



## Leveraging Private Finance: Lessons for Climate and Development Effectiveness

In the debate over the Green Climate Fund (GCF), some Parties have emphasized the need to leverage and crowd in private finance. While there is an appropriate role for the private sector, years of experience in the fields of development finance and carbon finance (i.e. carbon markets) demonstrate that efforts to engage private finance merit a high degree of caution by the GCF Board. *Prior to committing to a private sector strategy, the Board should arrive at a better understanding of the private sector's efficacy in generating pro-poor, climate friendly investment.*

Investment patterns and characteristics established by existing institutions that have tried to leverage the potential of private finance, such as the Clean Development Mechanism (CDM) and the International Finance Corporation (IFC), provide important lessons for the GCF. An excessive focus on crowding in private finance can lead to an erosion of transparency, social and environmental integrity, public accountability, and equity, ultimately undermining climate and development effectiveness.

### **Bypassing low income countries and small/medium enterprises**

Private finance is motivated by profit first and foremost. It is thus difficult to drive private investment towards poorer countries, where there is generally higher risk. This is demonstrated by the IFC, where in 2012 less than 29% of investment went towards the poorest countries (i.e. IDA countries).<sup>1</sup> In fact, 37% of all investment in 2009 went to Brazil, India, Russia, China, and Turkey alone.<sup>2</sup> Similarly, over 75% of all projects in the CDM pipeline in 2012 were located in China, India, Brazil and Mexico.<sup>3</sup> Moreover, the CDM is strongly biased towards large-scale projects that produce large numbers of credits; smaller-scale projects, which would be more likely to have sustainable development benefits, would not generate offsets as cheaply.

It is especially difficult to direct private investment toward local companies in low income countries. Though these are the enterprises most subject to credit scarcity and high borrowing costs, they are traditionally the least served by the IFC. Of the IFC's investment in low income and lower-middle income countries from 2006 to 2011, only 2.4% went to small and medium enterprises, and all of that money was channeled through financial intermediaries. The European Investment Bank fared even worse, with only 0.4% of investment in non-European countries directed to small and medium enterprises from 2007 to early 2012.<sup>4</sup>

### **Failure to reach the poor**

The World Bank Group's own Independent Evaluation Group (IEG) found that of the IFC projects it examined, only "13% of projects had objectives with an explicit focus on poor people." The IEG also found that economic growth attributed to IFC investment does not inherently lead to a decrease in poverty, "the majority of [IFC] investment projects generated satisfactory economic returns but did not provide evidence of identifiable

<sup>1</sup> [http://www1.ifc.org/wps/wcm/connect/CORP\\_EXT\\_Content/IFC\\_External\\_Corporate\\_Site/Annual+Report/2011+Printed+Report/Global\\_Results/](http://www1.ifc.org/wps/wcm/connect/CORP_EXT_Content/IFC_External_Corporate_Site/Annual+Report/2011+Printed+Report/Global_Results/). Accessed 11 October 2012.

<sup>2</sup> Moody's Investors Service, *Credit Analysis, International Finance Corporation*, June 2010, at

[http://www.ifc.org/ifcext/about.nsf/AttachmentsByTitle/Moodys\\_IFC\\_Report/\\$FILE/Moodys\\_IFC\\_Report.pdf](http://www.ifc.org/ifcext/about.nsf/AttachmentsByTitle/Moodys_IFC_Report/$FILE/Moodys_IFC_Report.pdf).

<sup>3</sup> UNEP – RISO Centre, *All CDM projects in the pipeline in Brazil + Mexico + India + China as a fraction of all projects*, at <http://www.cdmpipeline.org/cdm-projects-region.htm#1>. Accessed October 2012.

<sup>4</sup> Pereira, Javier, Eurodad, *Cashing in on climate change: Assessing whether private funds can be leveraged through the Green Climate Fund and other channels to help the poorest countries respond to climate challenges*, April 2012, at [http://eurodad.org/wp-content/uploads/2012/04/CF\\_report\\_web.pdf](http://eurodad.org/wp-content/uploads/2012/04/CF_report_web.pdf).

opportunities for the poor to participate, contribute to, or benefit from the economic activities that projects directly or indirectly support.”<sup>5</sup>

### **Proliferation of financial intermediaries - environmental, social and transparency challenges**

Experience at the IFC strongly suggests that the GCF’s efforts to leverage private investment will result in the prolific use of financial intermediaries and co-financiers. The greater the use of financial intermediaries, the more intrinsically difficult it will be for the GCF to ensure implementation of and compliance with environmental and social standards. Similarly, the financial sector’s desire for less disclosure, liability, and accountability for the environmental and social outcomes of their transactions will pose a significant challenge for GCF efforts to promote sustainable development and climate effectiveness in the use of climate funds.

