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Will the Green Climate Fund be an evolution or revolution in the maturing world of climate finance ?

In the context of the science of climate change, it is now 95-100 percent certain that human influence has been the dominant cause of the observed warming since the mid-20th century.[1] The urgent case for tackling climate change has never been clearer. The expectation is that an international agreement on climate change will be achieved at Paris in December 2015 at the 21st session of the Conference of the Parties (COP21). A new agreement is seen as being crucial to reach the objective of ensuring that further global warming is kept at or below two degrees Celsius – the 2° Target.

However, in order to achieve this 2° Target, the IEA estimates that an annual incremental investment is required in developing countries of about US$565 billion by 2030[2]. These numbers are much higher when the overall global cost of de-carbonization is taken in to consideration[3]. It is universally accepted that it is not possible for such large amounts of money to be mobilized by efforts of the public sector alone. A step change in the current state of climate finance with the inclusion of the private sector is essential to achieving this. A metaphorical revolution in climate finance is needed. The success of the COP21 "… will largely depend on progress and agreement on the issue of climate finance; and the prospect of mobilizing it at the required pace and scale."[4]

In this article we look to whether that revolution can be achieved by the recently operational Green Climate Fund (GCF).

Evolution

In order to understand and assess the GCF, it is necessary to view it in the context of efforts in climate finance in the last decade.

These efforts to date have, broadly speaking, been led by the public sector along with some more recent efforts on the capital market side through green bond issuance. International instruments include funds such as the Global Environment Facility, the Climate Investment Funds and the Adaptation Fund. National funds include Brazil's Amazon Fund, Bangladesh's Climate Resilience Fund and Indonesia's Climate Change Trust Fund. Multilateral development bank managed or sponsored funds include the World Bank's Prototype Carbon Fund, BioCarbon Fund, the EIB's Post 2012 Carbon Fund, the Multilateral Carbon Credit Fund and many others operated by the ADB, KfW, EBRD etc.

However, a critical assessment of the overall performance of these various funds sets out a story of success but only at a limited scale. Recent analysis by the Overseas Development Institute of nine of the international funds demonstrates about $1 billion a year having being approved since 2008[5]. This scale is clearly insufficient to cope with the financing needs to support the 2° Target.

Having analyzed the impact of these vehicles on climate finance in the past decade, the ODI report summarizes the key changes that need to be adopted by the next generation of climate finance instruments. These are that funds:

(i) need to take more risk and support innovation;

(ii) deploy the appropriate type of financial tool for the job (and not just the lowest cost tool);

(iii) need better engagement with national stakeholders and private sector investors using a broader range of partnerships;

(iv) should focus on developing enabling environments for climate finance investments, particularly in countries where a clear policy commitment to climate change is emerging; and

(v) should set a high bar for targeting impact of the programs they support to ensure that they are truly transformative.

Off the back of this experience in international climate finance, the GCF was created as an operating entity of the United Nations Framework Convention on Climate Change financial mechanism in December 2011. The GCF's purpose is to make a "significant and ambitious contribution to the global efforts towards attaining the goals set by the international community to combat climate change."[6]

Revolution

The GCF already carries the weight of expectation at its inception. Under the anticipated COP21 agreement, it will no doubt feature as the lead vehicle to bring about the necessary change in mobilizing climate finance and investment in developing countries, which face significant economic challenges to investment in adaptation and mitigation projects. Its ultimate ambition is to promote a "paradigm shift" towards low-emission and climate-resilient economic development.

The GCF aims to deliver on this by funding a diverse portfolio of adaptation and mitigation projects which will be put forward by a mix of international, regional and national, public and private sector entities accredited by it. Currently there are twenty accredited entities, but it is anticipated that there could be up to one hundred.

The GCF seeks to raise and mobilize $100 billion per year of funds by 2020. Currently the GCF has pledges of just over US $10 billion from over 30 countries, which is a commendable start.

The GCF recognized right from its inception that direct engagement with private sector actors and overcoming the traditional barriers to private sector investment would be crucial to unlocking and mobilizing funds at scale. In a sharp contrast to its

