



Innovative climate finance

Examples from the UNEP Bilateral Finance
Institutions Climate Change Working Group
2011



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Table of Contents

Table of Contents	3
Executive Summary	4
Mini Glossary	7
1. Introduction	8
1.1 Objective – beyond just climate finance policy and tracking	8
1.2 Background data on contribution by BFIs	8
1.3 Defining innovative climate finance	10
2. Example cases of innovative finance by BFIs	13
2.1 Blending facilities – helping to achieve affordable cost of capital	13
2.2 Support for policy development – tackling policy risk	15
2.3 Green Credit Lines – getting affordable credit to ‘the ground’	16
2.4 Risk sharing instruments – the key to lowering the cost of capital	18
2.5 Support for carbon markets	19
2.6 Financing forest protection and REDD	20
2.7 Support for small and medium size projects and programs	20
3. Benefits of innovative climate finance instruments	21
3.1 Scale	21
3.2 Timeliness	21
3.3 Leverage	21
3.4 Flexibility	21
3.5 Scalability and Replicability	22
3.6 Localisation	22
3.7 Least cost	22
3.8 Transaction costs	22
4. The Green Climate Fund and BFIs	23
5. Key Insights and Conclusions	24
Notes	24

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.

- BFI 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.
- BFI 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.
- BFI 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.
- BFI 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, BFI 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

^aNote 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.

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: Agence Francaise de Developpement (**AFD**), European Investment Bank (**EIB**), Japan International Cooperation Agency (**JICA**), **KfW** Entwicklungsbank (Germany’s development bank) and the Nordic Environment Finance Corporation (**NEFCO**).

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.”

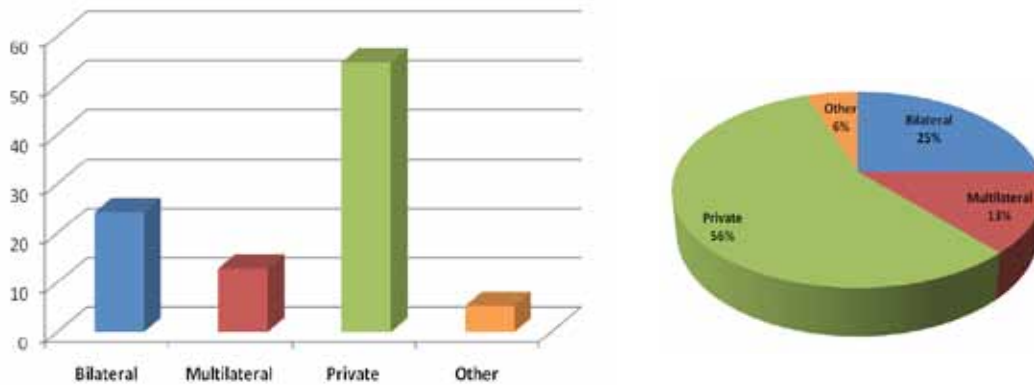
Data derived from this Climate Policy Initiative report is provided in Figure 1.

2 E.g. recent work and reports by the Chatham House Renewable Energy Finance Project, the Climate Policy Initiative (CPI), Climate Strategies with the University of Zurich, the Institutional Investors Group on Climate Change (IIGCC) with others, the OECD, the Overseas Development Institute (ODI), the UK DECC Capital Markets Climate Initiative (CMCI), the World Economic Forum and the World Resources Institute (WRI)

3 This report can be downloaded at http://climatepolicyinitiative.org/generic_datas/view/publication/117

4 Or a group of nations acting together in the case of the EU. Note, to be consistent with this report, the data in Figure 1 from the CPI report has been adjusted to reflect the European Investment bank (EIB) as a bilateral institution, not a multilateral institution.

FIGURE 1.
Sources of climate finance in 2010 – estimates in \$US billion, and percent share



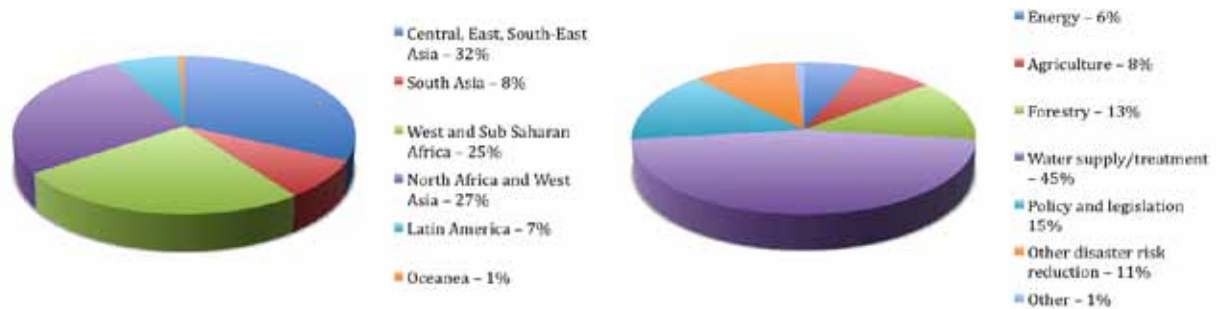
Source: Derived from CPI, The Landscape of Climate Finance (see footnote 4)

Importantly, the finance provided by BFIs also has a wide coverage at both regional and sectoral scales. Figures 2.1 and 2.2 are taken from the November 2011 report *Bilateral Finance Institutions and Climate Change: A Mapping of 2010 Climate Financial Flows to Developing Countries* ('the 2011 Mapping Report') prepared by the Stockholm Environment Institute for the UNEP BFI CCWG.

