

Finance for climate action: Scaling up investment for climate and development

*Summary of the Independent High-Level Expert
Group on Climate Finance report*

Amar Bhattacharya

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Report of the Independent High-Level
Expert Group on Climate Finance

November 2022

Members of the Independent High-Level Expert Group on climate Finance

Co-chair



Ms Vera Songwe

Co-chair



Professor Lord Nicholas Stern

Executive Secretary



Mr Amar Bhattacharya

IHLEG members



Dr Amal-Lee Amin



Dr Barbara Buchner



Mr Daniel Titelman



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Mr Jean-Paul Adam



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Dr Muhamad Chatib Basri



Dr Omar El-Arini



Mr Alain Ebobissé



Mr Christoph Bals



Ms Sara Jane Ahmed



Professor Avinash Persaud



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Secretariat

Context

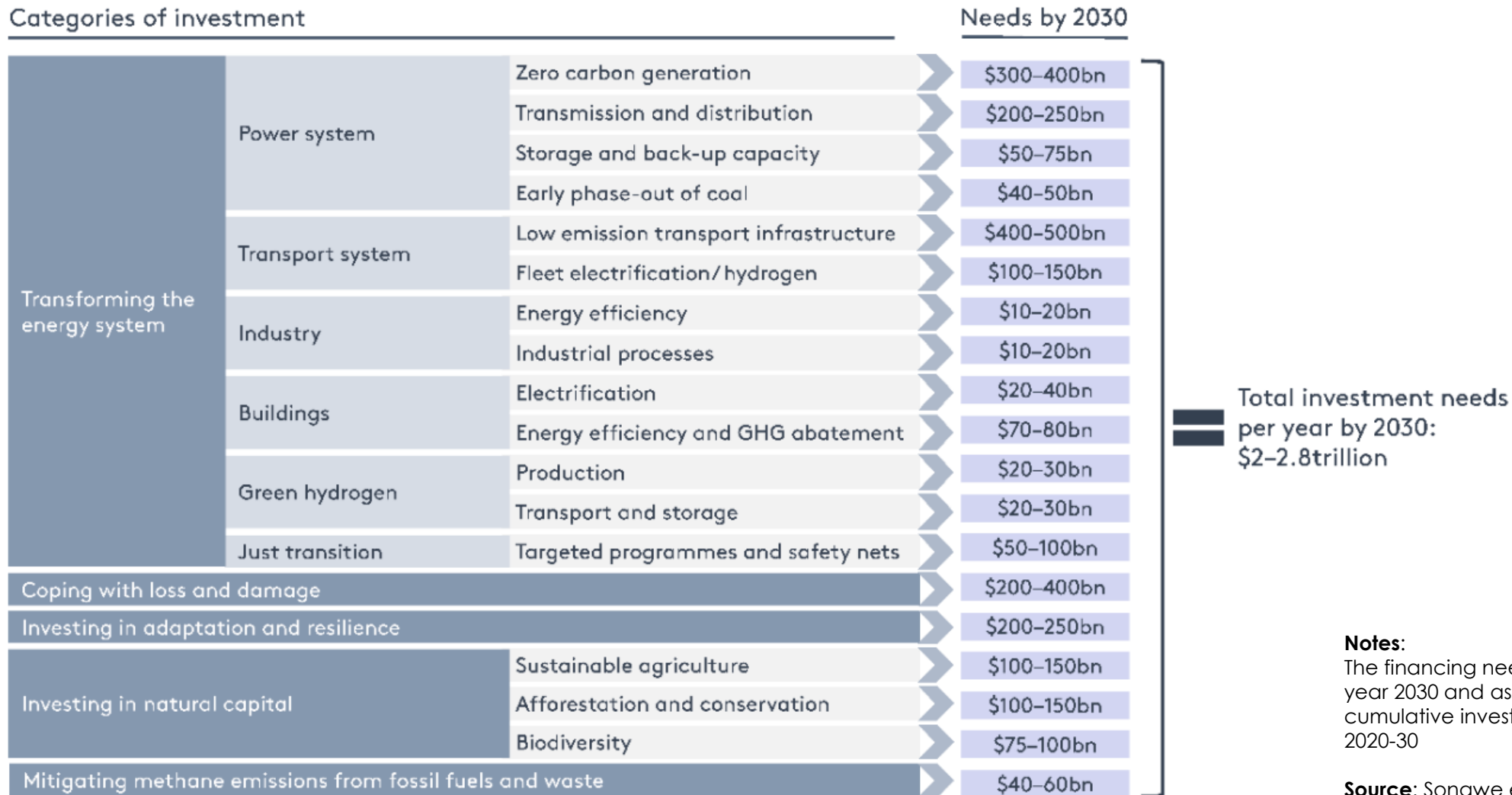
- A moment of great risk and great opportunity. One path leads to attractive growth and development, the other to great difficulties and indeed destruction.
- Even before the COVID-19 pandemic, EMDEs were facing challenges. As a result of the Covid pandemic and the war in Ukraine, **EMDEs are under great pressure**.
- The present trajectory is one of slow growth, low investment and public spending, and rising debt service burdens in many, if not most, EMDEs.
- At the same time the urgency and opportunity of tackling climate change is becoming ever clearer. Acting on climate is not a cost as many have propounded but rather an opportunity to unlock new and better forms of growth.
- **There is a real opportunity** to make a breakthrough on both development goals and climate, building on the progress achieved by emerging markets and developing economies (EMDEs) and new technological options.
- Seizing that opportunity will **require a clear strategic direction, strong and purposive policies, a massive scaling up and shift in investment and the mobilisation of the right finance at the right scale**.

