Network for Greening the Financial System

Technical document

Conceptual Note for the NGFS Handbook on Scaling Up Blended Finance for Climate Adaptation and Mitigation in EMDEs

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NGFS

Central Banks and Supervisors
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Contents

1. Role of climate blended finance and the NGFS in greening the global financial system

The challenges of addressing climate change are enormous, with estimates of global investments needed to achieve the Paris Agreement's goals ranging between US$3 trillion and US$ 6 trillion per year through 2050[1]. Part of this financing will flow from the joint contribution of better climate policies and better capital allocation by the private financial sector. Part of this financing will also come from the provision of public resources and more generally climate finance. Yet, it is likely that financing falls short of what would be needed, especially in emerging market and developing economies (EMDEs)[2]. In particular, global climate finance currently amounts to only a fraction of the financing needs despite considerable funding amounts committed by governments globally.

Additionally, EMDEs, which account for two-thirds of global carbon emissions and are particularly vulnerable to climate hazard, face a host of daunting cyclical and structural challenges. High inflation and the ongoing global monetary policy tightening have exacerbated structural headwinds for climate financing in EMDEs. Global financial conditions have tightened sharply, raising the specter of sizable portfolio outflows from EMDEs while upward price pressures remain elevated. In addition, the Russian invasion of Ukraine has caused significant disruptions in commodity markets and sparked energy security concerns. With the perception of the trade-offs between energy security and climate transition rapidly changing, there is a risk that the required rapid decommissioning of fossil fuel-fired power plants may become more challenging and the transition toward renewables more costly, complex, and disorderly[3]. Finally, the deterioration in the global economic outlook this year is exacerbating already-elevated debt distress in many countries, constraining their ability to implement climate policy reforms while further tightening fiscal space.

As in advanced economies (AEs), debt remain by far the main source of funding for climate adaptation and mitigation in EMDEs. However, sustainable debt issuance in these countries is limited, lower than in advanced economies, and with a high share of foreign currency issuance—reflecting a lack of depth in domestic capital markets[4], a dearth of large corporations, and an investor base for sustainable bonds that is largely located in advanced economies.

The transition to a low-carbon, climate-resilient global economy will require a concerted and collaborative effort by policymakers, the private sector globally and the financial system to overcome several obstacles. These include addressing a range of key market failures—including externalities linked to greenhouse gas emissions and market failures related to information availability, technology spillovers, and incentives in capital markets—as well as uncertainties about future climate policies and rapidly evolving technology.

Given limited fiscal policy space and high debt levels in many EMDEs after the pandemic, private capital will be vital to finance climate adaptation and mitigation efforts. It is therefore crucial to foster a conducive investment environment, putting in place the right climate policies and using a set of suitable tools to attract a broad range of private investors—including carbon pricing and subsidies, public investment, favourable lending policies, improved climate information architecture (data,

[1] Estimates suggest that $3 trillion to $6 trillion across all sectors are required per year by 2050 to mitigate climate change by substantially reducing greenhouse gas emissions. In addition, a further $140 billion to $300 billion a year by 2030 is needed to adapt to the physical consequences of climate change, such as rising seas and intensifying droughts. Source: Torsten Ehlers, Charlotte Gardes-Landolfini, Fabio Natalucci and Prasad Ananthakrishnan, "How to Scale Up Private Climate Finance in Emerging Economies" IMF Blog, Oct 2022.

[2] While the focus of this initiative is on EMDEs, it is recognized that mature economies are not immune to the challenge of raising financing to address climate change.

[3] The geopolitical tensions over this period have also exacerbated resource concerns more broadly, highlighting crucial interdependencies between scarcity of critical minerals and commodities needed for climate transition efforts.

[4] The development of local bond markets in EMDEs will be important to enhance the ability to finance climate adaptation and mitigation as well as broaden the domestic investor base.

taxonomies/classifications, and disclosures), legal and institutional frameworks, and financial regulations.

Against this backdrop, blended finance—deploying public and donor capital to de-risk private capital investments in order to mobilize financing for climate adaptation and mitigation projects—has a critical role to play in scaling up private climate financing.[5] Blended finance can enhance the risk-return profile of climate adaptation and mitigation projects by absorbing risk and levering up private capital, thereby attracting a broader set of private investors and contributing towards building a more mature climate financial ecosystem in EMDEs. It combines enhanced financing with capacity building, technology transfer, and institutional support to enhance bankability and reduce risks to the private sector. Blended finance is not new but providing means to scale it up rapidly is an imperative, necessitating a collective effort by the public and private sector across the globe. The time is now, given the urgency in addressing climate change, the sheer size of financing needs, and the herculean challenges faced by EMDEs.

