

Chapter 6

Rethink development finance for climate

Development banks and development finance institutions are major financiers of infrastructure and could play a stronger role in supporting developing countries transition to low-emission, resilient development. This chapter presents an overview of why development banks play a critical role, with a special focus on national development banks (NDBs). It discusses progress to date, as well as barriers and potential opportunities of scaling up climate finance. Three key actions are proposed for governments and the banks themselves: strengthen mandates and incentives, mobilise new investors and sources of finance to create new climate markets, and use concessional finance strategically.

Key messages

While many different actors will need to be mobilised to help address the sustainable infrastructure challenge, development banks and development finance institutions are critical, particularly in developing country contexts. But for these banks to play a transformational role, they need to do more to integrate climate into underlying development objectives, better align overall portfolios with the Paris Agreement and scale up efforts to unlock commercial investment. Development banks cannot do this alone – their activities are dependent on, and strongly influenced by, shareholder and client governments. Scaling up climate action requires governments and development banks to make three key changes:

- Strengthen development banks' mandates and incentives to deliver transformative climate action.
- Bring new investors and sources of finance to investments to create new climate markets.
- Use concessional finance to enable development banks to drive the transformation.

Why are development banks transformative?

Meeting the goals of the Paris Agreement will require all countries to reduce emissions and increase resilience to climate change. While most developing countries – especially low-income countries – are not currently a major source of emissions, they must make a decisive transition towards a climate-compatible future if they are to safeguard the significant gains made in improving human development in past decades. Poorer populations and communities are often the most vulnerable to the impacts of a changing climate, and without decisive action, increasing climate impacts could drive more than 100 million people into poverty by 2030 (Hallegatte et al., 2016^[1]). Further, new work shows that climate change could induce over 143 million people from three regions – sub-Saharan Africa, South Asia, and Latin America – to migrate out of their own countries (Rigaud et al., 2018^[2]).

Making a decisive transition towards climate-compatible development pathways will require developing countries to adopt inclusive development strategies, underpinned by development plans and infrastructure pipelines that consider climate change. Improving “hard” infrastructure – roads, power plants, water supply systems – is key, as is addressing “soft” infrastructure – governance and financial systems, institutions, and agriculture and forestry sectors. While many different actors will need to be mobilised to help address the challenge, development banks – publicly-owned financial institutions with a specific development or policy mandate – are critical. These institutions leverage finance from capital markets due to their strong credit ratings and the backing of their shareholder governments, and in turn provide financing to support development outcomes.

Development banks - national, regional, bilateral, multilateral - are established financiers of infrastructure, and this role can be further strengthened to shift investment for low-emission, resilient infrastructure. Their value added is three-fold:

- **Financing:** Development banks provide concessional and non-concessional finance for greenfield low-emission, resilient infrastructure projects in developing countries. These projects provide a proof-of-concept for specific technologies and investments, and business models, in new markets. They also have the potential to be refinanced later in the project cycle by commercial investors.
- **Mobilising:** Development banks can attract commercial investment *directly* to projects by improving the risk-adjusted returns from renewable energy and sustainable transport projects through risk mitigation tools and approaches. They also act as intermediaries in blending finance from donor governments and investors to scale up commercial investment (OECD, 2018^[3]).
- **Reforming policies and creating markets:** Development banks can also mobilise investment *indirectly* by supporting governments in reforming core climate and broader investment policies, removing specific barriers to investment, and stimulating the creation of markets to scale up climate action. They also help to shape and direct public investments by supporting governments in planning their infrastructure and developing pipelines of projects and bring these projects to bankability through targeted project development support.

Underpinning all three dimensions is the contribution that development banks make to building capacity – institutional, technical, knowledge – both for public institutions and for private market participants. For example, development banks can work with local financial intermediaries to build awareness and help develop green finance products, which in turn can help demonstrate the viability of green finance for the local market. Development banks also demonstrate and lead by example, by putting in place measures, such as climate risk screening approaches, to align overall portfolios with climate change.

What is the state of play?

Development banks have committed to going beyond business as usual and have made ambitious commitments to scale up climate action and increase their green and climate finance activities. The major multilateral development banks (MDBs) have adopted climate finance targets, committing to double or even triple the finance they provide by 2020. The latest joint report by the major MDBs estimates that these institutions committed USD 35 billion in climate finance in 2017, representing a 28% increase from 2016 (IDB et al., 2017^[4]). Beyond the MDBs, members of the International Development Finance Club (IDFC) – a global network of bilateral and national development banks and finance institutions based in OECD and non-OECD countries – committed USD 173 billion in ‘green’ finance in 2016. This includes USD 159 billion for climate objectives (both domestic and cross-border) and USD 14 billion for other environmental objectives (IDFC, 2017^[5]). Newer institutions are also committing to sustainability. The New Development Bank, which is supported by the BRICS¹ countries, aims to earmark 60% of its financing for renewable energy projects (New Development Bank, 2016^[6]).

Development banks can play a critical role in solving the infrastructure challenge in developing countries. But for their support to be truly transformational, they must support countries to “leap frog” less sustainable development pathways. This will mean delivering on the climate targets and action plans to which they have committed, aligning their overall portfolios better with the goals of the Paris Agreement, scaling up efforts to mobilise commercial investment, and supporting client countries in pursuing climate-friendly development (OECD, 2017^[7]).

What are the barriers and opportunities for change?

Development banks cannot deliver on this agenda alone – their activities are dependent on and strongly influenced by shareholder and client governments. Shareholder governments influence the work of bilateral development banks and MDBs through the provision of capital as well as the review of policies and projects. While the governance arrangements of national development banks (NDBs) and bilateral banks may vary, many of them are an integral part of government systems, and their mandates and activities respond directly to policy signals. Country and regional contexts also influence how ambitious development banks can be in scaling up climate action and mobilising commercial investors. For example, a lack of established pipelines of projects in developing countries, currency and foreign exchange risks, as well as the international regulatory environment around financial stability (e.g. Basel III regulations), can inhibit efforts to mobilise commercial capital for low-emission infrastructure such as renewable energy (OECD, 2018^[3]; Ang, Röttgers and Burli, 2017^[8]).