Finance for what? Investment and spending priorities for climate action and sustainable development

1. A major, rapid, and sustained investment push is needed to drive a strong and sustainable recovery out of the COVID crisis, transform economic growth and to deliver on shared development and climate goals.
2. While the investment push is needed across the full spectrum of the sustainable development goals, the key investment and spending priorities to ramp up climate action and deliver on the related sustainable development goals are:
 - **Transformation of energy systems:** major and rapid scale up of renewable energy; complementary public infrastructure; energy efficiency and transformation of demand; just transitions. Curb methane emissions.
 - **Respond to the growing vulnerability of developing countries** to climate change: both more frequent and damaging extreme events and the effects of “slow onset” especially on heat, precipitation and water. This will mean much better mechanisms to deal with loss and damage as well as greatly accelerating the investments in adaptation and resilience.
 - **Investing in sustainable agriculture** which will be key to mitigation, adaptation and development. And we must ensure that we begin to restore right away the damage that we have done to our natural capital in terms of degraded land, deforestation, and damage to our water supply and oceans.

Investment gaps are significant across all sectors

Investment/spending needs for climate action per year by 2030



Notes:

The financing needs are estimated for the year 2030 and as such do not represent cumulative investments for the decade 2020-30

Source: Songwe et al. (2022)

Investment must scale up by several points of GDP

Investment/spending needs per year for sustainable development and climate action for EMDCs (other than China):

Estimate	2019 US\$ billion	2019 % GDP	2030 US\$ billion	2030 % GDP	Gap (2030 minus 2019) ¹ US\$ billion	Gap (2030 minus 2019) ¹ % GDP
SDG-related investment²	2,385	11.3%	5,880	18.2%	3,500	6.9%
Of which climate and related investments³	450	2.1%	2,250	6.9%	1,800	4.8%

Notes:

1. Gap is defined as difference between estimated investment needs in 2030 and current baseline of investment in 2019.
2. Human capital, sustainable infrastructure (including on the energy transition), adaptation and resilience, AFOLU.
3. Energy transition, adaptation and resilience, AFOLU

Source: Bhattacharya et al. (2022)

The growth and structural change agendas in EMDCs will already entail substantial energy investment. Savings from avoided investments in fossil fuels in EMDCs dwarf additional climate investment needs.

Investment requirements in natural capital, adaptation and resilience, and spending on loss and damage will be additional.

Translating investment opportunities to reality: unlocking ambitious investment programmes

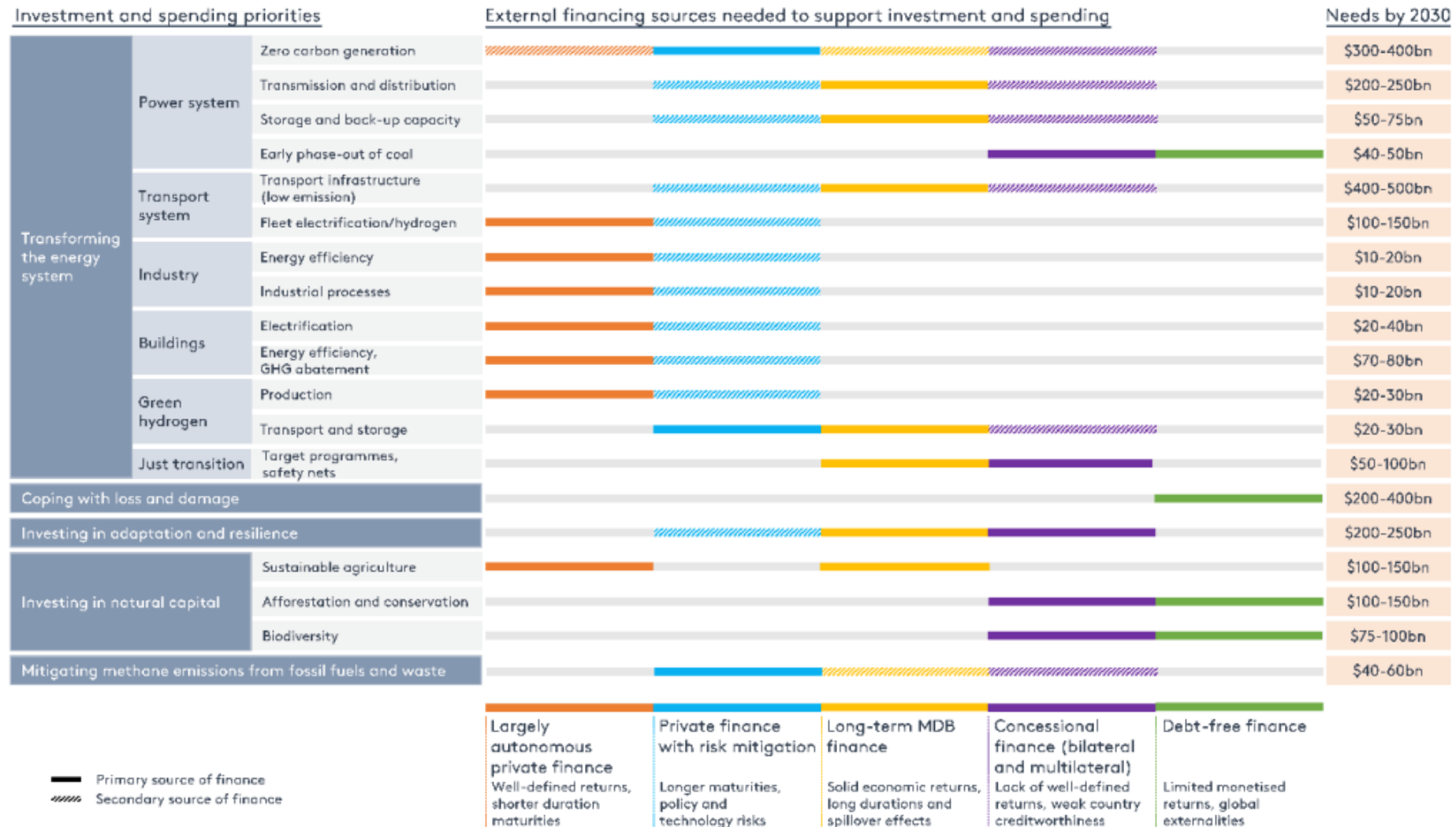
- Investments to ramp up climate action, for both mitigation and adaptation, will remain academic, unless countries are able to develop and implement investment programmes in a purposeful way.
- These **programmes need to be translated into concrete pipelines of projects and supported by a favorable investment climate**. Investment depends on expectations, and clarity and credibility over the medium term are crucial.
- Countries will need therefore strong and sustained policy and institutional reforms to unlock the scale and quality of investments that will be needed, much of which will have to come from the private sector. A concerted push will be needed on **capacity building**.
- **Country/sector platforms**, driven by countries, help bring together key stakeholders around a purposeful strategy, scaling up of investments, tackling binding constraints, ensuring a just transition and mobilization of finance especially private finance.
- It will also be important to make market mechanisms work more effectively and efficiently to direct capital where needed.