FIGURE 2.1
Financing by UNEP CCWG BFIs for Mitigation in 2010 – Regional and Sectoral shares



FIGURE 2.2
Financing by UNEP CCWG BFIs for Adaptation in 2010 – Regional and Sectoral shares



Source of Figures 2.1 and 2.2: UNEP BFI Climate Change Working Group

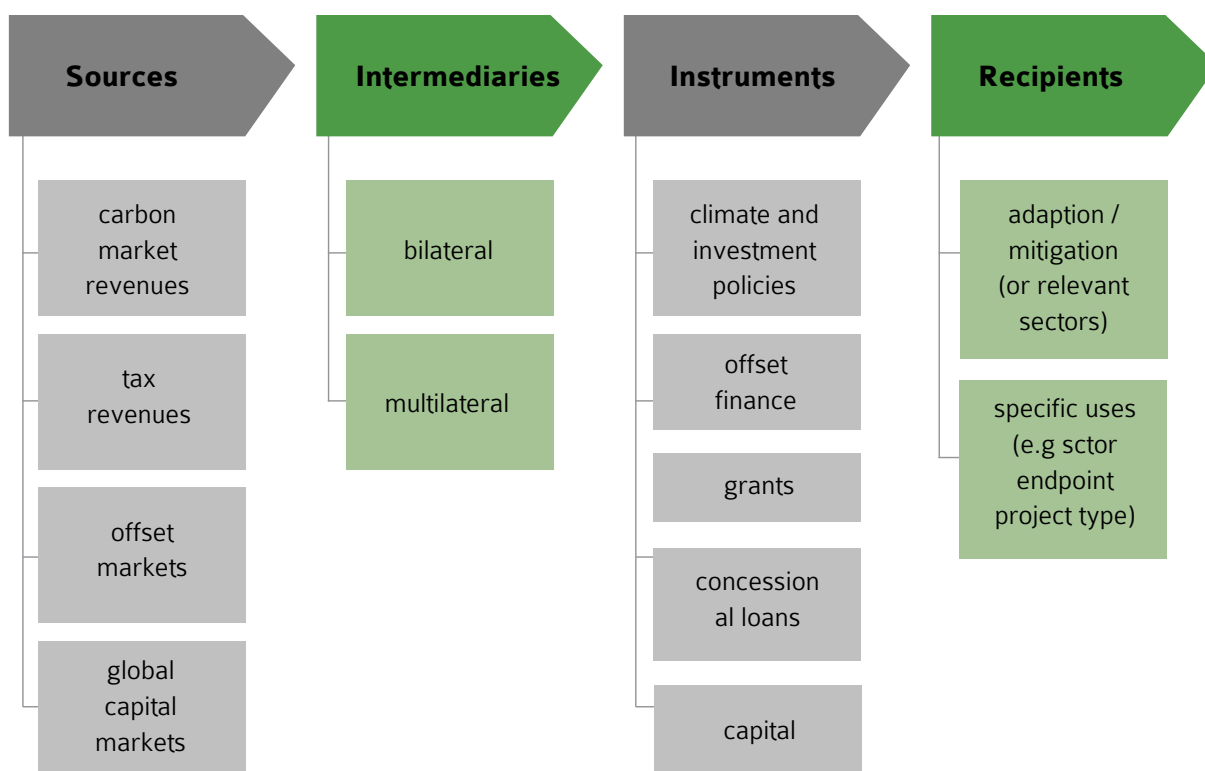
1.3 Defining innovative climate finance

This report complements the information from the 2011 Mapping Report by exploring the performance of the five BFIs in the UNEP BFI CCWG through a lens of ‘innovative climate finance’. In addition to the substantial share of public climate finance provided through BFIs, their proven ability to be innovative is also something not fully appreciated. Yet innovation that is able to be widely scaled-up and replicated will be at the heart of

the transformation needed in climate finance – in scale, space and timeliness – to achieve the investments needed globally in climate change mitigation and adaptation.

Like other work in this subject area, this report takes the broad view of what constitutes ‘climate finance’. Figure 3 draws from a useful diagram in the CPI ‘Landscape’ report which shows flows of the aggregate of public finance, public-private finance and private finance from sources through to recipients by way of intermediaries and utilising a range of instruments.

FIGURE 3.
The dimensions of climate finance, public and private



Source: “Derived” from The Landscape of Climate Finance, Climate Policy Initiative, October 2011

BOX 1.

Effective and Efficient – a lens through which to view innovation

The attributes of being effective and/or efficient can be described in terms of some key outcomes and also the process by which these are achieved.

Effective

- **Scale:** the amount of outcomes, including in comparison with some level of sought or potential outcomes
 - in amounts of finance provided
 - in results, e.g. in renewable energy or emissions reduction/carbon sequestration
- **Timeliness:** the speed with which finance gets deployed, e.g. how long it takes between when public finance is provided by donors and when investments on the ground

- are evident
- **Leverage of co-finance:** the scale of investments compared with the scale of initial public monies – where co-finance can be other public finance and private sector investment
- **Flexibility:** able to be tailored to better address specific circumstances
- **Scalability:** the potential for further outcomes in the same jurisdiction, given the experience of the initial investments
- **Replicability:** the potential for similar outcomes in other jurisdictions, given the experience of the initial investments
- **Localisation:** the building of local ‘ownership’ and durability of outcomes through engagement

with, and building capacity of, domestic actors

Efficient

- **Least (lower) economic cost:**
 - maximising the achievement of lower cost outcomes prior to significant financing being directed to more costly measures
 - achieving outcomes with minimal rents/windfalls being enjoyed by market participants
- **Low transaction costs:** minimising organisational costs and ‘friction losses’ (costs of intermediation) which add to overall project costs and mean less of the public finance gets to ‘the ground’ of the actual project or program.

BFI serve primarily as intermediaries for the flow of public finance from their governments to recipient countries. Some key points to note with respect to climate finance provided by BFIs are:

- (i) the type of finance ranges from outright grants to market rate loans;
- (ii) there are a range of concessional financing instruments that sit between grants and market rate project finance;
- (iii) which instruments are most applicable in a given situation will depend on the project and national circumstances; and
- (iv) associated with point (iii), the cost of the finance will be different (i.e. increases progressively going through the instruments from grants to market rate loans).

A definition for ‘innovative’ is more difficult to pin down. In many ways innovative can be seen as something quite subjective. As well, it can be very context specific. In general terms, innovative can often be seen as being new or different compared with some norm. But this does not get one very far when discussing something like public climate finance which, itself, is a relatively new term and practice.

A methodological approach taken in the preparation of this report was to ask experts in the UNEP BFI CCWG what they consider as being innovative among their financing practices, and why.⁵ From their responses it seemed feasible and useful to describe innovative by linking this with the more commonly used terms **effective** and **efficient** (see Box 1).