A more catalytic role can be played by development banks, especially in supporting developing countries, to go beyond the ambition in current Nationally Determined Contributions (NDCs) and avoid locking in emissions-intensive development. This will require governments and the banks to rethink three areas. First, all development banks will benefit from stronger mandates to act on climate, supported by enabling institutional incentive frameworks and adequate staff capacity. This will differ significantly by institution, for example, MDBs and bilateral banks are generally at a more advanced stage of integrating climate concerns into their operations than many NDBs in developing countries. Further, development banks must support countries to create enabling environments and markets and de-risk investments to attract new investors, through a greater focus on mobilisation of commercial finance. Finally, governments should encourage development banks in their efforts by allocating concessional finance strategically to enable investments with the greatest potential to achieve the Paris goals, as well as create markets and make way for more investments with less concessional terms.

6.1. Strengthen development banks' mandates and incentives to deliver transformative climate action

Do more to align portfolios with climate goals

Development banks are not a homogenous group, but include a broad range of institutions which, working in domestic or international contexts, cover a range of geographies, and provide sovereign or private financing (see Box 6.1). They also differ significantly in their levels of mainstreaming climate considerations as well as their capacity to deliver on climate actions. At a broad level, several MDBs, NDBs and bilateral development banks have joined private banks in the Climate Action in Financial Institutions Initiative and signed up to the Initiative's five voluntary principles for mainstreaming climate action, which include an emphasis on screening climate risk as well as monitoring climate impacts. At an institutional level, some banks have adopted climate-risk screening tools and approaches to help identify the risk from future climate change on projects and introduce adaptation measures into project design. These approaches are at their most advanced in MDBs, with some banks (e.g. Asian Development Bank (ADB), Inter-American Development Bank (IDB) and the World Bank) rolling these out across their operations (AFD et al., 2015^[9]), but are at an early stage of adoption across most national development banks and DFIs.

Development banks are also introducing approaches to discourage emissions-intensive technologies and alternatives. EBRD and EIB, among other banks, have adopted shadow carbon prices and are using them as part of the investment decision-making process for selective projects (Hawkins and Wright, 2018^[10]). Several MDBs and bilateral development banks have moved away from supporting emissions-intensive technologies such as coal, and recently, some NDBs are doing the same. For example, the Brazilian National Development Bank (BNDES) has stated it will no longer support the financing of coal power projects. Some development banks account for the carbon impact of their projects and have also incorporated climate-related indicators into their corporate scorecards. In many cases, however, they report on indicators such as greenhouse gas savings and not necessarily on the overall carbon footprints of their portfolios, which is one measure of the extent to which their operations are aligned with the goals of the Paris Agreement (OECD, 2017^[7]).

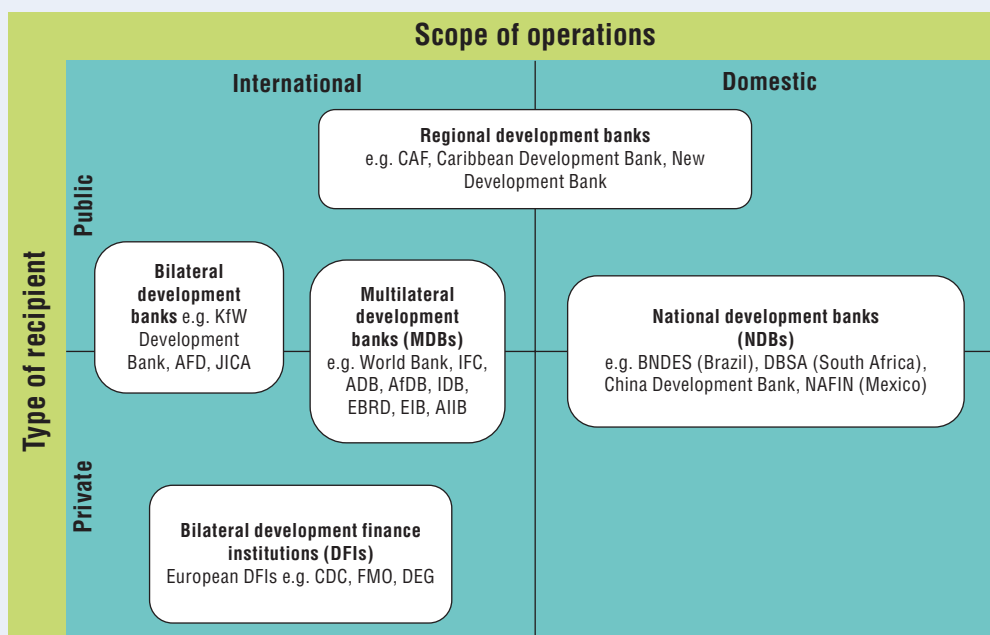
Box 6.1. Development banks play complementary roles

MDBs – like the World Bank – and bilateral development banks – like Germany's KfW Development Bank and France's *Agence française de développement* (AFD) – are backed by strong credit ratings and the support of their shareholders. They finance public and private projects, and bring knowledge and experience from different regions. MDBs usually include both public sector and private sector operations, and sometimes these work as separate institutions e.g. the International Finance Corporation (IFC) within the World Bank Group.

Specialised “private sector” oriented bilateral development finance institution (DFIs) – like France's Proparco, the UK's CDC and the US's Overseas Private Investment Company – finance the private sector to help create markets and spur growth, and increasingly, target the engagement of commercial investors.

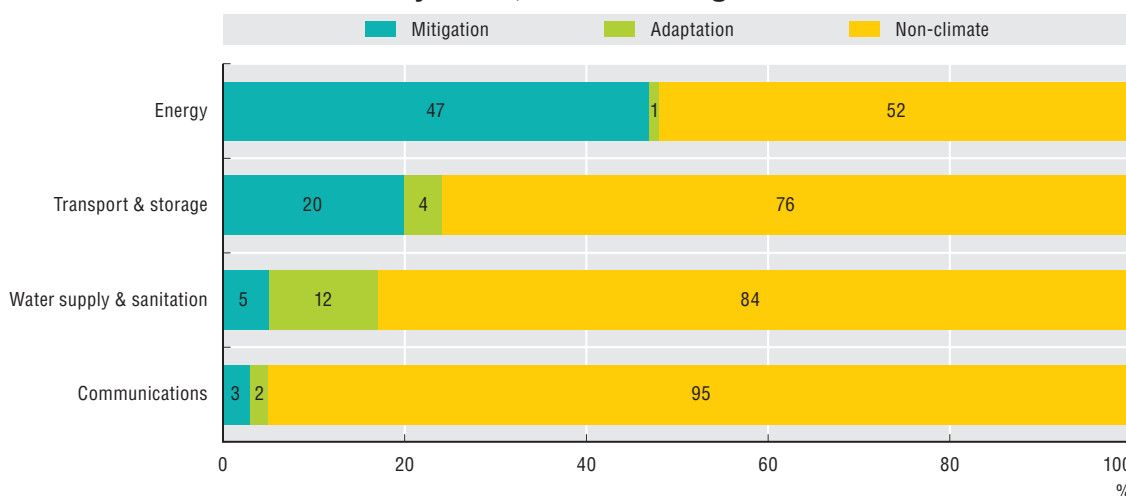
At a domestic level, NDBs – like the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) in Brazil or the Development Bank of South Africa (DBSA) – are domestic institutions with knowledge of and connections to local markets and actors. They finance public and private projects, and supply long-term financing in local currency. Figure 6.1 provides a simplified map of development banks and DFIs.