A New Approach to Finance: Scale, Urgency and Options

- The scale of the investments needed in EMDEs over the next five years and beyond will require a debt and financing strategy that tackles festering debt difficulties, especially those of poor and vulnerable countries.
 - That leads to a major expansion and **revamp of both domestic and international finance, public and private.**
- An overall financing strategy must utilise the **complementary strengths** of different pools of finance to ensure the right scale and kind of finance and to reduce the cost of capital rather than simply focusing on the aggregate number.
 - It must embody a **holistic and comprehensive approach** to climate finance.
 - It must **align all finance with sustainability, including climate goals**, in line with Article 2.1c.
 - It must **create the necessary partnerships** to deliver concrete results.

An additional \$1 trillion per year is needed in external finance from different sources

External financing sources for investment and spending priorities for climate action and related development goals



Notes:

The categories of investment and spending necessary to meet climate and development goals are shown on the left-hand side. For each, we outline the mix of financing needed from external sources to support the related investment and spending priorities.

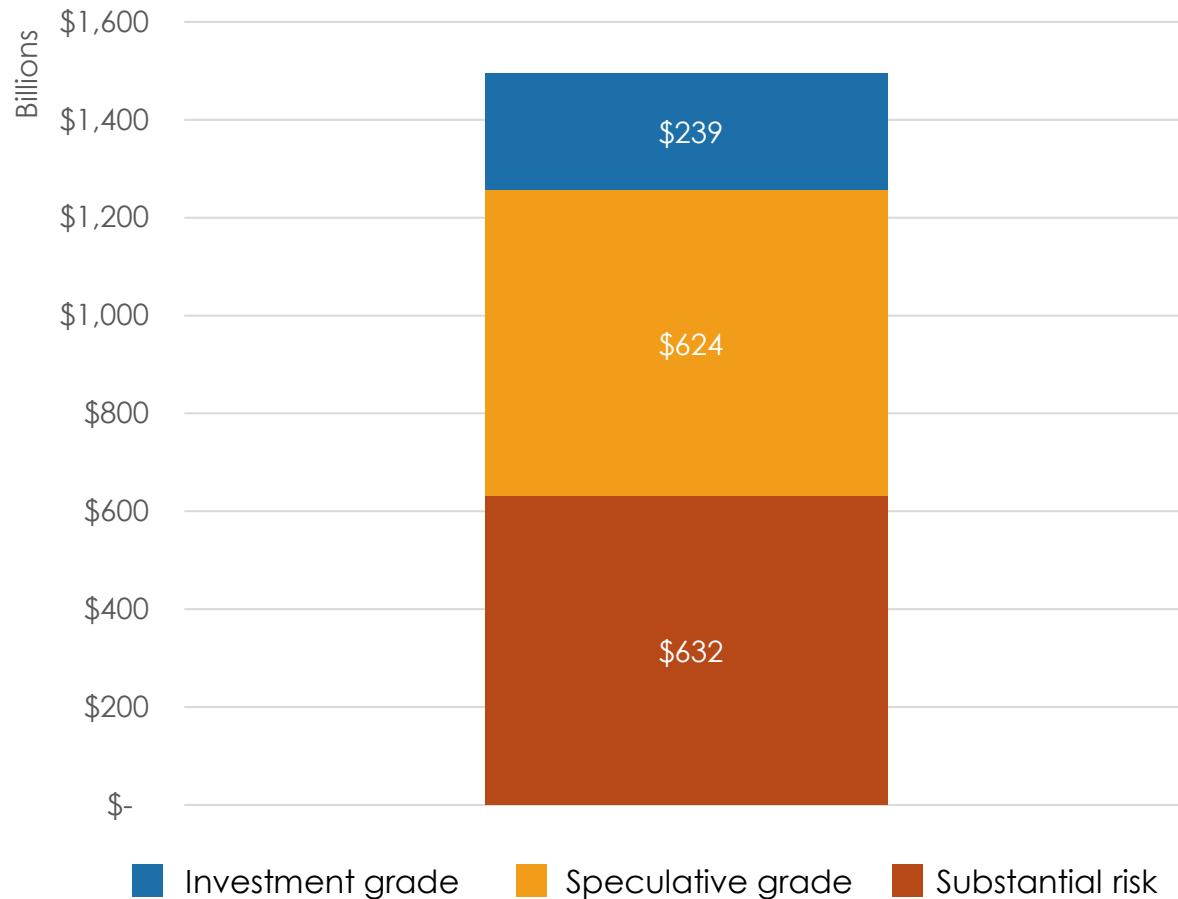
We distinguish between sources that would constitute the primary source of financing for one sector, and those that would play a secondary role.