5 In the mini glossary provided at the beginning of this report, a number of instruments are set out in what can be seen as classical and innovative groupings – where innovative is based on the descriptions as used by the CCWG.

This also seems a useful way to think about it because policy maker documents frequently use these terms as primary objectives or yardsticks. A notable example is a point in the “Draft governing instrument for the (UNFCCC) Green Climate Fund” by the Transitional Committee in its 18 October 2011 report:

“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....”

It is unlikely that any given approach to climate finance would be considered as useful and innovative if it was seen to be ineffective or inefficient. Conversely then, innovative might be discussed in the context of the attributes of what is seen to be effective and efficient. Being innovative across multiple attributes (including some particular ones) might also then be seen as related to the concept of ‘transformative’.

In section 2, instruments and case examples seen by the UNEP BFI CCWG as representing innovative approaches to climate finance are described in some detail. In section 3, these instruments are then further explored against the innovative defining attributes set out in Box 1. Section 4 discusses the Green Climate Fund and BFIs. Section 5 finishes with key insights and conclusions.

Example cases of innovative finance by BFIs

Experts in the BFIs in the UNEP CCWG identified the following list of examples of instruments representing innovative climate finance (each is described in detail in the sub-sections that follow):

Blending facilities, e.g. where BFIs provide 'zero cost' grant finance into a finance package involving 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
 - Low Carbon and Resilient Development Program
 - NAMA Readiness
- **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'
 - Funds for climate finance
 - First loss guarantees
 - Separate treatment of political risk
- **Support for carbon markets**, where, for example, BFIs have provided some unique assistance to support the access of project investments to the Clean Development (CDM) or Joint Implementation (JI)
 - Conditional loans for CDM project promoters
 - Carbon Funds – Climate certificates

- **Financing forest protection and REDD**
- **Support for small and medium size projects and programs**

- Partial guarantees
- Contestable proposal calls for grants

An important initial 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.

2.1 Blending facilities – helping to achieve affordable cost of capital

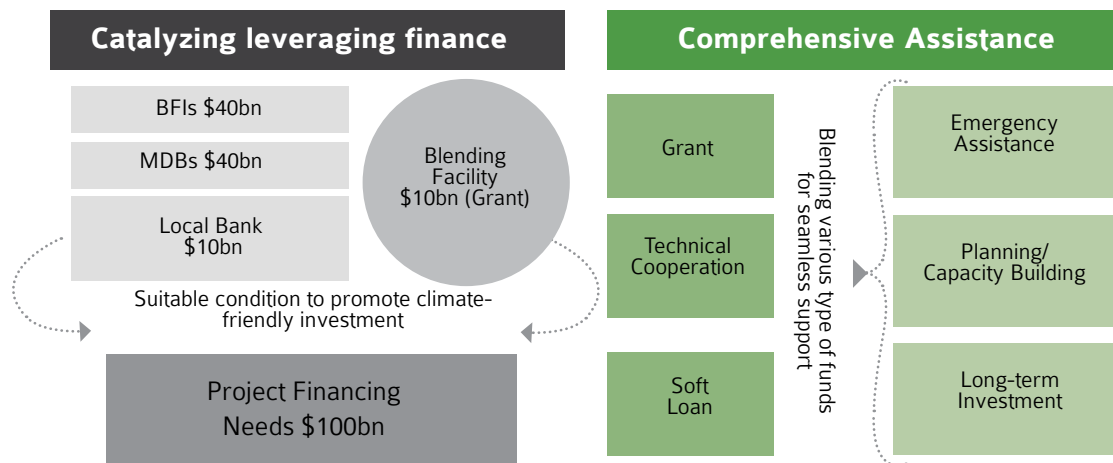
Blending mechanisms aim at, inter alia: (i) financing projects that would otherwise not be financed thanks to the pooling of resources and the complementary use of grants and loans, and (ii) ensuring a high leverage effect on limited grants resources.

A principal feature of blending facilities is that they add grant funds to a blend of debt finance from a number

of financial institutions (e.g. BFIs, MDBs, local banks) so that the overall equivalent cost-of-capital of debt finance meets the project finance needs of specific projects. In turn, the availability of affordable debt finance can help project developers attract the necessary equity finance (especially from private investors) that underpins the overall finance package.

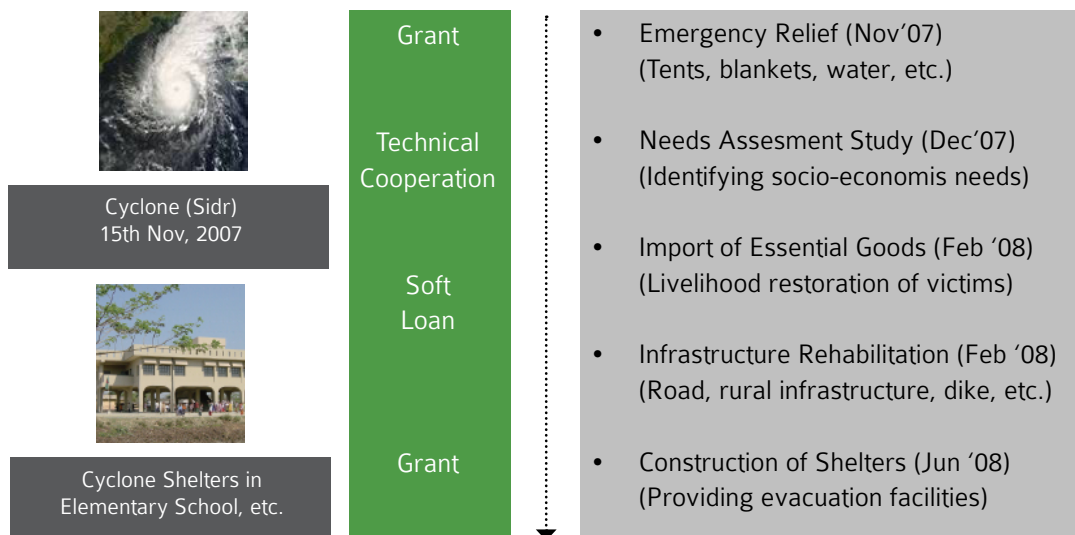
Figure 4 shows a generic example. Here the \$10bn grant from the blending facility has served to bring down the cost of debt for the overall \$100bn finance package to a level that is affordable for the project. Each of the other elements of the debt finance package (i.e. the loans from the BFIs, MDBs and local bank involved) had an interest rate that when aggregated was overall too expensive.