Figure 6.1. The scope of operations and recipients of development banks and DFIs vary



Climate targets, strategies and tools are driving increases in funds to support climate action, but there are still gaps in support for climate-compatible infrastructure, as illustrated by MDBs' support for infrastructure sectors. Based on data reported by the MDBs to the OECD Development Assistance Committee (DAC), six MDBs² committed USD 32.2 billion to infrastructure sectors per year, on average in 2015-16, of which USD 9.9 billion (31%) was climate-related.³ Across infrastructure sectors, the energy sector recorded the highest share of climate-related commitments (48%) in 2015-16, with 25% of commitments to transport and 17% of commitments to water being climate-related. These figures include specifically defined climate components of projects only and therefore the share of investments that would be climate-screened would be higher. While the optimum level of mainstreaming of climate considerations will vary by sector, these figures point to a general need for more concerted action in the transport and water sectors (Figure 6.2).

Figure 6.2. **Share of MDB commitments for infrastructure that are climate-related, by sector, 2015-16 average**



Note: This graph is based on commitment data (constant USD 2016 values) reported to the OECD DAC by the following MDBs: African Development Bank (AfDB), the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), the Inter-American Development Bank (IDB) and the World Bank. The International Finance Corporation (IFC) is not included in this graph due to lack of data. Climate-related components of projects are those that target mitigation and adaptation, based on the joint MDB Climate Finance Tracking Methodology. MDB commitments include concessional and non-concessional support. Source: OECD (2017^[11]), OECD-DAC Statistical System (database), <http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/climate-change.htm>.

StatLink  <https://doi.org/10.1787/888933856473>

Several banks recognise the need to align their portfolios with the goals of the Paris Agreement. At the 2017 One Planet Summit, the major MDBs and IDFC committed as a group to “redirect financial flows” in support of a transition towards climate-compatible development. AFD has committed to make all their activities consistent with low-carbon and climate-resilient development and to support countries in their formulation of low-carbon and climate-resilient development trajectories (“100% Paris Agreement-compatible”) (AFD, 2017^[12]). Building on these commitments there is a need for more work to clarify what it means in practice to align portfolios with the goals of the Paris Agreement. As shown in Figure 6.2, the share of climate-related infrastructure commitments varies by sector. This does not mean that the remainder of the portfolios in these sectors are necessarily detrimental to the achievement of the goals of the Paris Agreement, but there is a lack of

information in this area. A recent study of alignment proposes that for MDB portfolios to be truly coherent with the Paris Agreement, they should “only consist of investments that either actively support or do not undermine” the Paris temperature goal (Germanwatch and NewClimate Institute, 2018^[13]). It proposes that one way for MDBs to do this would be to clearly track aligned and misaligned investments. Certainly, it is important for development banks to reduce or phase out investments in emissions-intensive technologies e.g. coal power generation.

In addition to aligning portfolios, development banks must continue to integrate climate objectives into their development goals and provide financing for infrastructure that delivers simultaneously on the Sustainable Development Goals (SDGs). For example, delivering clean energy access can be a “golden thread” for development running through all the SDGs by contributing to inclusive economic growth, greater gender equality and education, better human health and well-being, while also leading to reduced greenhouse gas emissions and improved local environments. Clean energy opportunities are available in developing countries, as illustrated by the case of energy access in sub-Saharan Africa (see Box 6.2). However, development finance for the latest and most promising technologies is still relatively limited and does not yet match the potential to take these to scale.

Box 6.2. Decentralised solar and innovative business models can dramatically increase clean energy access in sub-Saharan Africa

Nowhere is the imperative of clean energy access more evident than in sub-Saharan Africa, where electricity access extends to only about half of the region’s population. Lack of access is a drag on the region’s economic development, and the opportunity costs of chronic electricity shortages alone are estimated at 2% of annual GDP.

Social well-being is challenged by a lack of access to clean cooking, which is available to only one-third of the population. Reliance on traditional, highly polluting cooking fuels like wood, dung and charcoal carries a high human toll, harming especially women and children, and is estimated to cause a half a million premature deaths per year in sub-Saharan Africa alone.

Despite some progress, further policy and financing efforts are not keeping pace and the energy access gap is widening. The region will account for 90% of the world’s population without electricity and for nearly 40% of those without clean cooking by 2030, without stepped up action (IEA, 2017^[14]).

What are the barriers to expanding clean energy access?

Despite opportunities to scale up the markets for clean energy and clean cooking, many barriers remain:

- Solar household system (SHS) and Pico solar device markets are growing fast. However they could expand even more quickly with supportive commercial policies, such as measures aimed at removing import tariffs and foreign currency restrictions, or at strengthening local capital markets to attract working capital and lower the cost of doing business.
- Mini-grids require more complex infrastructure planning, enabling energy regulations, and higher levels of organisational support and investment. While they often rely on capital subsidies to be built, mini-grids do not require operating subsidies, unlike most grid systems. Mini-grid businesses with the right skill sets are emerging, but the risk-return proposition for investors is still weak and governments in many cases have been slow to reform regulations, such as tariff rules, to incentivise investments.
- Clean cooking policies are often not ambitious enough and not prioritised, leading to poor implementation and limited financing. Though women could become powerful entrepreneurial players and agents of change in this area, their role is not widely embraced in today’s markets.

Box 6.2. Decentralised solar and innovative business models can dramatically increase clean energy access in sub-Saharan Africa (cont.)

Yet, the opportunity to scale up is clear. Innovative technologies and market developments, especially for solar, are dramatically expanding the number of options and lowering the costs for ensuring universal access by 2030.

What policies are required?

A major step-up in policies and financing is required, including building greater domestic capacity to utilise the needed investments and to attract new businesses.