On the right-hand side we outline the estimated investment and spending requirements by 2030 for each category.

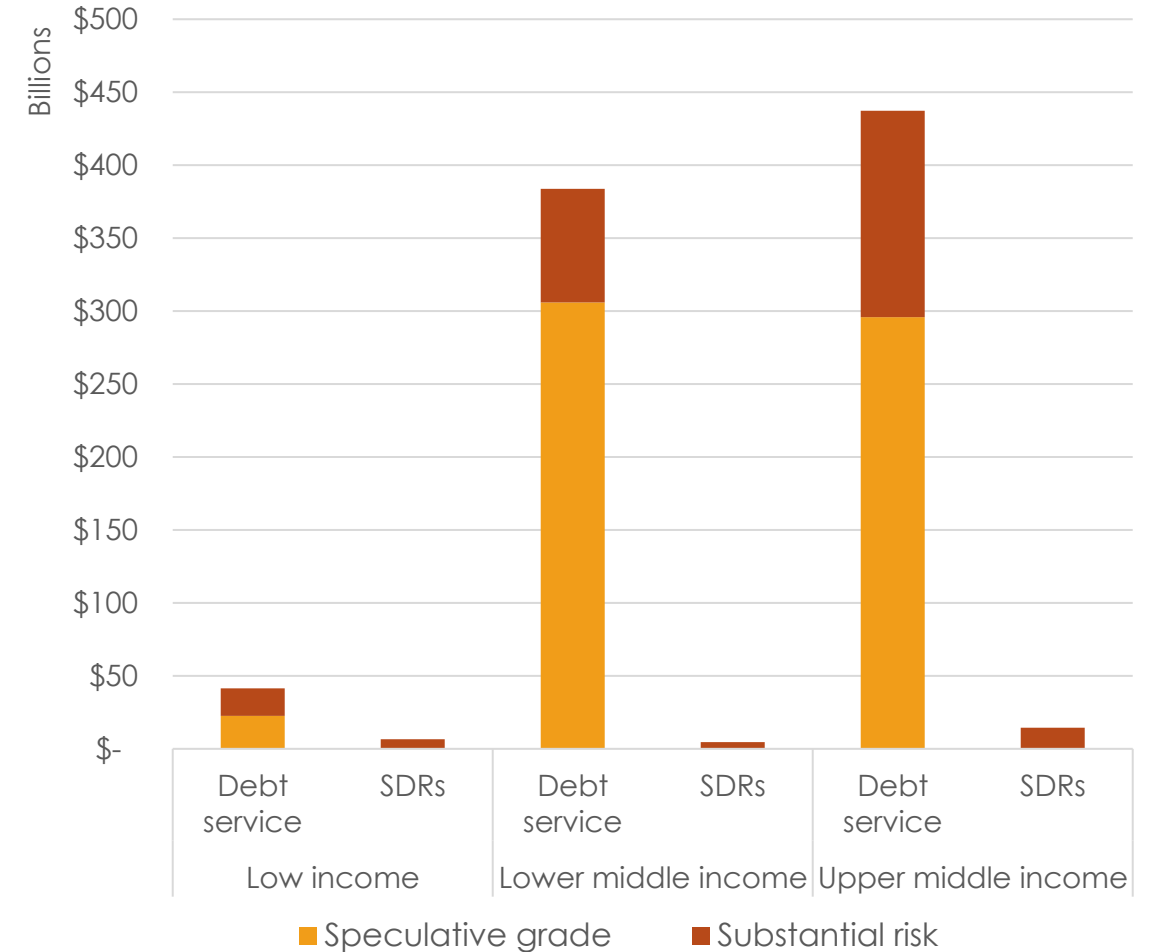
Source: Bhattacharya et al. (2022)