Today, the financial services sector is the largest in the IFC’s portfolio. But the outsourcing of development finance has led to deterioration in transparency and implementation of environmental and social standards. In 2009, 58% of IFC investments in financial intermediaries ultimately funded subprojects that were of high or medium social and environmental risk.<sup>6</sup> But the IFC does not ensure that subprojects comply with environmental and social standards. Instead, it largely relies on self-assessment, monitoring, and reporting from the financial intermediary itself.

### **Carbon markets - questionable environmental and development benefit**

Some Parties and carbon market proponents have called for links (of various sorts) to be made between the GCF and carbon markets. But there is a basic misalignment of interests -- with carbon offset project proponents and financiers on the one hand, and environmental and development integrity on the other. Buyers and sellers of carbon credits do not have an intrinsic motivation to ensure greenhouse gas reductions, but they do have an inherent interest in ensuring the creation and delivery of tradable carbon credits. This misalignment of interests opens the door to fraud, and it has caused many credits to be issued for projects that do not reduce or prevent greenhouse gas emissions. It is estimated that 40% to 70% of CDM projects are not additional, in effect leading to increased global emissions.<sup>7</sup> Furthermore, few CDM projects actually provide sustainable development benefits, and many have actually had harmful impacts.

### **Poor accountability, tax havens and roadblocks to reform**

The lack of transparency associated with private finance has broad ramifications. Absent specific requirements, international finance will gravitate towards tax havens and secrecy jurisdictions. The private financing arms of many multilateral development banks (MDBs), including the IFC, rely on financial intermediaries based in tax havens. Domiciliation in such locales has led to the loss of billions of dollars from developing countries through tax evasion and avoidance. These secrecy jurisdictions are so much a part of the MDBs’ business that some MDBs have actually lobbied against financial reforms designed to regulate parts of the “shadow banking sector,” such as private equity and hedge funds.<sup>8</sup>

Private financiers have also resisted reforms that would hold them accountable for failures to protect the climate. For example, in California, carbon brokers and buyers resisted a requirement that would make them liable for the failure of offsets projects to reduce emissions or comply with regulations, since it would increase their financial risks and potentially reduce profits. At the CDM, project developers have sought to block stakeholders from appealing Executive Board decisions to issue credits for projects that fail to reduce emissions or result in human rights violations. At the same time, lobbying groups like the International Emissions Trading Association want an appeals process that would work in their favor only, by allowing them to challenge CDM Executive Board decisions that do not issue credits.

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<sup>5</sup> Independent Evaluation Group of the World Bank Group, *Assessing IFC’s poverty focus and results*, 2011, at <http://ieg.worldbankgroup.org/content/ieg/en/home/features/poverty.html>.

<sup>6</sup> The Bretton Woods Project and Ulu Foundation, *Out of sight, out of mind? The International Finance Corporation’s investments through banks, private equity firms and other financial intermediaries*, November 2010, at <http://www.brettonwoodsproject.org/FI2010>.

<sup>7</sup> CDM Watch, *CDM Watch Recommendations on the Reform of the CDM*, 28 November 2011, at [http://www.cdm-watch.org/wordpress/wp-content/uploads/2012/02/CDM-Watch-recommendation-for-CMP-decisions\\_2811201.pdf](http://www.cdm-watch.org/wordpress/wp-content/uploads/2012/02/CDM-Watch-recommendation-for-CMP-decisions_2811201.pdf)

<sup>8</sup> See for example, Arnold, M., Financial Times, “Development banks attack planned EU fund rules”, 2 May 2010 at <http://www.ft.com/intl/cms/s/0/256b7704-55fe-11df-b835-00144feab49a.html#axzz1THLDCcBK>.