- Official development finance (ODF) flows in the region need to be directed towards emerging clean energy access opportunities. This is especially true in areas where subsidies are needed to grow markets, i.e. mini-grids and clean cooking. Development finance actors are committing about USD 6 billion per year in ODF to the electricity sector in sub-Saharan Africa (excluding domestic and private flows). However, the majority of finance flowing to electricity today is for on-grid operations and almost no ODF flows to clean cooking (SE4ALL, 2017^[15]). To expand renewable mini-grids and clean cooking businesses, there is a need to increase and leverage international ODF for blending to de-risk and attract private investment at scale. This is starting to happen, but not at the level required to bring about transformative change.
- Domestic leadership, policy reforms and greater capacity are also required to better align fiscal incentives, allow system-wide integration of decentralised renewable electricity, and help public and private investments flow. Development finance actors and governments will need to collaborate on these underpinning policies.

In the specific area of clean cooking, international public finance could play a useful role by creating an initial demand for clean cooking, and engaging women as champions of change through awareness-raising campaigns. Governments also need to work with donors to foster support behind implementation of such innovative projects.

While providing electricity access via national grids will continue to play a key role in sub-Saharan Africa, there is potential for leapfrogging traditional centralised power systems based on fossil fuels to cleaner sources.

Advances in new energy technologies (e.g. solar mini-grids, small and photovoltaic-powered devices, such as “Pico” solar lanterns, or SHSs) are already providing access to millions of users. About 4 million Pico and SHS units were sold in 2016-17, an increase of 50% in one year. These are expanding rapidly in East Africa, and are now emerging in West and Central Africa, and are already attracting commercial finance with markets buoyed by the declining cost of solar devices. These new off-grid and mini-grid options can reach people faster and in a more targeted way than grid expansion alone, and while the cost per kilowatt hour is often higher than grid-based electricity, these options come with many benefits. They are less capital intensive and offer affordable electricity services at a much lower cost than diesel alternatives, for example, providing clean, affordable electricity to unconnected rural and underserved urban populations.

For clean cooking, a range of clean cookstove and fuel opportunities also exist (e.g. from improved biomass fuels to liquified petroleum gas). While funding the supply of fuels for clean cooking may require large investments, these options can also deliver huge social and economic returns.

Source: Corfee-Morlot, J., P. Parks, J. Ogunleye and F. Ayeni (2018^[16]), *Achieving Clean Energy Access in Sub-Saharan Africa* (forthcoming), *Financing Climate Futures Case Studies*.

Empower national development banks to play a greater role in transforming climate action

The development and climate finance landscape is changing rapidly, especially with regards to infrastructure. The relatively modest role of international development actors is highlighted clearly in the breakdown of infrastructure financing in developing countries. Miyamoto and Chiofalo (2016^[17]) estimate that official development finance – from donors, MDBs and bilateral banks – makes up only 6-7% of infrastructure financing in developing countries, with most of the resources coming from national governments and a third from the private sector. Emerging economies also play a greater role than before. In 2014, for example, non-DAC countries (including many emerging economies) provided an estimated 17% of total global development co-operation finance (around USD 32 billion) with this amount being seen to increase year on year between 2010 and 2017 (Benn and Luijkx, 2017^[18]).

Within this changing development finance landscape, NDBs, particularly those from emerging economies, are set to play a larger, and potentially transformational, role in scaling up finance for low-emission, resilient infrastructure in domestic contexts (see Box 6.3). NDBs are well placed to understand country-specific bottlenecks to climate investments due to their proximity to the market and relationships with local public and private actors. NDBs also provide financing in local currencies, and by adopting measures to integrate climate considerations into their lending activities, they can have a demonstration effect among other financial institutions in the country.

The potential of NDBs is highlighted more prominently in regional and national contexts. A detailed assessment of public and private climate finance for projects in South Africa between 2010 and 2015 found that national development and other public banks – like the Development Bank of South Africa (DBSA) and the Industrial Development Corporation of South Africa – played a major role, mobilising 64% of the USD 10.1 billion in private co-finance in these projects (McNicoll et al., 2017^[19]). It also found that NDBs from other emerging economies (such as the China Development Bank) are also increasingly important, mobilising 17% of the private co-financing in South Africa in 2014-15. Similarly, another study focused on Latin America found that 12 domestically focused institutions in Brazil, Chile and Mexico provided USD 11 billion in climate finance in 2015 in these three countries alone, the majority of which went to infrastructure sectors, and supported the scale up of private investment (Abramskiehn et al., 2017^[20]).

NDBs from emerging economies, in particular, need to be empowered by their governments and the international community to take on a stronger role in climate action. Coherent mandates and clear policy trajectories are critical for NDBs, many of which continue to support coal-related projects. In addition, many NDBs lack sufficient expertise and processes to adequately include climate considerations in their operations and may not have the capacity or the experience needed to access international climate support and scale up green financing. Targeted support could help NDBs develop and roll out climate-risk screening and other mainstreaming approaches. Despite their importance, the absence of widely adopted standards for reporting green investments amongst NDBs makes it difficult to track and assess what these banks finance. Initial inroads are being made in this area through the harmonised “Common Principles on Climate Finance Tracking”, jointly established by IDFC members and MDBs, which set out definitions and guidelines for tracking climate finance and has enabled individual banks to collect information in a comparable way (AFD et al., 2015^[9]). Despite this, comparable, granular information on the composition of NDB portfolios is not yet readily available (OECD, 2017^[7]).

Box 6.3. The role of emerging economy NDBs in scaling up climate-compatible infrastructure

Among development banks, NDBs from major emerging economies such as Brazil (BNDES), China (the China Development Bank), South Africa (DBSA) and Turkey (the Industrial Development Bank of Turkey, TSKB) are rising to the forefront of international discussions on infrastructure and climate change.

Many of these banks are part of the International Development Finance Club (IDFC), a global network of 23 development banks and finance institutions, which includes emerging economy NDBs; OECD-based bilateral development banks like KfW, AFD and JICA; and subregional development banks like the Development Bank of Latin America (CAF). IDFC members committed USD 173 billion in 'green' finance in 2016, including USD 159 billion in climate finance and USD 14 billion in finance for other environmental objectives. The major share of this finance stemmed from institutions based in non-OECD countries, and supported domestic projects. The remainder – USD 26 billion – went towards financing projects in other countries. While much of this cross-border financing originated in banks in OECD countries, USD 7 billion was committed by IDFC members based outside the OECD for other developing countries, highlighting the growing role of emerging economy banks in international environment-related development finance.

The case of two banks – BNDES in Brazil and DBSA in South Africa – highlights the role NDBs already play in their national contexts and their support for low-emission, climate-resilient infrastructure.