FIGURE 4.
Example of a generic blending mechanism



Source: Presentation by UNEP BFI CCWG to the United Nations, 9 March 2011

FIGURE 5.
Example of a JICA blending mechanism helping Bangladesh to cope with cyclones



Source: Presentation by UNEP BFI CCWG to the United Nations, 9 March 2011

The \$10bn of zero interest grant finance makes the difference.

In addition to this quantitative leverage effect, blending instruments have an important qualitative effect by contributing to an improvement of donor/BFI coordination – to the strong benefit of the partner (recipient) countries. They also allow for the participation of a wide range of professional financial actors, thus enabling a strong leverage effect on both existing public and private financial institutions and their climate financing activities and new professional actors.

Figure 5 sets out the elements of a JICA initiative in Bangladesh on coping with cyclones. This facility provides continuous support from emergency assistance to mid-long term adaptation.

Another good example of a blending facility is the EU Africa Infrastructure Trust Fund (ITF), operational since 2007 and managed by EIB. The success of this facility has led to it being a model for replication. The ITF provides grants to subsidise interest rates in energy, transportation, water and IT sectors in Africa. For the ITF, it is expected that each €1 of grant funds will generate over €14 in total investments. In addition to subsidising interest rates, other possible uses of grant funds provided through the ITF include financing insurance premiums and, as well, the financing of preparatory studies (e.g. on environmental and social issues, market and pricing studies etc) as well as other technical assistance (e.g. for the implementation of an environmental management plan). These are examples of the “comprehensive assistance” shown in Figure 4.

Following the success of the ITF model, the EU (Commission jointly with a number of EU member states and EU development financiers) has decided to scale up this financial tool, so has created specific climate change windows in all EU regional investment facilities, including (in addition to the ITF) the Neighbourhood Investment Facility (NIF), the Latin America Investment Facility (LAIF), the Investment Facility for Central Asia (IFCA) and the newly founded Asia Investment Facility (AIF). These climate change windows help streamline and mainstream climate finance within these facilities and help to provide a basis for tracking climate finance, e.g. through the application of Rio markers for climate change⁶ in categorising projects.

These so called Loan and Grant Blending Facilities are all coordination platforms among donors and partners. Substantial development finance volumes are leveraged by linking EU budget grants with loans by EU development financiers. The development financiers participating in a given facility collaborate in a complementary approach by delegating specific project management to one lead financier, relying fully on its standards, procedures and practices, and therefore decreasing transaction costs.

To improve complementarity and division of labour, AFD, EIB and KfW has elaborated procedural guidelines under the framework of the Mutual Reliance Initiative (MRI), which was launched in 2009. The objective of the MRI is to delegate central tasks in project preparation, implementation and monitoring to the maximum possible extent to the institution who is subsequently assuming the responsibility as Lead Financier. As a principle, this delegation of tasks and responsibilities is based on mutual recognition, not on harmonization of procedures.

Practical experiences were made during a two year pilot phase. Some cooperation project examples are:

- Wind Farm “Gulf of el Zayt” (Egypt) – cooperation of EIB and KfW
- Improved Water Supply and Sewerage Program (Egypt) – cooperation of EIB, AfD, KfW
- “Caprivi Interconnector” cross-border Energy Transmission for Zambia, Namibia, Botswana (as part of the Southern African Power Pool) – cooperation of EIB, AfD, KfW

There have now been 14 pilot projects in the Mediterranean and in Africa, Caribbean, Pacific group (ACP) countries that have tested and demonstrated the benefits of the MRI approach. Attention has focused on the identification of similarities and opportunities for the mutual recognition of each other’s standards and procedures in co-financing activities. In practice, the MRI has the objective to establish a joint operational platform. The combination of project reality and procedures during the pilot phase will feed into a set of agreed joint minimum standards and procedural guidelines that take into account the specific requirements of each institution.

6 “Rio markers” identify development assistance (aid) spending that targets objectives of the three Rio conventions (climate change, biodiversity and desertification).

2.2 Support for policy development – tackling policy risk

Policy risk is one of the greatest barriers to accessing affordable private capital at the scales needed. Policy risk is caused by poor, inadequate, or non-existent policy frameworks. Put another way, policy risk is reduced as investors become more certain about the policies that exist (and will exist) which influence the returns upon which the investors are relying to make the investment worthwhile compared with others they might consider.

Low Carbon and Resilient Development Program

The Low Carbon and Resilient Development Program (LCRDP) supports the implementation of nationally driven climate change action plans in developing countries and encourage public policies with high structural effects on investments and financial flows. A contribution by BFI (and with other international donors) is linked to a policy matrix, i.e. a set of key evolutions brought to the national regulatory framework. The policy matrix is country-driven and reflects the national priorities to tackle climate change.

A key feature of the LCRDP is that it is complementary to sector-based projects and provides a positive signal to private investors on the developing countries' willingness to address climate change in the longer term. Moreover, initiatives under the LCRDP can achieve what sector-based projects financed on a loan or grant basis would not be able to do – by focusing on the public sector policy development process and being of a sufficient size to capture the attention of officials at higher levels (including in central finance ministries) where decisions need to be made.

The LCRDP initiative by AFD and JICA started supporting countries with ambitious strategies to tackle climate change in 2008. The first LCRDP was in Indonesia. AFD with JICA have now provided USD 1.6bn over 2008-2010 direct to the state budget to support Indonesia's low carbon and resilient development strategy. The program supports expertise and technical assistance on specific themes, such as forests, renewable energy and energy efficiency.

Impacts of the Indonesia LCRDP include:

- improvements in the energy regulation in 2009 to set a feed-in tariff for geothermal electricity producers
- development of a regulation that will foster private investments in renewable energy
- REDD+ strategy, energy efficiency (e.g. set up of ESCOs)
- foster inter-ministerial coordination (establishment of the Climate Change Council)

The LCRDP initiative has since developed similar operations in Mexico, Mauritius and Vietnam and future operations are under preparation. Figure 6 sets out the elements of an AFD and JICA funded policy support program in Vietnam combining the policy improvement achieved through the LCRDP with corresponding actions using other financial and technical assistance projects.