The NGFS can play a key role by identifying a set of best practices and principles and by offering guidance on modalities to support the evolution and scaling up of blended finance for climate adaptation and mitigation in EMDEs. With its global membership of central banks, supervisors and regulators, it can act as a catalyst to mobilize mainstream finance to support the transition toward a sustainable economy. The NGFS can contribute to the global collaborative effort by using its convening power to raise awareness about "climate blended finance" and bring together relevant public and private stakeholders. Given the complexity of some blended finance structures and the regulations on the use of certain financing vehicles (in particular securitization vehicles), the NGFS can also provide advice on how best to establish regulatory clarity and identify and consider potential regulatory and practical barriers hampering the scaling up of various approaches to blended finance in the climate space. More broadly, central banks, supervisors and regulators can provide an additional perspective, in particular in EMDEs where domestic financing (including for climate adaptation and mitigation projects) remains underdeveloped and where large, sudden capital flows can have significant macro financial implications. As such, NGFS members are also interested in ensuring that the scaling up of blended finance is implemented consistently with other policy objectives (e.g. developing local currency capital markets, deepening domestic financing capacity, preserving macro financial stability, adopting international regulatory standards, mainstreaming of climate-related efforts). This blended finance initiative will complement the NGFS core work of supporting its members in assessing the macroeconomic and financial stability implications of climate change and adjusting their policy actions accordingly.

As a key deliverable of the blended finance initiative, the NGFS Handbook is intended to leverage on and complement efforts by the public and private sector by focusing on three keys areas:

1) identify and draw on key lessons from past case studies on blended finance projects, not only in EMDEs but also in advanced economies where blended finance has been employed;
2) identify some of the elements needed to build a mature climate blended finance ecosystem in EMDEs; and
3) highlight a set of best practices and principles to scale up blended finance for climate adaptation and mitigation in EMDEs. This will also include a review of issues related to the regulatory treatment of blended finance projects.

[5] There are different definitions of blended finance reflecting different types of financing instruments and partnerships between public and private capital, including the OECD DAC Blended Finance Principles, DFI Enhanced Blended Concessional Finance, and Convergence, for example. The definition used in the envisaged Handbook is for illustrative purposes only

2. Learnings from past blended finance projects: What went well and what did not

Learning from experience, there are various impediments related to both the demand for and the supply of private climate financing that need to be addressed.

On the demand side, impediments include insufficient capacity and expertise in project selection and development; projects that are not ambitious enough or not aligned to robust climate policies; shortage of bankable projects (often due to hurdles related to high upfront costs and capital expenditures); a lack of access to private capital; and a lack of demand in EMDEs for multilateral development banks (MDB) financing from EMDEs owing to, among other factors, policy conditionality, the perception of complex procurement, and onerous financial monitoring and management requirements.

On the supply side, barriers include long time-horizons for infrastructure projects; idiosyncratic project risk and inability to diversify risk; poor governance, transparency and accountability; lack of scale vehicles to aggregate projects; unattractive risk-return profile of investable projects; structures too bespoke and not replicable in scale; financial instruments that do not effectively align investor incentives; a relatively small investor base (relative to financing needs); fiduciary duty considerations; limited role of blended finance in asset allocation models; lack of concessional and catalytic capital providers; and scope and scale of involvement of MDBs, including insufficient leverage of public risk-absorption capacity.

There are also specific risks related to a weak investment landscape in some EMDEs, spanning from political, legal, regulatory, policy and macroeconomic issues (especially exchange rate risks). Strengthening the policy, institutional and legal framework is an important precondition to attract longer-term private capital as well as a crucial factor to manage possible macro-financial challenges that could arise from much-needed climate capital flows to EMDEs. An inadequate policy framework to capitalize on impact and the absence of a robust climate information architecture (data, taxonomies/classifications, and disclosures) also hamper the ability of investors to monitor, verify and evaluate the impact of their investments.

Moreover, carbon-intensive investments remain attractive in many EMDEs, underscoring the need for reallocation of capital away from fossil fuels and the mobilization of private climate financing for low-carbon and renewable investments.