Both banks are important actors in the context of national economic development and infrastructure.

BNDES is one of the largest development banks in the world, with total assets estimated at 13% of GDP in 2017, and has played a major role in financing infrastructure in Brazil. DBSA is one of three NDBs in South Africa, has a strong focus on infrastructure development, and increasingly works outside of South Africa to support infrastructure development in other countries in the Southern African Development Community.

BNDES and DBSA already support the deployment of low-emission infrastructure in their countries.

As the government's main instrument of long-term finance, BNDES is often implicitly a key implementer of government policy and plans on the environment. For example, BNDES manages the Amazon Fund, Brazil's main REDD+ financing mechanism, and has supported the development of Brazil's wind industry by financing wind power across the country. The bank has also maintained or increased its green economy-related financing in recent years, despite a decrease in overall disbursements.

Similarly, DBSA has played an important role in supporting South Africa's transition to a green economy through the management of the Department of Environmental Affairs-funded Green Fund, and is accredited under the Green Climate Fund (GCF) and the Global Environment Facility (GEF). DBSA's support for the setup of South Africa's Renewable Energy Independent Power Producer Procurement Programme and subsequent financing for projects within the programme highlights its role as a key player in the roll-out of the government's renewable energy plans.

Transitioning from "financer" to "mobiliser" of investment for infrastructure

Spurred by national awareness of the limitations in public finance and the need for more infrastructure investment, both BNDES and DBSA are transitioning from their traditional role as providers of long-term finance for infrastructure to enablers and mobilisers of other sources of finance.

DBSA has clearly recognised the importance of this transition, and has recently adopted a corporate target and is reporting on finance catalysed as a result of their operations, alongside original measures of disbursement and portfolio size. The bank's proposed Climate Finance Facility, recently approved for financing from the GCF, is an example of how DBSA can support the mobilisation of commercial finance. The facility is based on a blended finance structure that will crowd in commercial capital by improving the risk-return profile of commercially viable climate projects in local currency that are not able to self-fund in the market.

Box 6.3. The role of emerging economy NDBs in scaling up climate-compatible infrastructure (cont.)

BNDES's new mission recognises the importance of its ongoing work on capital markets development. In May 2017, BNDES issued a USD 1 billion green bond which was the first international green bond issuance by a Brazilian bank. Another example, is the bank's BRL 500 million Sustainable Energy Fund (*Fundo de Energia Sustentável*), which builds on an established securitisation framework to finance the construction of sustainable energy projects and securitise the less risky operational phase of sustainable energy projects.

Source: OECD (2018^[21]), *Mobilising commercial capital for sustainable infrastructure: Insights from national development banks in Brazil and South Africa* (forthcoming), *Financing Climate Futures Case Studies*; IDFC (2017^[5]), *IDFC Green Finance Mapping Report 2016*, International Development Finance Club (IDFC).

Strengthen mandates, incentives and capacity

Shareholder governments need to give development banks stronger, more coherent mandates to deliver transformative climate action by integrating climate with underlying development objectives, reflecting this in corporate scorecards, and putting in place supportive internal incentive systems to encourage staff to scale up climate action. Incentive structures in development banks need to reflect sustainability outcomes alongside financial targets. Corporate and staff performance in some institutions, and unless otherwise managed, can be driven more by financial indicators (e.g. commitments or disbursements) than by efforts to mobilise commercial finance, or the potential contribution to development outcomes such as climate change (Bhattacharya et al., 2018^[22]). This encourages an emphasis by institutions and individual officers on larger investments, especially in infrastructure, but does not necessarily encourage investments in areas such as energy efficiency or distributed renewable energy where the ticket sizes could be smaller but which are critical for reducing emissions and building resilience. The example of sub-Saharan Africa, which faces gaps in development finance for distributed renewable technologies, illustrates this (see Box 6.2). Some development banks resolve this by working with financial intermediaries, for example in the case of energy efficiency credit lines.

Development banks also need to have adequate capacity and skills to scale up transformational action on climate change. They need to dedicate efforts to “non-traditional” areas (i.e. investment models that support the financing of new technologies and programmatic approaches centred on climate change), and avoid a bias towards more traditional infrastructure projects when assessing investment opportunities. While bilateral and multilateral development banks are beginning to build these skills in country and sector departments, many NDBs in developing countries still face significant capacity gaps in these areas. Often multilateral and bilateral development banks also work with NDBs to build their capacity. For example, IDB has set up the Green Finance in Latin America and the Caribbean platform, which supports NDBs to exchange knowledge and scale up green financing products and approaches.⁴

6.2. Bring new investors and sources of finance to investments to create new climate markets

The investment gap for infrastructure, especially in developing countries, highlights the need for scarce public resources to be used strategically to attract commercial investment, where suitable. As a result, the links between private finance and development

finance are getting closer, with many private finance actors embracing the Environmental, Social and Governance (ESG) agenda, and with more pressure on development banks and development finance institutions to work closely with commercial actors. This convergence is particularly prominent in impact investing, an emerging area where private investors and development finance institutions work side-by-side to support projects that have a measurable environmental or social impact as well as produce financial returns (Wilson, 2016^[23]).

Development banks are beginning to make headway in mobilising private climate investments. At the international level, development finance institutions – such as IFC and the European DFIs – directly engage with and finance private businesses and local banks in developing countries. They can facilitate investors’ involvement in climate-related investment by, for example, pooling small-scale projects together and raising finance through green bonds. Blended finance – the use of development finance to mobilise commercial support for development projects – is also increasing among development banks and DFIs (OECD, 2018^[3]). Development banks use a range of risk mitigation instruments (such as guarantees), mezzanine financing and syndication to attract commercial investment to low-emission infrastructure projects. In many cases, concessional finance from donor and climate funds is used in conjunction with development bank financing to provide senior debt with longer tenors or concessional interest rates to help bridge the viability gap for climate-related investments. One innovative approach to attract commercial investment is the use of subordinated capital in structured blended funds. The EIB-managed Global Energy Efficiency and Renewable Energy Fund (GEEREF), for example, uses a blended capital structure to attract commercial investors, investing capital in specialist renewable energy private equity funds which in turn support greenfield renewable energy projects, through a ‘fund of funds’ model (OECD, 2018^[3]).