Cumulative commitments by AFD on LCRDP represent more than €1.2bn over 2008-2010 for eight LCRDPs. AFD is also exploring climate change policy lending for local authorities, i.e. direct contribution to the local authorities budget without a government guarantee.

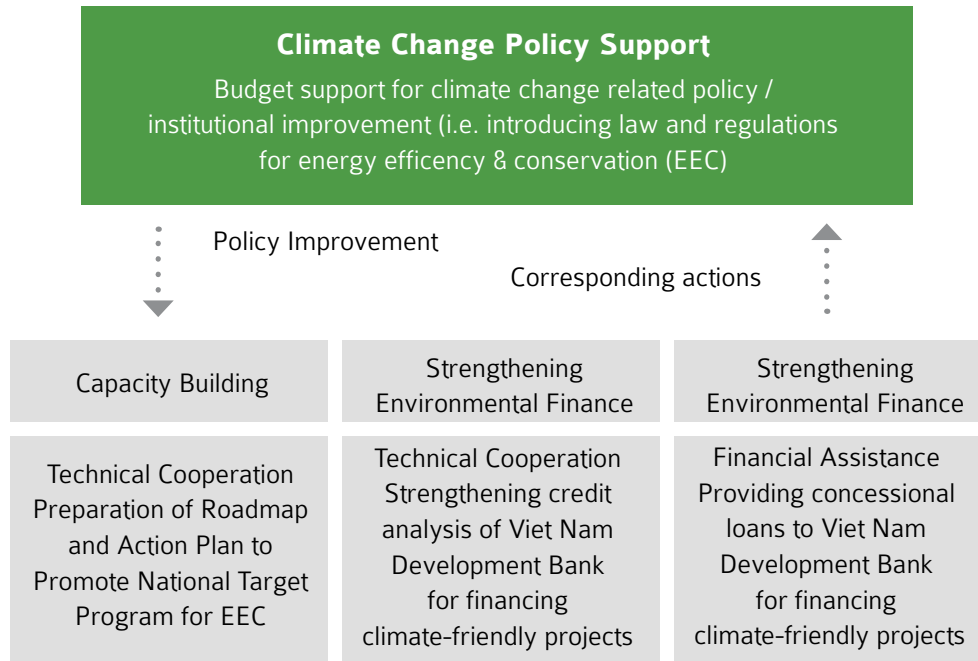
In Indonesia, JICA has also provided a similar strategic and multi-layered assistance. For example, JICA is providing technical assistance to the Indonesian government for developing the measurement, reporting and verification (MRV) system and NAMA for mitigation actions, together with the policy support through LCRDP.

NAMA Readiness

In a new initiative in partnership with NOAK (the intergovernmental Nordic Group on Climate Change), NEFCO is piloting market readiness programs on up-scaling mitigation action at a national level. This technical assistance project is initially working in Vietnam (cement sector) and Peru (solid waste management) and is being conducted within a NAMA framing with a view to build readiness for programs that may receive support and investment.

KfW has commissioned a study on how to use PoAs as a starting point for fast track, bottom up NAMA design and implementation. The study draws from the experiences gathered by KfW's PoA Support Center Germany and uses the programmatic CDM as a starting point for the development of NAMAs.

FIGURE 6.
Case Example: Support for energy efficiency in Vietnam



Source: Presentation by UNEP BFI CCWG to the United Nations, 9 March 2011

2.3 Green Credit Lines – getting affordable credit to ‘the ground’

Green Credit Lines provide appropriate funding and dedicated technical support to development banks and local commercial banks in developing countries aimed at building capacity and overcoming the financial and technical barriers to scaled-up investment. AFD, KfW, JICA and other BFIs have now developed partnerships with financial institutions in different countries on all continents.

An example is JICA’s Environmentally Friendly Solutions Fund in cooperation with the Sri Lanka National Development Bank and seven commercial banks. In parallel, JICA also provides a Technical Cooperation facility for local private firms accessing finance from this fund. JICA has been supporting similar low-carbon, energy efficiency investments through financial intermediaries and technical assistance in many developing countries including Indonesia, Thailand, India, China, Iran, Saudi Arabia, Poland, Latin American countries, etc.

Green credit lines help the recipient banks to develop their “climate” strategy and climate finance portfolio and mitigate credit risk – and in turn promote the financing of private green investments that comply with climate friendly eligibility criteria and support private companies and households in elaborating their green investments. Green credit lines provide banks with special partnership conditions allowing them to seize the opportunities of climate change finance. The BFIs work together with local banks in partnership to help them to identify investment potential, select sectors with the highest potential and define an action plan that aims to reduce the barriers to investment in the country. Loans granted to customers provide them with incentives (e.g. maturity) to invest.

In addition, KfW provides grants for consultancy services to support the implementation of energy efficiency and renewable energy (EE/RE) loan products and the institutionalisation of EE/RE within the partner lending institutions. This enables them to introduce a new innovative loan product, to gain access to new client groups, and to have an early entry into a growing green market. Partner countries thereby receive the transfer from KfW of a very successful and reliable model.

The design of all climate change credit lines is based on the recommendations from thorough market studies carried out by external experts. These studies mobilize all stakeholders (banks, companies, authorities) and provide insights on barriers that have to be overcome to develop investments in the field of climate change.

AFD and KfW have also developed tools to support and monitor their climate change credit lines. These tools estimate the carbon footprint and/or greenhouse gas emission reductions of different types of projects and provide insights to banks on the impact of their financing.

2.4 Risk sharing instruments – the key to lowering the cost of capital

The objective of risk sharing instruments is to mutualise resources and risk taking among a group of financial actors. These financial actors can be public bilateral or multilateral institutions, private institutions or other types of financial actors (e.g. foundations, investment funds, sovereign funds). Resources are pledged by these actors in a flexible financial vehicle (the risk sharing instrument) with a specific governance, and these actors usually have to co-invest in the project to ensure the quality of the investment.

Depending on different criteria (notably the financial capacity and the comparative advantages of the participants), resources are structured in order to maximise cost effectiveness of the action through equity/loan participation, first-loss piece or guarantee schemes. The implementing institution is responsible for the whole implementation of the financing on behalf of all the participants.