Rising debt obligations

Total developing country (ex. China) debt service, external PPG, 2021-2025



Speculative grade and below, total debt service 2021-2025 vs. SDR allocation

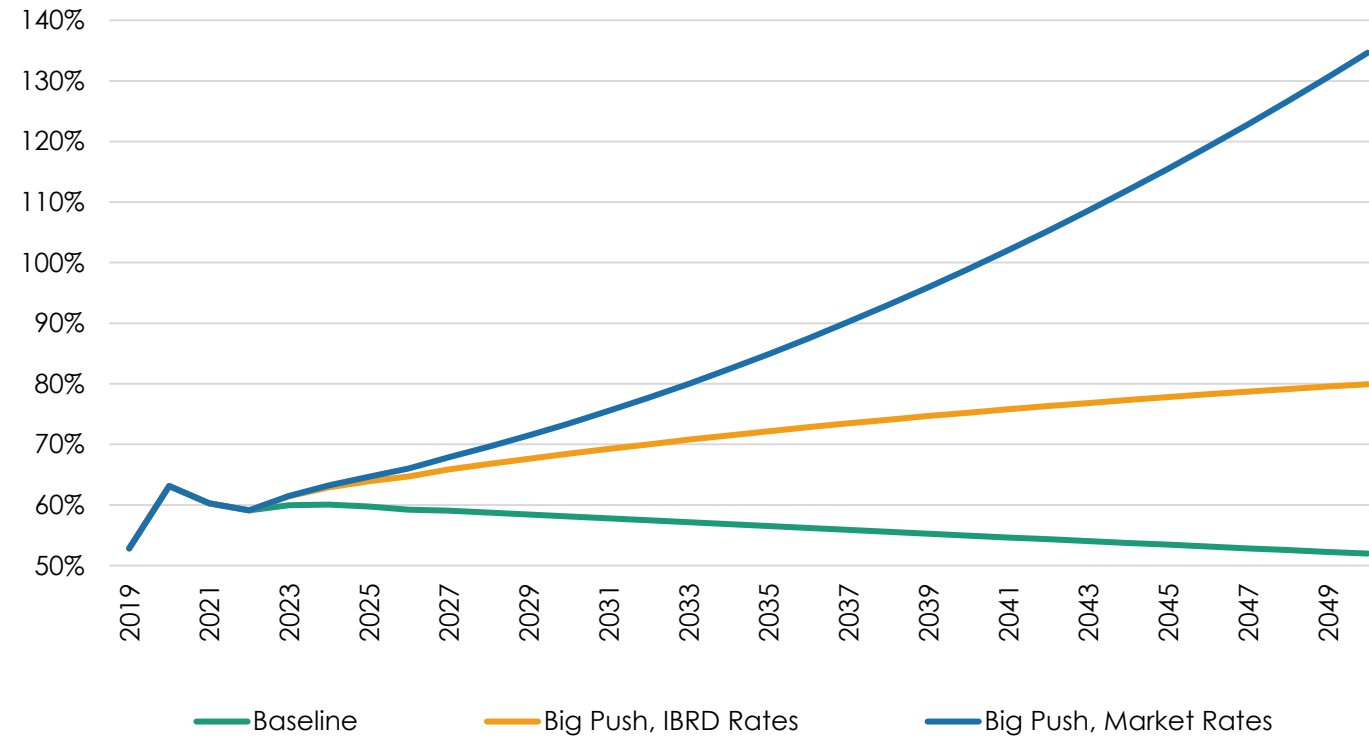


Debt and debt sustainability

- **A public debt overhang is a key bottleneck** to accessing new resources for needed investments. They can be alleviated over time if sound public investments are made.
- New research suggests that many debt servicing **difficulties stem from over-reliance on pro-cyclical private finance** (a liquidity problem), **and from inadequate global mechanisms to insure against shocks.**
- Tackling these debt difficulties will require a comprehensive approach with tailored solutions:
 - expanding access to low-cost official liquidity facilities
 - expanding the envelope of low-cost finance
 - including systematic debt-suspension clauses in loan contracts in the event of a natural disaster, as pioneered by Barbados
 - improving the functioning of the G20 Common Framework
 - modifying criteria for allocating concessional finance to include climate vulnerability
 - and expanding the use of debt/climate/ nature swaps.
- A “big push” strategy worsens creditworthiness by adding to fiscal deficits and new borrowing but improves it by raising growth and income levels. Simulations suggest **the net effect is to improve creditworthiness.**

Addressing the debt challenge

Average developing county debt projections from 2019 to 2040



Source: Songwe et al. (2022)

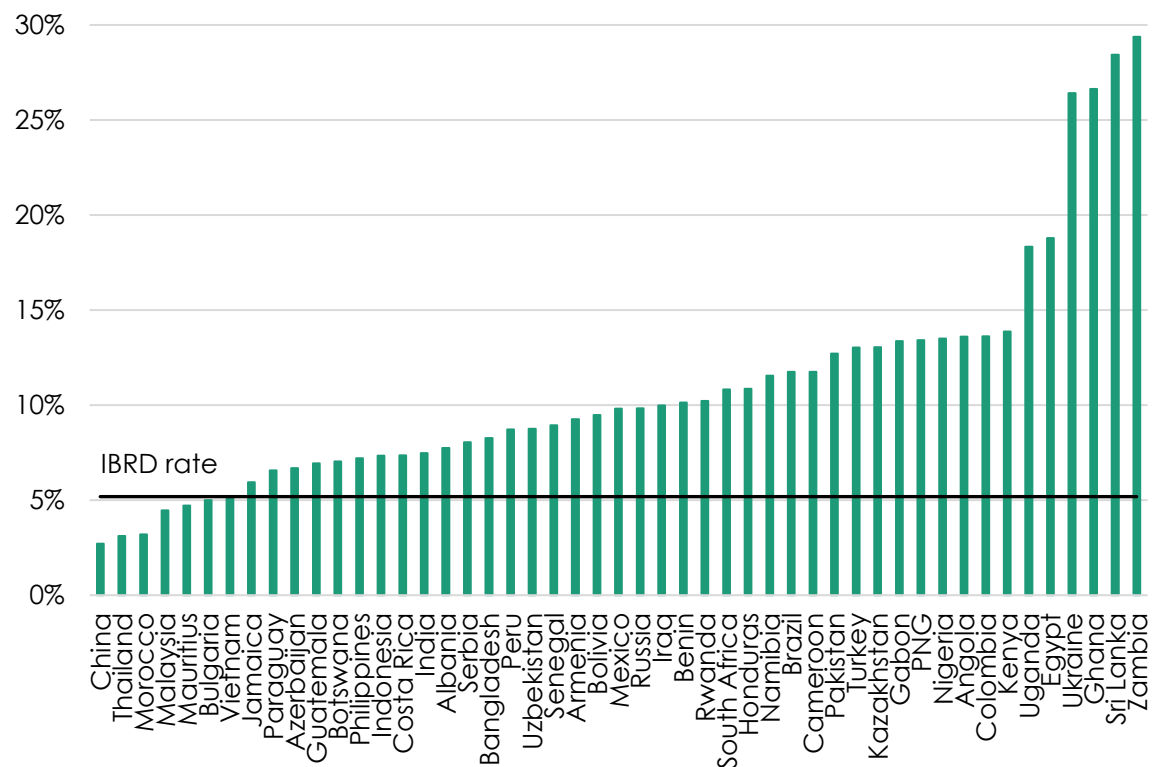
A big push strategy is feasible only if the incremental financing comes largely on terms that are affordable, comparable to IBRD rates of interest.