While these approaches are gaining traction, they are still only a small part of what development banks do. A much stronger focus on mobilising commercial investment is needed and will require banks to re-envision the way in which they finance development. This message is also echoed by the G20 Eminent Persons Group on Global Financial Governance (see Box 6.4), and is illustrated in the World Bank’s “Cascade approach”. It sets out a path for the bank to “maximise financing for development”, guiding bank staff to prioritise opportunities to draw on private finance for development outcomes where appropriate, and reserve scarce public financing for those areas where private sector engagement may not be feasible (World Bank Group, 2017^[24]). It also scales up bank support to improve the enabling environment for private investment. A concrete illustration of this approach is the Private Sector Window that has been created as part of the replenishment of the World Bank’s International Development Association (IDA) which supports the world’s poorest countries, and many fragile and conflict-affected states. This window represents a significant step forward in actively supporting public-private solutions in these countries (IDA, 2017^[25]). Jointly, MDBs have also signed up to the G20 Hamburg Principles for crowding-in private finance, which similarly take a step wise approach to mobilising commercial finance, first focusing on the investment enabling environment and then encouraging the prioritisation of commercial finance, where appropriate (G20 IFA WG, 2017^[26]).

In order to implement this vision, there will need to be a much stronger focus on bringing new investors and sources of finance with the explicit aim of creating new climate markets. This means working with governments to develop enabling policies and regulations to scale up commercial investment, optimising the risks that development banks carry, and using

concessional finance – through blended finance, for example – in cases where investments are critical to achieve climate goals, but cannot be viably financed through non-concessional windows.

Box 6.4. G20 Eminent Persons Group: A greater focus on mobilising private capital for development impact is central to proposed reforms for global financial governance

The G20 Eminent Persons Group on Global Financial Governance (EPG) was tasked by G20 Finance Ministers and Central Bank Governors to review global financial architecture and the current system of governance of International Financial Institutions (IFIs). The purpose of this review was to propose reforms that the G20 could take forward to better support sustainability in a changing global context.

The EPG's report to the G20 was released in October 2018, and includes 22 proposed reforms focused on three areas: increasing collaboration to achieve development impact, improving the resilience of the global financial system, and improving the way the G20 and IFIs work. Central to these proposals is the recognition that a much greater focus is needed on domestic resource mobilisation as well as on mobilising private investment in order to solve development challenges.

The report suggests that development finance needs to be re-oriented to focus on reducing and managing risk so as to mobilise capital at scale, including through a greater focus on securitisation and better risk insurance. In particular, the EPG's fourth proposal is to "Reduce and diversify risk on a system-wide basis to mobilise significantly greater private investment, including portfolio-based infrastructure financing". It suggests that to achieve this, the G20 must:

- "Shift the basic business model of the MDBs from direct lending towards risk mitigation aimed at mobilising private capital";
- Put in place "system-wide political risk insurance"; and
- "Build a developing country infrastructure asset class" to attract institutional investors.

Source: G20 Eminent Persons Group on Global Financial Governance (2018_[27]), *Making the Global Financial System Work for All*.

This could be encouraged through a greater emphasis on the crowding-in of private commercial finance, where this is possible and relevant, in corporate scorecards (Blended Finance Taskforce, 2017_[28]). However, while the use of "leverage ratios" is a helpful metric used in annual reports to highlight the volumes of finance crowded in, they need to be dynamic, reflecting changes in country contexts (e.g. rapidly falling costs of renewable energy over time). At the same time, the development banks and DFIs must have in place clear exit strategies to avoid eventual crowding out of commercial capital (OECD, 2017_[29]). In addition, indirect efforts to mobilise commercial finance – such as support towards enabling environments – are not captured well in most current efforts to measure mobilisation, and too great a focus on leverage ratios could disincentivise these much-needed efforts (McNicoll et al., 2017_[19]). Developing agreed metrics to track indirect mobilisation could help incentivise these efforts and monitor future progress. It is also important to ensure that measures to mobilise commercial finance are well aligned with climate goals.

While there are no "silver bullets" that can overcome the array of barriers to mobilising commercial investment for low-emission, climate-resilient infrastructure at scale,

development banks and other stakeholders, working together, can help resolve major bottlenecks and build the much-needed project pipelines in developing countries by:

- **Intermediating and aggregating smaller investments** through, for example, structured blended finance vehicles, to help bridge the mismatch between the nature of the demand side of financing for projects and the nature of supply of financing from financial markets, and to bring in institutional investors.
- **Standardising the terms and conditions related to low-emission infrastructure projects** to help unlock private investment, including those underpinning different instruments, approaches and contractual agreements. One recent example is the TerraWatt Initiative, which brings together development banks and other finance institutions, legal firms and associations to compile open source contracts and guidelines for solar energy in an effort to bring down related transaction costs (TerraWatt Initiative_[30]).
- Deploying risk mitigation measures, including efforts to **effectively manage currency risks**, which are critical for channeling investment towards developing countries. More effective pooling of resources and collective risk management could help reduce the cost of providing long-term finance in local currency.

6.3. Use concessional finance strategically to enable development banks to drive the transformation

Governments – and the capital as well as the concessional finance that they provide – are important direct and indirect drivers of change among development banks. Financing from NDBs reflects the policy directions of their government, and can, in many cases, support investments in pollution, emission-intensive investments. The China Development Bank, for example, is rapidly scaling up green finance, but continues to support coal, as does DBSA (OECD, 2017_[7]).

Amongst the MDBs, shareholders directly influence environmental performance and guide activities and operations, usually engaging at a strategic level (when reviewing or updating policies) and at an operational level (when approving projects) (Crishna Morgado and Taskin, 2018_[31]). They also provide capital and concessional finance to support targeted operations. The recent capital increase for the World Bank Group, for example, clearly encourages the bank's approach to actively crowd in private resources as well as its support for climate change and other global public goods (World Bank, 2018_[32]). Governments also use external policy channels to give policy directions to development banks – for example, in the case of Italy's G7 Presidency and Germany's G20 Presidency in 2017.⁵

As shareholders and investors in development banks and development finance institutions, governments must make greater efforts to provide clear, coherent signals and guidance to take a stronger role in driving transformative climate investments. Amidst demands for support on a variety of development challenges, development banks' efforts to mobilise private capital for sustainable infrastructure are dependent both on their own balance sheet and lending capacity, as well as on concessional finance from donors. The latter is key to help bridge viability gaps for investments in countries where markets are maturing and are not yet optimal for mobilising commercial finance purely at market terms (Trabacchi et al., 2016_[33]).