Risk sharing mechanisms have several benefits:

- They allow building a critical mass of resources and actors (e.g. for program financing).
- They promote and enhance synergies among financial actors based on their complementarity and comparative advantages.
- They allow for a leverage effect compared to one single institution and for mutualising risks between partners, thus optimising the use of the balance sheet of each of the financial institutions.
- They allow for shared approaches among financial actors thus facilitating adoption of common methodologies and diffusion of technical expertise.
- They can leverage scarce public funds with capital from DFIs and private investors in order to maximise the impact.
- They might be structured as Public Private Partnerships (PPP) bringing in private sector knowhow.

Funds for climate finance:

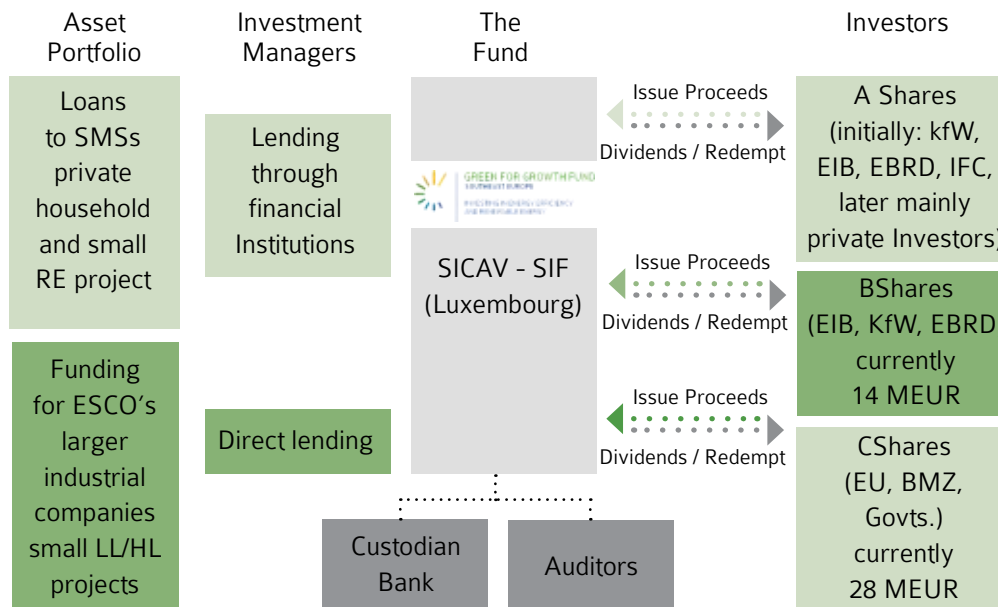
Example of **Interact Climate Change Facility (ICCF)**: The ICCF is an initiative of AFD, the EIB and twelve European development finance institutions (EDFIs). The fund was created in 2010, with an initial closing of €300mn. ICCF is a finance matching facility committed to creating a portfolio of climate friendly investments by the private sector in its target countries – in Africa, the Caribbean, the Pacific, Asia and Latin America.

ICCF is promoted to help catalyse financial flows through a risk sharing vehicle. It can be considered as providing high leverage effect tools to improve the use of existing resources. These types of mechanisms are by nature very flexible tools, adapted to tailor-made cooperation between financial institutions with a possible thematic or geographic focus.

Example of the **Global Climate Partnership Fund (GCPF)** and the **Green for Growth Fund, Southeast Europe (GGF)**: These are similarly structured Managed Investment Vehicles (MIVs) and as such public-private partnership funds involving donor agencies, international finance institutions and private institutional investors. The GGF and GCPF are mainly providing medium and long-term financing to local financial institutions in the partner countries. Figure 7 sets out the structure of for GGF.

These funds have a layered risk structure, resulting in three classes of shares, offering investors different risk-return profiles and comprising financial resources from multilateral and bilateral donors, states, international financial institutions and private investors, and are thus an important instrument of international development cooperation. Furthermore, this collective structure has been instrumental in encouraging much more cohesive donor activity in the financial sector.

FIGURE 7.
Structure of the Green for Growth Fund



Source: Presentation by UNEP BFI CCWG to the United Nations, 9 March 2011

The funds provide a range of financial instruments: medium to long-term senior loans, subordinated loans, syndicated loans, letters of credit, guarantees, mezzanine debt instruments and local debt securities. Partner financial institutions can be local banks and micro finance institutions which in turn on-lend these funds to SMEs, private households and municipalities, for them to finance adequate investments in energy efficiency measures and renewable energy. In addition to this, direct financing from the funds' capital is possible (to a limited extent) for pilot projects in the area of renewable energy. The funds also have a financing component for accompanying consultation services. The funds are used on a rolling basis, allowing the money which is paid back to flow into the fund assets. This instrument does therefore not continually eat into public funds on the provider side.

First loss guarantees

EIB provides first loss guarantees in equity or debt funds in order to reduce the risk level for private investors and attract more capital from the private sector. This is done in cooperation with other organisations providing grants.

Separate treatment of political risk

Carving out of the political risk from guarantee contracts, including transfer and convertibility risk, has enabled the EIB to provide long term loans to private sector

borrowers for which otherwise no adequate guarantees would have been available.

2.5 Support for carbon markets

Conditional loans for CDM project promoters

This EIB facility helps project promoters with the preparation and registration of CDM projects. Finance is provided in the form of a conditional loan, only to be repaid in case of project registration by the CDM Executive Board.

Carbon Funds – Climate certificates

The **KfW Carbon Fund** is KfW's procurement platform for project-based carbon credits issued under the flexible mechanisms of the Kyoto Protocol. The KfW Carbon Fund offers tailor-made services for CDM/JI projects. KfW, on behalf of the German Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (BMU), implements the PoA Support Centre Germany. The aim is to reach so far untapped small and micro emission sources that would not be able to afford the CDM/JI transaction costs individually. The scope of work of the PoA Support Centre comprises the development

of a portfolio of eligible Programmes of Activities (PoA), capacity building activities and dissemination of information. An experienced partner for projects, KfW offers advisory, structuring and assessment services for program proposals as well as financing and grants to cover the preparation of program concepts, project design documents (PDDs) and monitoring plans.