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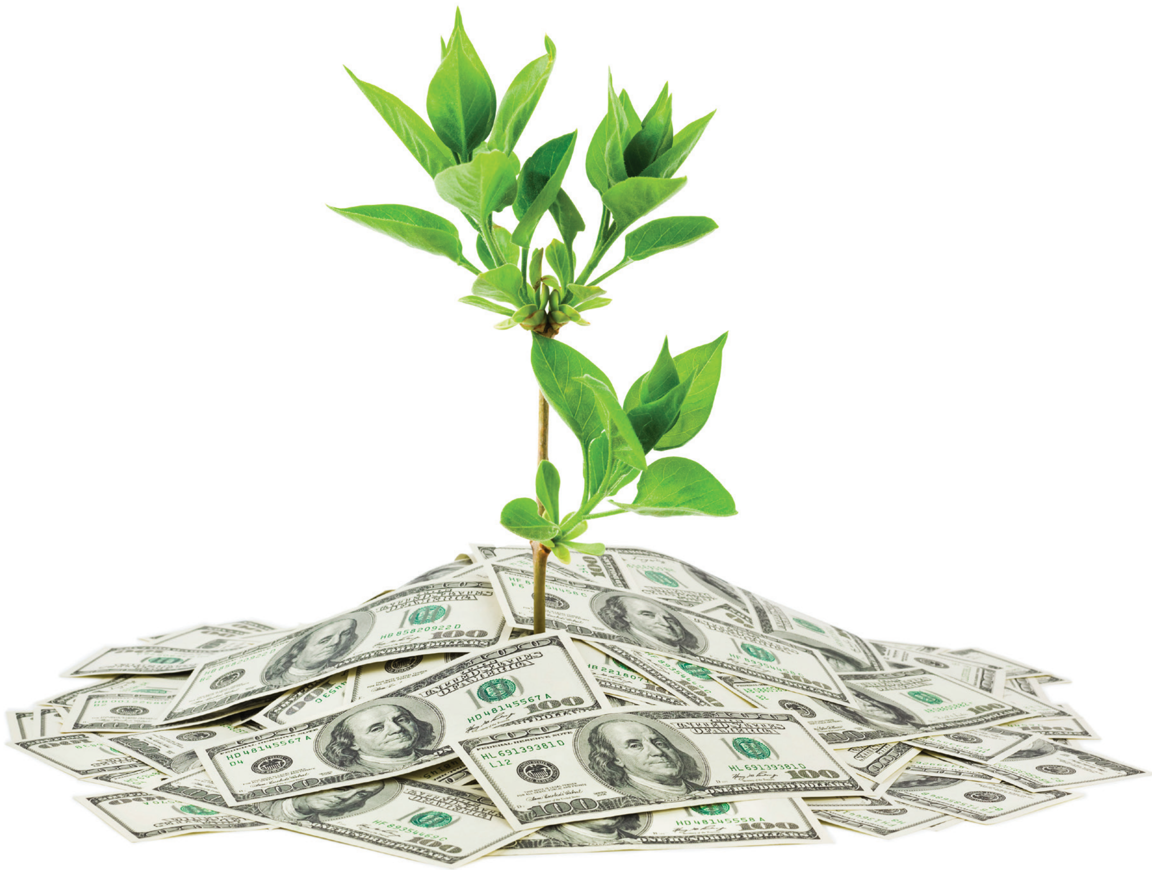

predecessors, the Private Sector Facility was established as an integral component of the GCF. The role of the Private Sector Facility is to "directly and indirectly finance private sector mitigation and adaptation activities at the national, regional and international levels."[7]

> *"It is too early to say whether the GCF will bring about the climate finance revolution that is needed to attract the unprecedented required levels of private sector investment."*

The PSF appreciates that there are a number of major risks and barriers that, to date, have impeded private sector investment in climate-related projects in developing countries. Some of those risks are generic in nature, such as policy uncertainties, economic and political instability, weak regulatory and legal regimes, and currency and foreign exchange fluctuations. Such risks can only be addressed through political, regulatory or economic reform. That said, a significant number of the risks are responsive to financial and technical support. The PSF has made significant progress in developing a range of innovative initiatives and modalities which it hopes will address these risks and barriers.

(i) Project risk

At a project level, the key issue is the financial viability of the particular investment. Key issues associated with climate-related investments include the higher upfront costs, inconsistent or insufficient revenue generation, longer pay-back periods (due to the longer term nature of climate-related projects) and, particularly in the case of adaptation projects, inability to create a revenue generating, asset-backed investment opportunity.

A key differentiator of the PSF will be the credit enhancement support that it can provide to underwrite or mitigate the risk to private sector investors. The GCF has indicated that it will be prepared to take on higher levels of risk than existing funds and commercial lenders. Concessional financing will be a key risk transfer mechanism adopted by the PSF to enhance the credit-worthiness of projects and facilitate the crowding-in of private sector funds. The PSF anticipates using instruments such as subordinated debt, equity, guarantees and first-loss instruments to absorb the risks associated with climate-related projects, in particular adaptation projects.