Targeted, concessional finance for climate action – provided bilaterally from governments as well as through multilateral climate funds – can help development banks make the case for climate-related investments to client countries and institutions that are not yet actively seeking such investments. Importantly, the changing climate finance architecture,

including the scale down of the Climate Investment Funds and the operationalisation of the Green Climate Fund, has implications for how NDBs, MDBs and bilateral DFIs access concessional finance. To continue to encourage development banks to help developing countries transform their development pathways, governments should ensure there is adequate concessional financing available, and that it is allocated to investments which have the potential to create markets and make way for more investments at less concessional terms, e.g. by creating scale or serving as proof-of-concept for newer approaches. New work in this area suggests that climate finance should be prioritised based on two factors: the level of ambition (i.e. contribution to the Paris goals) and the potential for transformation (i.e. the degree to which it could reduce barriers to future climate investments). In addition, the level of concessionality of climate finance should be proportionate to the effort required to make it viable (World Bank, 2018^[34]).

Concessional finance – through blended finance – is also key to increase the viability of public and private investments in countries where markets are not yet optimal for mobilising commercial finance purely at market terms. An example of this is the Canadian Climate Fund for the Private Sector in Asia, managed by ADB, which uses concessional finance to support private sector projects with a high climate impact but that were unlikely to have proceeded on a commercial basis alone (ADB^[35]). This support needs to be well-targeted and efficiently allocated to help make projects viable. Its use in mobilising private finance should be underpinned by strong policy principles and standards to ensure that the focus is on crowding in investment without distorting markets (OECD, 2018^[3]). MDBs and bilateral DFIs have agreed on joint principles to govern the use of concessional finance in private sector operations, emphasising issues such as additionality, minimising concessionality, the importance of reinforcing markets and for underpinning these investments with robust ESG standards (IFC, 2017^[36]).

Notes

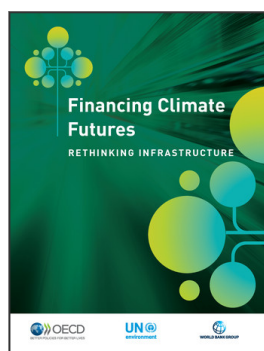
1. A group of five large emerging economies composed of Brazil, the Russian Federation, India, the People's Republic of China and South Africa.
2. Including the Asian Development Bank (ADB), the African Development Bank (AfDB), the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IDB) and the World Bank – excluding the International Finance Corporation (IFC).
3. This is based on data reported to the OECD DAC by the MDBs. MDBs report activity level development finance data as well as climate-related activity level data to the OECD DAC. Climate-related data includes climate co-benefits i.e. climate-related components of projects (i.e. those that target mitigation, adaptation, or both mitigation and adaptation) and is based on the joint MDB Climate Finance Tracking Methodology.
4. For more information: <https://www.greenfinancelac.org/>
5. Italy's G7 Presidency supported a discussion on the alignment of MDB portfolios with the Paris Agreement, and the Hamburg Climate and Energy Action Plan under Germany's G20 Presidency called on MDBs to deliver scaled up climate action.

References

- Abramskiehn, D. et al. (2017), *Supporting National Development Banks to Drive Investment in the Nationally Determined Contributions of Brazil, Mexico, and Chile*, Inter-American Development Bank (IDB), Washington, DC, <https://publications.iadb.org/bitstream/handle/11319/8520/Supporting-National-Development-Banks-to-Drive-Investment-in-the-Nationally-Determined-Contributions-of-Brazil-Mexico-and-Chile.PDF> (accessed on 19 October 2018). [20]

- ADB (n.d.), *Canadian Climate Fund for the Private Sector in Asia*, Asian Development Bank Web Portal, <https://www.adb.org/site/funds/funds/canadian-climate-fund-for-the-private-sector-in-asia> (accessed on 19 October 2018). [35]
- AFD (2017), *Climate and Development Strategy 2017-2022*, Agence française de développement, Paris, <https://www.afd.fr/sites/afd/files/2017-12/climate-development-strategy-2017-2022.pdf> (accessed on 19 October 2018). [12]
- AFD et al. (2015), *Mainstreaming Climate Action within Financial Institutions: Emerging Practices*, https://www.mainstreamingclimate.org/wp-content/uploads/2017/03/fi_mainstreaming_epp_en-1.pdf (accessed on 19 October 2018). [9]
- Ang, G., D. Röttgers and P. Burli (2017), “The empirics of enabling investment and innovation in renewable energy”, *OECD Environment Working Papers*, No. 123, OECD Publishing, Paris, <http://dx.doi.org/10.1787/67d221b8-en>. [8]
- Benn, J. and W. Luijckx (2017), “Emerging providers’ international co-operation for development”, *OECD Development Co-operation Working Papers*, No. 33, OECD Publishing, Paris, <https://doi.org/10.1787/15d6a3c7-en> (accessed on 19 October 2018). [18]
- Bhattacharya, A. et al. (2018), *The New Global Agenda and the Future of the Multilateral Development Bank System*, Brookings Institution, Center for Global Development and Overseas Development Institute (ODI), https://www.brookings.edu/wp-content/uploads/2018/02/epg_paper_on_future_of_mdb_system_jan30.pdf (accessed on 19 October 2018). [22]
- Blended Finance Taskforce (2017), *Better Finance, Better World: Consultation Paper of the Blended Finance Taskforce, Business and Sustainable Development Commission* (Blended Finance Taskforce), London, http://s3.amazonaws.com/aws-bsdc/BFT_BetterFinance_final_01192018.pdf (accessed on 19 October 2018). [28]
- Corfee-Morlot, J. et al. (2018), “Achieving Clean Energy Access in Sub-Saharan (forthcoming)”, *Financing Climate Futures Case Studies*, 3CS and Carbon Limits Nigeria, Paris. [16]
- Crishna Morgado, N. and Ö. Taskin (2018), “Managing environmental risks in development banks and development finance institutions: What role for donor shareholders? (forthcoming)”, *OECD Development Co-operation Working Papers*, OECD Publishing, Paris, <https://doi.org/10.1787/22220518> (accessed on 19 October 2018). [31]
- G20 Eminent Persons Group on Global Financial Governance (2018), *Making the Global Financial System Work for All*, <https://www.globalfinancialgovernance.org/assets/pdf/G20EPG-Full%20Report.pdf> (accessed on 26 October 2018). [27]
- G20 IFA WG (2017), *Principles of MDBs’ strategy for crowding-in Private Sector Finance for growth and sustainable development*, G20 International Financial Architecture Working Group, https://www.bundesfinanzministerium.de/Content/DE/Downloads/G20-Dokumente/principles-on-crowding-in-private-sector-finance-april-20.pdf?__blob=publicationFile&v=2 (accessed on 19 October 2018). [26]
- Germanwatch and NewClimate Institute (2018), *Aligning Investments with the Paris Agreement Temperature Goal: Challenges and Opportunities for Multilateral Development Banks*, Germanwatch and NewClimate Institute, https://newclimate.org/wp-content/uploads/2018/09/MDB_WorkingPaper_2018-09.pdf (accessed on 19 October 2018). [13]
- Hallegatte, S. et al. (2016), *Shock Waves: Climate Change and Development Series Managing the Impacts of Climate Change on Poverty*, The World Bank, Washington, DC, <https://openknowledge.worldbank.org/bitstream/handle/10986/22787/9781464806735.pdf> (accessed on 27 September 2018). [1]
- Hawkins, J. and H. Wright (2018), *How are development banks performing on shadow carbon pricing?*, E3G Web Portal, <https://www.e3g.org/library/how-are-development-banks-performing-on-shadow-carbon-pricing> (accessed on 19 October 2018). [10]
- IDA (2017), *What is the IDA18 IFC-MIGA Private Sector Window?*, International Development Association (IDA), World Bank, <https://ida.worldbank.org/sites/default/files/pdfs/ida-psw-brief-may-2017.pdf> (accessed on 19 October 2018). [25]
- IDB et al. (2017), *2016 Joint Report On Multilateral Development Banks’ Climate Finance*, <http://dx.doi.org/10.18235/0000806>. [4]
- IDFC (2017), *IDFC Green Finance Mapping Report 2016*, International Development Finance Club, https://www.idfc.org/Downloads/Publications/01_green_finance_mappings/IDFC_Green_Finance_Mapping_Report_2017_12_11.pdf (accessed on 19 October 2018). [5]

