilateral organizations and aid agencies, governments, and dedicated climate funds.

Bilateral sources and channels: Bilateral financial institutions (BFIs) are institutions, agencies, or funds primarily belonging to or governed by individual countries. This includes bilateral DFIs and development cooperation agencies of individual countries. These institutions are capitalized through the public budget of the donor country, supplemented by own-source funds and funds raised on global capital markets. Examples of bilateral channels for climate finance include Germany's International Climate Initiative (IKI), the United Kingdom's International Climate Finance (ICF) commitment, Germany's Global Climate Partnership Fund (GCPF), and Norway's International Climate and Forest Initiative (NICFI), among many others.

Multilateral sources and channels: Multilateral financial institutions and funds have several governing members, including both borrowing developing countries and developed donor countries. This includes multilateral development banks (MDBs), which may be global (for example, the World Bank Group) or regional (for example, the Inter-American Development Bank, the Development Bank of Latin America, and the Asian Infrastructure Investment Bank) in focus, as well as other regional institutions and United Nations (UN) agencies. Funds for these multilateral institutions are raised from a variety of sources and donors, including capitalization from member governments, fees for services, and income from different financial instruments such as concessional and non-concessional loans, among others.

Climate Funds: Sometimes referred to as carbon funds, these are dedicated, climate-specific funds, often multi-donor, set up and managed by national, bilateral, and multilateral organizations that usually provide trustee and administrative services. These funds may have a specific thematic focus, such as climate change mitigation and adaptation, and specific sectoral focuses, such as transport, energy, forestry, or land use, among others. In addition to money pledged from donors, many of these funds leverage significant sums of finance, frequently from DFIs and by de-risking investments to mobilize additional private finance. Multilateral climate funds play a key role in supporting developing countries to adopt low-carbon, climate resilient development pathways as well as adapt to the impacts of climate change. Examples of climate funds include: (i) Global donor funds established by UN agencies, such as the Global Environment Fund (GEF), the Climate Investment Funds (CIF), and the Green Climate Fund (GCF); (ii) other global donor funds, such as the Global Energy Efficiency and Renewable Energy Fund (GEEREF); and (iii) regional and national climate funds and channels, such as those established by several developing countries, with a variety of forms and functions, resourced through international finance and/or domestic budget allocations as well as the domestic private sector. The Indonesian Climate Change Trust Fund was one of the first of these institutions to be established.

Private Sources

As the cost of mitigating and adapting to climate change increasingly outweighs the amount of public funding and financing available, there is a global need to close the financial gap by mobilizing more private investment to ensure transformational and long-term impacts across all economies. The sources of private finance include funds and savings of individuals and corporations (which are often managed, pooled, and/or invested through intermediaries such as commercial financial institutions, portfolio management firms, asset management companies, and/or pension funds), institutional investors, asset managers, corporate actors, institutional funds, philanthropic organizations, and non-profit organizations, among others.

In many cases, the primary motive of private climate investors is to realize a risk-adjusted rate of return on their investment, as well as co-benefits such as sustainable development, gender-related, or social outcomes, which may be explicitly or implicitly included in their mandate as related filters for investment decisions. Nonetheless, private sources vary in their risk appetites and objectives. Some of the general categories of private finance sources are summarized, as follows.

- Traditional commercial investors: These types of traditional financiers make investments primarily to generate financial returns and, as noted above, comprise the largest share of private sector climate finance. This category includes private equity firms, commercial banks, bond issuances, and other common and established sources of commercial finance. As compared to other categories of private investors, discussed below, these investors generally target more proven, less risky projects that promise a commercially viable rate of return, meaning financing is priced on market terms. Large-scale infrastructure projects usually require special purpose vehicles (SPVs) to attract project finance through project loans, private equity, or project bonds. Large commercial banks and infrastructure funds (often capitalised by institutional investors) are among the main actors that provide private sector financing for infrastructure.
- Angel investors/venture capitalists: Private investors that target earlier stage, higher risk projects with a relatively high rate of failure. Due to the high expectation of failure, however, these investors expect a correspondingly high return on investment for those projects that succeed.
- Impact investors: Impact investing is an approach to investing that aims to generate both financial returns and achieve positive environmental and/or social impacts. Impact investors play an important role because they inhabit a unique space between private investors, which tend to expect a relatively high risk-adjusted return, and public and philanthropic investors, which can absorb more risk and expect less return. While impact investors need some return on investment to maintain financial sustainability, their return expectations may be more flexible, especially if they are seeing significant environmental and/or social impacts from their investments.
- Philanthropic investors: Donor-based organizations that are motivated to make investments predominantly to generate positive social and/or environmental impacts and by achieving maximum impact in terms of climate-related outcomes, with relatively less or no financial return on invested funds.

Blended Finance

Blended finance is the strategic use of development finance for the mobilisation of additional finance towards sustainable development. Blended finance refers to the use of both public and private financing for projects that contribute to low carbon, climate resilient interventions and achieving sustainable development outcomes, but where actual or perceived risks are too high for commercial lenders to bear on their own. Blended finance attracts commercial capital to projects that contribute to sustainable development, while mitigating risk and helping ensure adequate financial returns to investors. Public financing is used to reduce investment risks for the private sector and to reduce the cost of financing. To this end, blended finance aims to: (i) finance projects that would otherwise not be financed by pooling of resources; and (ii) ensure a high leverage effect on limited public resources. Blended finance can play an essential role in unlocking, scaling up, and channelling commercial finance towards sustainable development in developing countries. Similarly, public co-financing can be key to unlocking climate finance from the private sector by taking on certain risks that the private sector will not bear, such as technological risk where projects rely on new or relatively untested technologies that, if successful, have the potential to be transformative.

Blended finance is not an approach to investing but an approach to structuring transactions in a way that brings in multiple types of investors. Blended finance makes it possible, for example, for a government agency, a private equity investor, and an impact investor to all invest alongside each other while achieving their own objectives. Impact investors often, but not always, invest in blended finance transactions alongside other kinds of capital. Similarly, climate funds and DFIs are increasingly seeking to co-finance projects alongside private investors, to increase flows of private capital into projects that support sustainable development and increase the development impact of every public collar invested. Accordingly, the financial leverage ratio, here referring to the amount of private capital mobilized as compared to the amount of public investment, is an increasingly important criteria for many of these climate finance sources.

However, it can be difficult for different public, private, and non-profit groups to collaborate in existing structures, particularly across borders.[4] In addition, preparation costs associated with blended financing can be high, making it more challenging, particularly for small projects. These challenges, coupled with the overall inadequacy of concessional finance resources relative to climate investment needs, have contributed to a decline in blended finance projects in recent years. Specifically, the USD 14 billion in tracked blended finance deals 2019-2021 reflects a steep drop from $36.5 billion in the previous three-year period.[5] Accordingly, more must be done to improve coordination between the public and private sectors to realize the significant leverage potential promised by blended finance transaction structures.

Footnote 3: See, for example, Buchner, Barbara, et al. 2013. The Role of National Development Banks in Catalyzing International Climate Finance.

Footnote 4: Tett, Gilian. 2022. "The flood of green finance must be diverted from the west."

Footnote 5: Gold, Shabtai. 2022. "Blended finance for climate fell 60% despite calls for more funds."

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