Mobilizing private finance at scale

- A growing proportion of investments can now be undertaken by the private sector. However, the mobilisation of private finance today is far too low and will have to increase many times over.
- Several private-sector led initiatives have been launched over the past two years to mobilise finance for sustainable investments in EMDEs, including GFANZ. The IFC and other private sector arms of the MDBs have also come forward with important new initiatives to catalyse private finance.
- **Private and public sectors need to work together** to unlock investment opportunities, reduce, manage and share risk, and bring down the cost of capital. Promising de-risking tools to facilitate the translation of financial assets into financial flows for a strengthened response to climate change.
- While there is broad private sector commitment to align with climate goals and increase financing for climate action, there is now a **need to develop concrete and standardised approaches** that can unlock institutional capital at scale.
- Sustainable finance agenda to help expand and improve the alignment of climate finance.

The cost of capital must be tackled

Developing country 10-year bond yields



Source: Trading Economics and World Government Bonds, Market Insider, and Haver Analytics

Return expectation from solar projects in EMDCs

Country	S&P Rating	Required return from solar project (%)
Germany	AAA	7%
USA	AA+	9%
UAE	AA	10%
Saudi Arabia	A-	12%
Chile	A	12%
Morocco	BBB-	15%
India	BBB-	17%
Algeria	B	18%
Oman	BB-	18%
Peru	BBB	20%
Costa Rica	B	21%
Namibia	BB-	21%
Ghana	B-	22%
Brazil	BB-	22%
Nigeria	B+	22%
Bolivia	B+	24%
Tanzania	B	24%
Egypt	B	28%
Zambia	CCC-	38%
Argentina	CCC+	52%

Source: CPI, forthcoming

MDBs are central to the expansion of investment in climate and development action in EMDEs

- Considering the scale and urgency of current climate and development challenges, MDBs need to significantly increase their activity moving from a counter-cyclical to a sharp investment focus.
- Building on their combination of policy advice, investment and capacity building, MDBs need to re-orient their strategies and operational activity to:
 - **step-up engagement with their countries of operations** to support the formulation of effective development and climate strategies and plans including LTS, NDC, NAP and sector decarbonisation pathways
 - **accelerate economic and sectoral policy analysis and advice driving transformative change**, including strengthening the investment climate in countries which is key to expand private sector involvement and finance
 - **build-up investment planning and project pipeline development** including support to definition of optimal sector investment plans consistent with sector decarbonisation pathways
 - **expand support to country institutional and capacity building.**
- MDBs must play a key role in supporting country-based sector platforms driving mitigation, adaptation and nature protection actions building on their strong dialogue with their countries of operations.

Unleashing the potential of the MDBs and DFI system (1)

- **Working as a system, the MDBs should engage with countries and the private sector** to play a purposive and proactive role in helping countries define, identify, enable and foster the investments and programmes necessary for the implementation of the Paris Agreement, reinforced by the Glasgow Pact. This should include strong support for country and regional platforms.
- A large **scale-up in the collaboration between MDBs and the private sector** is warranted, given the major role of the private sector in the necessary investments and their finance.
- **The MDBs must significantly increase their work with the public sector** and authorities to enable the large necessary public investments that are core to the overall necessary investment programmes.
- The MDBs and their shareholders must explicitly recognise that these tasks **require a multiplying of their flows of finance by a factor of three in the next five years**. This would also make the cost of capital manageable.

Unleashing the potential of the MDBs and DFI system (2)

- This scaling up of financial flows from the MDBs can be **built in part on more effective utilisation of the capital already available**, including by applying the ideas of the valuable recent report on capital adequacy commissioned by the G20.
- Shareholders must also recognise that **capital increases for the MDBs over the coming five years will be required** to achieve the necessary three-fold increase in flows
- The ideas from the Capital Adequacy Frameworks (CAF) (including the greater use of guarantees) and the capital increases required are very low cost to the budgets of country-shareholders in relation to the flows of resources released. In the language of finance ministries, they are **extraordinary ‘value for money’**.
- Beyond the MDBs, there is great potential to harness the entire public development bank system.
 - **Bilateral DFIs** can greatly step up their support for green investments.
 - **Local development banks** are best placed to provide a powerful impetus to local lending, longer horizons, public domestic resources, and local capital markets.
 - Creating a **new architecture of cooperation among development banks**, as the Finance in Common initiative is trying to do, can be a powerful means to accelerate climate investments.