(ii) Technology risk

Many climate-related technologies are at early stage development and do have the proven track record that investors require. Even proven climate-related technologies have not in many cases effectively penetrated developing country markets and are unproven under local conditions. The nascent stage of climate technologies in developing countries means that supply chains are immature and the necessary resources may be unavailable, which pushes up the overall costs.

In addition to the more innovative risk-absorbing instruments, PSF plans to deploy traditional funding instruments in a more targeted way to address specific technology risks could be mitigated, e.g. by providing subordinated loans or grants at the project/technology development stage to establish the viability of a technology in local conditions. Reducing the risk at this stage will help to create the economic signal for the crowding-in of private sector investment at the project implementation stage. This would be particularly effective at unlocking the adaptation market given the typically larger scale nature of such projects and the increased risk to investors.

(iii) Financial barriers

Limited financial instruments and lack of access to local capital markets are significant barriers to private sector investment at scale. The range of private sector actors and their particular requirements on risk and return have, to date, not been adequately catered for by climate finance. Lack of an established project pipeline also presents a significant barrier to building a diversified investment portfolio that is attractive to institutional investors.

To achieve the required scale of private sector investment, the PSF plans to deploy a variety of financing instruments – including the use of green bonds, commercial paper, syndicated products and private placements[8] – which accommodate the varied needs and risk appetite of a diverse spectrum of private sector players. The climate bonds market is growing rapidly; the total issuance in 2014 was $36 billion and that figure was projected to rise to $100 billion this year[9]. The GCF plans to work through the accredited entities to issue or underwrite project specific bonds, which would be ring-fenced and asset-backed. It can enhance its support for such bonds by injecting credit or liquidity, i.e. act as a "market maker" and create the economic signal for investment.

The GCF's longer-term aim is to build up a portfolio of investments and a balance sheet and to invite investment in GCF issued bonds by commercial banks and institutional investors. The GCF will target scale, with issuances in the range of $100 million to $100 billion. In the shorter term, the GCF will look to the accredited entities to put forward proposed projects and investments that are structured in such a way as to attract third party private investors.

(iv) Structural barriers

Many developing countries lack the required technical and financial capacity to "lead the fight" against climate change at a local level and to create viable opportunities for private sector investment. There is also a general lack of awareness regarding climate-related projects and investment opportunities amongst private and public sector actors.

The GCF is pursuing a country-driven program to build readiness and capacity, in order to give local stakeholders the necessary tools to pursue climate-related opportunities. The GCF is also investing significant resources in raising awareness of climate-related project and investment opportunities. This will be particularly important to unlocking the adaptation market; effective engagement with local stakeholders will be crucial to identifying the opportunities to monetize the benefits of adaptation projects and create the necessary returns on private sector investment. This will be complemented by the establishment of a mobilization vehicle to create a pipeline of projects that can meet the investment needs of institutional investors.

Conclusion

It is too early to say whether the GCF will bring about the climate finance revolution that is needed to attract the unprecedented levels of private sector investment required in a world seeking to meet the 2° Target. Its success will depend on its ability to be different from its predecessors, to engage the private sector and to be a true catalyst for leveraging the public sector finance it receives.

It is likely that the GCF will have relatively modest ambitions during the first round of its project funding approvals in the lead up to Paris. But what comes later in 2016 and beyond will be the true measure of the effectiveness of the GCF, as the role of the PSF continues to evolve and the range of private sector investment opportunities expands.

COP21 may not produce an international agreement that achieves the 2° Target, but it will put us on a path towards that. It is highly likely that the path will get significantly steeper beyond 2030, but the urgency need for action on climate change means that private sector engagement in climate finance must ratchet up soon. The steps, policies and decisions taken by the GCF in the next few years will be the key to this.

ENDNOTES

1 IPCC (2015) Fifth Assessment Report: Climate Change 2014 Synthesis Report
2 IEA (2008) Energy Technology Perspective 2008: Scenarios and Strategies to 2050
3 The IEA estimates that the total additional investment required to decarbonise the energy system by 2050, in a manner consistent with the 2° Target, is USD 44 trillion. Energy Technology Perspectives 2014, IEA.
4 UNEP Finance Initiative (2014) Demystifying Private Climate Finance
5 Overseas Development Institute, Climate Finance: Is it making a difference? December 2014.
6 http://www.gcfund.org/about/the-fund.html
7 GCF (2011) Governing Instrument for the Green Climate Fund
8 GCF (2015) Private Sector Facility: Potential approaches to mobilizing funding at scale, GCF/B.09/11/Rev.01
9 http://www.climatebonds.net/, although more recent data indicates that the actual figure may fall some way short of that due to a slowdown in the first half of 2015.

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