The purchase of post-Kyoto certificates makes long-term purchases possible and KfW provides support for project and program development. KfW, in conjunction with EIB launched EIB-KfW Carbon Program II with a volume of EUR 100 million. The focus is on sustainable projects in least developed countries and programmatic CDM (PoAs).

2.6 Financing forest protection and REDD

Since the 1990s, KfW has been working on projects devoted to biodiversity with funding of more than €1.4 billion, laying a solid foundation for the conservation of the forests as part of wider efforts to tackle climate change. KfW contributes to the REDD readiness process, for instance by financing satellite-based monitoring and field stations and by developing national emissions registers. It also helps with the large-scale implementation of REDD plans, covering such areas as fighting forest fires, monitoring illegal felling, protected area networks, sustainable forestry management and land rights. Funding can also be provided for the development and implementation of financial incentive schemes – such as grants for forest conservation and payments for environmental services – and the compensation of proxy-based REDD emissions reductions, both designed to reach the local population as they are the ones who are directly dependent on their environment being protected.

The EIB supports investments in afforestation and reforestation, forest management improvement, forest fire prevention measures and forestry funds to help to combat erosion, diversify rural economies and create carbon sinks.

2.7 Support for small and medium size projects and programs

Partial guarantees

The NEFCO administered **ProClimate Facility**⁷ is a pilot partial climate guarantee and associated technical assistance facility. The purpose of the facility is to support small and medium sized climate friendly investment projects that often would not otherwise be realised due to lack of financing or their size. The facility targets renewable energy, energy efficiency, and cleaner production projects in low income countries. The provision of guarantees is to close remaining financing gaps and so complete the financing plan. Projects should at a minimum have equity sponsors and a credible financing plan and preferably have expressions of interest from identified providers of senior debt. The facility is a risk bearing instrument which provides cover against possible default on loan repayment. The Facility is currently assessing opportunities in east Africa, central America and the Mekong sub-region in Asia, working with commercial banks and development finance institutions.

Contestable proposal calls for grants

Under the NEFCO administered **Nordic Climate Facility** for small projects/programs, there is an annual call for innovative proposals for climate change adaptation and mitigation activities in low income countries. The best proposals may receive grant financing amounting to between €250,000 and €500,000. The third call for proposals launched in October 2011 has been granted €6 million by NDF for the theme **Innovative low-cost climate solutions with focus on local business development**.

⁷ The ProClimate and Nordic Climate Facility are funded by Nordic Development Fund, a sister organisation to NEFCO, also owned by the five Nordic governments.

Benefits of innovative climate finance instruments

This section looks across the range of innovative instruments described in section 2 to see what might be said with respect to the attributes of **effective** and **efficient** set out in Box 1.

3.1 Scale

The scale of 'innovative finance' provided by the BFIs in the UNEP CCWG has not yet been separately assessed in the mapping report exercises. This is something that could potentially be assessed in future years. As noted, innovation comes not only from the use of specific individual instruments; it can also be true of mixes of instruments including of 'classical' instruments.

Separate from the scale of funds is the scale of outcomes denominated in metrics relevant to climate change mitigation and adaptation. AFD has developed tools to support its climate change **credit lines**, such as the AFD Carbon Footprint tool which estimates the carbon footprint of different types of projects and provides insights to banks on the impact of their financing.⁸

3.2 Timeliness

Decision making procedures of bilateral development and finance institutions can be (much) faster than multi-governmental institutions, including UN agencies and MDBs. This is true with 'classical' financial instruments as well as the innovative ones discussed here. Being small(er) and nimble has its benefits. NEFCO, for example, is able to quickly pilot and test ideas that, if proven successful, can be taken up and enhanced by the larger BFIs in the group. In turn, their successes can inform strategies and programs of the multilaterals.

3.3 Leverage

The leverage effect of the BFI instruments can be seen in two senses. First, there is the leverage of one public sector institution's financial intervention(s) on the public monies coming into an overall financing package from other BFIs and MDBs. The **blending facility** mechanisms are a good case in point of this working. Second, there is the crucially important engagement of and 'crowding-in' of private sector capital – crucial, because the scale of

private sector investment needed is many multiples of the public sector finance that can be expected.

Tools can be seen as innovative if, for example, they explicitly bridge the financing gap of the private banking system in developing countries where tools to finance climate change are often inappropriate – and, in turn, catalyse other investments in the longer term.

Instruments addressing **risk** are especially important for leverage, such as the:

- **Interact Climate Change Facility;**
- **Global Climate Partnership Fund and the Green Growth Fund**
- **Green Credit Lines;**
- **treatment of political risk;**
- **conditional loans for CDM project promoters;**
- **first loss guarantees; and the**
- **(NEFCO) partial guarantees.**

These instruments might be considered as direct front-line financial tools. Equally important are the more indirect policy and capacity efforts that are the focus of the **Climate Change development Program Loan** initiative and the **technical assistance** elements of the financial instruments. The outcomes of these can provide positive signals to private investors on countries' willingness to address climate change in the longer term. In turn, this can reduce policy and project risks that may be core barriers to the engagement of more risk-averse private sector investors, especially those managing institutional investor capital – which is the largest source of private sector capital being globally invested, albeit only in limited amounts thus far in 'green' investments in developing countries.

3.4 Flexibility

The ability to be more nimble generally then applies also to being more flexible. This also can be seen in the ability to tailor packages of 'classical' and 'innovative' instruments, including across multiple BFIs working with each other – and with multilaterals and local banks. The **blending facility** mechanisms showcase this point in particular.

⁸ These tools are freely available on AFD's website at <http://climatechange.afd.fr>.

3.5 Scalability and Replicability

(these attributes are taken together here because the aspects of the instruments that connect to one typically also connect to the other):

In practice, the outcomes of the UNEP BFI CCWG have been built over time by learning what works well (and doesn't) from initial trials and pilots. These instruments are now applied in multiple project financings in multiple countries in multiple regions. Importantly, through stimulating the financial sector and the access of small and medium-sized enterprises to needed finance, they can contribute to the development of the market for energy finance and thus the more sustainable development path sought by many countries.