MDB's financial parameters

Capitalisation structure, commitments, statutory gearing ratios and headroom (US\$ billion)

Estimate	Total equity	Paid-in capital	Callable capital	Commitments	Lending limit ¹ , (loans/capital ratio)	Headroom
ADB	52.6	7.6	145.6	16.1	1.0	68.4
AfDB	11.1	7.1	134.1	6.0	1.0	94.9
AiIB	20.1	19.4	77.4	10.0	1.0	93.9
EBRD	22.9	7.2	27.2	12.7	1.0	18.3
EIB	85.1	25.7	262.4	76.5	2.5	353.4
IBRD	49.8	18.6	279.2	30.5	1.0	110.2
IDB	34.1	11.9	164.9	45.3	1.0	94.3
NDB	10.3	10.0	40.0	10.3	1.0	43.7

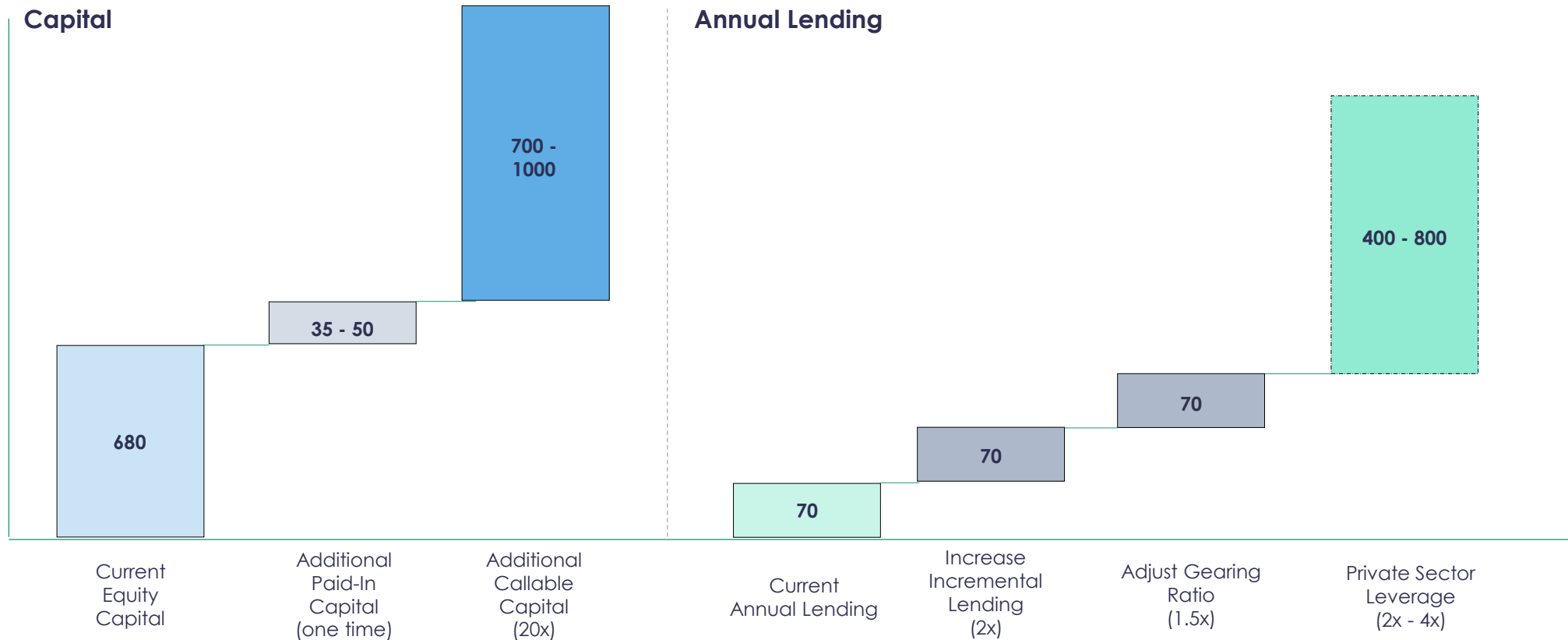
Notes: Data based on latest fiscal year (2021 or 2021).

1. The lending limit is defined as the amount that an MDB can lend relative to the amount of capital it has on its balance sheets, including both paid-in and callable capital where relevant.

2. The figures used for AfDB, AiIB and NDB represent approvals by the banks instead of commitments.

Sources: Moody's Investor Service; ADB Information Statement 2021; AfDB Annual Report 2020 and AfDB Financial Report 2020; AiIB Auditor's Reports and Financial Statements 2020 and AiIB Annual Report 2020; EBRD Investment of Choice 2022 and EBRD Financial Report 2020; EIB Financial Report 2020; IBRD Financial Statements 2021; IDB Information Statement 2020; NDB Annual Report 2020 and NDB Investor Presentation 2021.

Development banks can play a key role to moving from “billions” to “trillions” to finance a big push investment strategy



The MDBs have a crucial role to play in helping reduce government-induced risk through the use of their instruments (global equity, long-term loans, and guarantees), thereby reducing the cost of capital. They also bring trust and convening power in supporting projects and platforms.

Need better utilization of capital, more capital, and higher private sector multipliers to deliver necessary scale of finance.

Official concessional finance is critical

- Donors must double bilateral climate finance to \$60 billion by 2025 from its 2020 level.
- Donors must rapidly scale up their commitment to adaptation finance in line with the Delivery Plan.
- Donors can improve the effectiveness of limited concessional finance by aligning strongly behind country priorities and programmes, for example through country/sector platforms.
- Donors must enhance their support to the multilateral concessional climate-related funds.
- There is an urgent need to improve the architecture to respond to loss and damage.
- Donors and other climate finance providers must tackle the impediments to access faced by many developing countries.
- There is a need to enhance the transparency and predictability of climate finance, including from bilateral providers.