3. Building a mature climate blended finance ecosystem

Climate change brings not just risks to the financial system, but also opportunities for the private sector in terms of both financial rewards and possibility of having an impact. To achieve these objectives, an urgent task is to build a mature ecosystem in EMDEs that is supportive of providing financing for climate adaptation and mitigation, as well as a timely, orderly, and just climate transition. Toward this end, central banks and regulators can be a catalytic force to raise awareness and mobilize the private sector. Pricing risks appropriately – via enhanced information architecture and improved capital market structures in terms of climate finance – will contribute to the scaling up of blended finance in EMDEs.

To rapidly scale up blended finance for climate adaptation and mitigation there is a need to design and employ financial instruments and vehicles that can properly align incentives in both the public and private sector and entice private capital with varying appetite for risk. For example, green bond funds can attract various types of private sector actors. Outcome-based debt instruments such as sustainability-linked bonds can benefit EMDEs if key contractual terms are appropriately set.

The investor base should be expanded in parallel—to attract investors with different expected returns, various risk profiles, differing investment horizons, and broader objectives, including impact and social aspects. There are currently several initiatives, such as GFANZ, that can play a crucial role in channeling private capital from a broad set of investors,

including a higher level of institutional investor participation. Philanthropic capital is also important given its catalytic role and long experience. Finally, rating agencies can also contribute by rating structures conducive to enticing various private sector actors. Rating agencies need to work together with the public and private sector players to develop a well-understood and standardized rating methodology for blended finance structures.

The involvement of MDBs, as well as regional development and national infrastructure banks, are crucial to scale up climate blended finance. They can provide technical assistance and structuring advice to develop a pipeline and increase the supply of investable projects in EMDEs. In addition, they can provide risk-absorption capacity to lower the risk borne by private investors through grants, concessional loans, risk-sharing arrangements via public-private partnerships, risk-underwriting and guarantees, and direct equity investments. By doing so, MDBs can help crowd in private sector funding. It is also important to look for ways to better leverage the MDBs' balance sheets. Depending on the specific structure utilized, MDBs' participation in the form of guarantees or equity stakes allows levering up of available public money and maximizing the availability of climate financing to EMDEs. In this case, it is paramount to ensure that public money also share some of the upside of the investment if it takes on risk, and that a proper governance structure is put in place.

Commercial and investment banks can also play a key role as lead managers for financing sustainability projects. However, with limited balance sheets, regulatory capital, and liquidity requirements, banks often tend to offload these loans to nonbank lenders. However, institutional investors prefer larger deal sizes with a diversified pool of assets to reduce concentration risk. Therefore, there needs to be a shift toward a portfolio approach to blended finance deals, including through the structuring and securitization of typically illiquid or small-sized green and transition assets. The potential investor base for blended finance projects could be significantly larger with the use of structured finance assets, as they may be more easily accessible in capital markets.

Having in place adequate institutional and policy structures in EMDEs as part of the overall ecosystem will play a key role in building a pipeline of bankable projects and attract investment flows.

4. Principles and practices to scale up blended finance[6]

An attractive investment environment, built on good governance and investor relations, is a pre-requisite to scaling up blended finance for climate adaptation and mitigation. This requires an appropriate institutional, legal and policy framework, of which climate policies are an important component. Providing regulatory clarity will also be important given the complexity of some blended finance structures and the regulations on the use of certain structures, including securitization vehicles. A robust climate information architecture—comprising reliable and comparable climate data, internationally interoperable taxonomies/classifications, and climate disclosures—is also crucial to properly assess, price, and manage climate risks and opportunities. The role of data and reliable information is critical for many EMDEs to allow a more accurate assessment of investment and performance risk.

Avoiding fragmentation of global capital markets and regulatory approaches is paramount. Toward this end, there is a need to harmonize minimum reporting requirements for all stakeholders using reliable and comparable information (including that coming from transition plans) with some form of common finance reporting standards (including for blended finance structures and deals) that can be used for measurement, monitoring, verification, and impact assessment.

A larger risk-sharing engagement by MDBs, combined with greater risk appetite and additional resources, would go a long way in supporting risk mitigation and rapidly scaling up climate blended finance in EMDEs.

[6] Seeking to leverage on and complement existing principles, for example the DFI Enhanced Principles, the G20 Principles, the OECD DAC Blended Finance Principles, etc.