However, this BFI experience does not suggest an assembly line 'one size shoe for all' approach can now be taken. Scalability and replicability stem, in large part, from the diversity and flexibility of individual instruments, so the ability to package solutions appropriate to specific sector and national circumstances.

The constraints on scalability and replicability mostly connect to resources and capacity – so levels of public finance available and numbers of skilled and trained people on both sides of the bilateral relationships. There can also be issues of the investment environment in receiving countries, which the **Climate Change development Program Loan** initiatives are seeking to address.

3.6 Localisation

(The building of local 'ownership' and durability of outcomes through engagement with, and building capacity of, domestic actors)

A 'bottom-up' principle generally can be seen in the modalities by which BFIs operate. Instruments and initiatives such as the **Climate Change development Program Loan**, the **Green Credit Lines**, the **Blending Facilities**, the **Global Climate Partnership Fund** and the **Green for Growth Fund** all have the feature of engaging with host country governance and development finance institutions.

Providing local banks with special partnership conditions that allow them to seize the opportunities of climate change finance can be an important innovation. This also is true of tools that lead not only to improve the knowledge of local stakeholders but also to enhance local authorities' capacities to implement supportive policies.

The BFI approach therefore provides more direct access avenues to local players, so has the effect of leverage of another kind – locally knowledgeable human capacity.

3.7 Least cost

In economic terms, 'least cost' is normally seen as a core efficiency objective, albeit often just in the narrow sense of eliciting cheaper opportunities before more costly ones – so using market-based economic instruments like carbon taxes and emissions trading schemes to progressively move up the 'cost curve'.

A recent focus of study on climate finance and investment has been the importance of finding means to lower the cost-of-capital of the finance needed for 'green' investments. This line of reasoning suggests that overall project costs can be lowered substantially (and the use of green technologies preferred to 'brown') by reducing the risk of investments and thereby accessing equity and debt finance with lower expectations of returns and interest.⁹

This point is connected with the discussion above on leverage and risk – so, noted there, the range of instruments being provided by BFIs that have the effect of lowering risk and lowering the cost of capital.

At a practical and implementation level, one aspect of least cost is the use of processes in making finance decision that help minimise any rents or windfalls. This can be achieved, for example, through the detailed analysis supported through **technical assistance** facilities or the contestable processes of the **Nordic Climate Facility**.

3.8 Transaction costs

The efficiency objective of lowering transaction costs has as its simple objective to have as much of the finance leaving the 'balance sheet' of the original provider to arrive at its final use destination and achieve the sought mitigation and adaptation outcomes.

The Mutual Reliance Initiative, spearheaded by AFD, EIB and KfW, (see section 2.1) is an example of an initiative to reduce transaction costs.

9 The importance of this point should not be under-valued. It is clear that trillions of 'dollars' are needed in coming decades for investments in climate change mitigation and adaptation in developing countries. Public monies from developed countries is not available in the trillions. These amounts are of the scale of investments of institutional investor capital; however this tends only to be available in relatively low-risk investment bands – because pension funds and insurance funds have a primary need to pay out pensions and insurance claims. Risk, cost of capital, and the availability of funds at needed scale are therefore inextricably linked.

The Green Climate Fund and BFIs

The attention of the international climate finance community in 2011-12 is on the development of the institutional settings and working modalities of the 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 and the insights above about the role BFIs are currently playing 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, these resources being blended with their own resources. The blending would be mainly achieved through financial intermediaries. Existing **blending mechanisms** could be a model way to structure and implement GCF fundings in order to have quick, effective and efficient results.
- 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 and 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.



Key Insights and Conclusions

Key insights about the workings and achievements of BFs evident through the information provided in this report, and its underlying analysis, are:

- Significance of financing scale:** BFs provide a large portion of public finance currently flowing to developing countries for climate change mitigation and adaptation – estimated at 25% of global public finance in 2010. Importantly, the finance provided by BFs also has a wide coverage at both regional and sectoral scales. However these realities generally are not well known or recognised by the climate policy community. There is a risk, therefore, that the architecture of the international and domestic frameworks being put in place for the future expected increased levels of climate finance may not properly build from the successes of existing innovative finance approaches by BFs.
- Eye on the big picture:** Because on the funding ‘provider side’ BFs are connected to countries’ development and climate policy agencies, they have a bigger picture perspective and focus in terms of the outcomes they are mandated to achieve. In financing practice this, for example, translates to having a longer term vision and being able to switch from a project approach to a programmatic one depending on the circumstances of the country and sector, including across borders and supply chains (e.g. in the urban transport sector). The support for policies and planning needed to improve investment environments stems from this same big picture perspective.
- Technical expertise:** BFs have many years of experience 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.
- Local knowledge and engagement:** BFs 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.
- Human capital:** Scale is not something that should just be measured in the amount of funds. Another critical scale factor is the human capacity to deliver this quickly, efficiently and effectively – so achieve tangible results that meet the needs. BFs have considerable human capacity available to deliver their existing levels of financing activities. For some BFs this is further augmented by those working directly and indirectly in the field for associated bilateral development assistance agencies.
- Key points of leverage:** It is simply a statement of fact that public funds from developed countries are many times smaller than the scale of the global need for investment in climate change adaptation and mitigation. Private sector capital is needed in very large volumes. While in theory this is available, in practice it needs to be crowded in by smart public sector side interventions that work to get the risk-reward ratio in the ‘right’ zone for the critical private investor groups. BFs have proven experience with both financial instruments and policy-side support interventions that target these key points of leverage.
- Diversity of solution packages:** BFs provide a wide range 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.
- Nimbleness:** Among international financial institutions, BFs typically have easier and faster modalities for disbursements, and higher flexibility to decide and close on innovative financing solutions.
- Collaborative spirit:** BFs (as with individual countries’ development assistance agencies) are increasingly aware of the importance to collaborate and avoid duplication of effort. In the UNEP BFI CCWG there is already a significant practice of joint financing effort. There is potential for further expansion and collaboration, e.g. by and with the bilateral funding agencies from countries not included in the CCWG. In addition collaboration is important in ways beyond just the practice of finance, e.g. to enable effective coordination amongst this group of institutions, whose efforts need clear recognition by UNFCCC negotiators, and whose impact can be supplemented through greater awareness, closer coordination and potentially increased cooperation in their areas of activity.

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