Expanding the envelope of low-cost finance

- Given the scale of the investment challenge and the financing constraints, especially in low-income and vulnerable countries, we must pursue all promising and innovative options to mobilise low-cost finance including:
 - **Augment the use of special drawing rights (SDRs)** for climate finance by bolstering further the Resilience and Sustainability Trust established in the IMF; modernise the architecture for rechanneling SDRs; augment the pool of SDRs through regular issuance as envisaged in the Articles of Agreement; expand channels for use including MDBs; and leverage SDRs to catalyse private finance.
 - **Tap voluntary and compliance carbon markets** for priorities such as restoration of forests, peatlands and degraded land and the accelerated phase-out of coal.
 - **Create an International Financing Facility** for climate at the global and regional levels to leverage finance through use of guarantees, as has been done successfully for education.
 - **Leverage the growing flows of private philanthropy** to foster partnerships and mobilise finance for priority goals such as the Global Energy Alliance for People and Planet (GEAPP).

Carbon markets can provide meaningful scale of debt-free finance

Projected scale of financial flows through the voluntary carbon market in 2030

Market component	Lower estimate	Upper estimate
Demand	0.5 GtCO ₂ e	< 1.5 GtCO ₂ e
Price	US\$20/tCO ₂ e	US\$30/tCO ₂ e
Market value	\$10 billion	\$40 billion

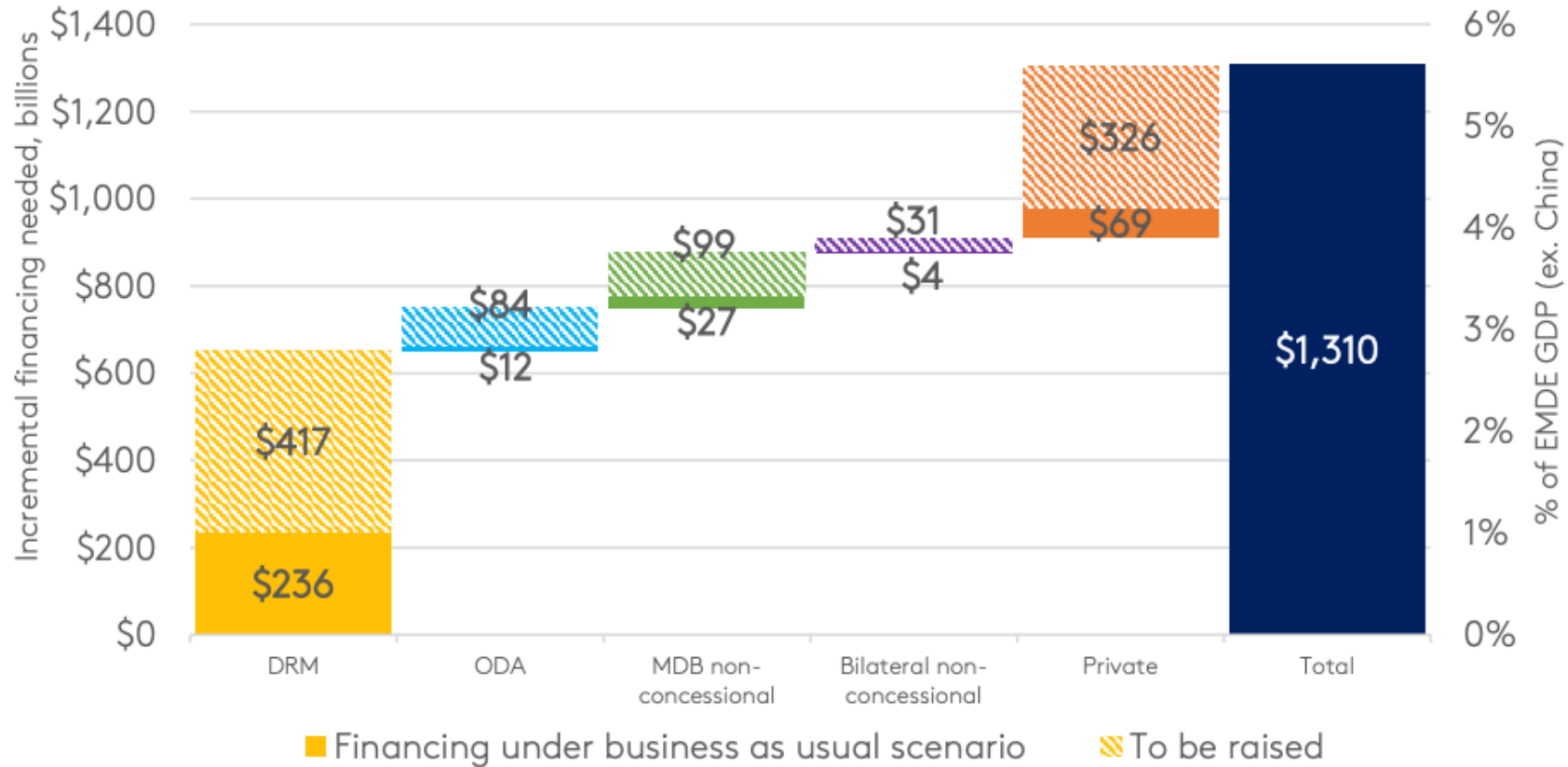
Notes: projections represent conservative estimates based on Trove's existing data on the extent of voluntary corporate commitments and expert judgements on feasible carbon prices. Discrepancy with estimates provided by the Taskforce for Scaling the Voluntary Carbon Market (TSVCM) is explained in the source publication.

Source: Trove Research (2021).

Integrity is essential: financed activities must drive genuine emissions savings aligned with the Paris temperature goals, requiring rising prices that reflect the social cost of carbon, and, in the case of voluntary action, purchasing and retiring carbon credits must not displace efforts to meet targets within organisations' own value chains.

A “Grand Match” to deliver on scale of finance needed

Grand-match financing strategy – incremental finance needed between 2019 and 2025 (billions 2019 US\$)



Source: Bhattacharya et al. (2022)

A sustained effort to boost financing from all sources must start now given the urgency of the climate challenge.