- IEA (2017), *Energy Access Outlook 2017: From Poverty to Prosperity*, International Energy Agency, Paris, https://www.iea.org/publications/freepublications/publication/WEO2017SpecialReport_EnergyAccessOutlook.pdf (accessed on 05 July 2018). [14]
- IFC (2017), *DFI Working Group on Blended Concessional Finance for Private Sector Projects: Summary Report*, International Finance Corporation (IFC), World Bank Group, https://www.ifc.org/wps/wcm/connect/30635fde-1c38-42af-97b9-2304e962fc85/DFI+Blended+Concessional+Finance+for+Private+Sector+Operations_Summary+R....pdf?MOD=AJPERES (accessed on 19 October 2018). [36]
- McNicoll, L. et al. (2017), “Estimating Publicly-Mobilised Private Finance for Climate Action: A South African Case Study”, *OECD Environment Working Papers*, No. 125, OECD Publishing, Paris, <https://doi.org/10.1787/a606277c-en> (accessed on 19 October 2018). [19]
- Miyamoto, K. and E. Chiofalo (2016), “Official Development Finance for Infrastructure: With a Special Focus on Multilateral Development Banks”, *OECD Development Co-operation Working Papers*, No. 30, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9e93790e-en>. [17]
- New Development Bank (2016), *NDB President: 60% of Funding Will be for Renewables - New Development Bank*, New Development Bank Web Portal, https://www.ndb.int/president_desk/ndb-president-60-funding-will-renewables/ (accessed on 19 October 2018). [6]
- OECD (2018), *Making Blended Finance Work for the Sustainable Development Goals*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264288768-en>. [3]
- OECD (2018), “Mobilising commercial capital for sustainable infrastructure: Insights from national development banks in Brazil and South Africa (forthcoming)”, *Financing Climate Futures Case Studies*, OECD Publishing, Paris. [21]
- OECD (2017), *Investing in Climate, Investing in Growth*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264273528-en>. [7]
- OECD (2017), *OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals*, OECD Publishing, Paris, <http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/OECD-Blended-Finance-Principles.pdf> (accessed on 19 October 2018). [29]
- OECD (2017), *OECD-DAC Statistical System (database)*, <http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/climate-change.htm> (accessed on 26 October 2018). [11]
- Rigaud, K. et al. (2018), *Groundswell: Preparing for Internal Climate Migration*, World Bank, Washington, DC, <http://hdl.handle.net/10986/29461> (accessed on 19 October 2018). [2]
- SE4ALL (2017), *Energizing Finance: Scaling and Refining Finance In Countries With Large Energy Access Gaps*, Sustainable Energy for All, https://www.seforall.org/sites/default/files/2017_SEforALL_FR4_PolicyPaper.pdf (accessed on 26 July 2018). [15]
- TerraWatt Initiative (n.d.), *The Global Solar Energy Standardisation Initiative*, TerraWatt Initiative Web Portal, <https://sesi.terrawatt.org/> (accessed on 19 October 2018). [30]
- Trabacchi, C. et al. (2016), *The role of the Climate Investment Funds in meeting investment needs*, Climate Policy Initiative, <http://climatepolicyinitiative.org/wp-content/uploads/2016/06/The-role-of-the-Climate-Investment-Funds-in-meeting-investment-needs.pdf> (accessed on 19 October 2018). [33]
- Wilson, K. (2016), *Investing for social impact in developing countries*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/dcr-2016-en>. [23]
- World Bank (2018), *Strategic Use of Climate Finance to Maximize Climate Action: A Guiding Framework*, World Bank Group, Washington, DC, <http://documents.worldbank.org/curated/en/879251537779825585/Strategic-Use-of-Climate-Finance-to-Maximize-Climate-Action-A-Guiding-Framework> (accessed on 19 October 2018). [34]
- World Bank (2018), *World Bank/IMF Spring Meetings 2018: Development Committee Communiqué*, <http://www.worldbank.org/en/news/press-release/2018/04/21/world-bankimf-spring-meetings-2018-development-committee-communique> (accessed on 26 July 2018). [32]
- World Bank Group (2017), “Maximizing Finance for Development: Leveraging the Private Sector for Growth and Sustainable Development”, http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23758671/DC2017-0009_Maximizing_8-19.pdf (accessed on 05 July 2018). [24]



From:
Financing Climate Futures
Rethinking Infrastructure

Access the complete publication at:
<https://doi.org/10.1787/9789264308114-en>

Please cite this chapter as:

OECD/The World Bank/United Nations Environment Programme (2018), “Rethink development finance for climate”, in *Financing Climate Futures: Rethinking Infrastructure*, OECD Publishing, Paris.

DOI: <https://doi.org/10.1787/9789264308114-9-en>

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.