Pro-poor Climate Finance: Is There a Role for Private Finance in the Green Climate Fund?

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The views expressed in this report represent those of Friends of the Earth U.S. and the Pan African Climate Justice Alliance and do not necessarily represent those of individual contributors to these organizations or the funding organizations.

Cover photo: Adaptive agriculture, floating seedbed in flooded area, Bangladesh.
Photo credit: Shariatpur Development Society (SDS), RESOLVE.

Contents

Executive summary 4
Chapter 1: Introduction 6
1.1 Adaptation and mitigation needs 7
1.2 Legal framework 9
Chapter 2: The private sector in developing countries 11
2.1 Characteristics of developing countries' private sector 11
2.2 What do good private investments look like? 15
Chapter 3: Private finance in the GCF 17
3.1 Risk versus return 17
3.2 Leveraging private finance in the GCF 18
3.3 Grants 20
3.4 Debt 22
3.5 Equity 24
3.6 Quasi-equity 26
3.7 Risk instruments 27
Chapter 4: Deconstructing additionality and leverage 30
4.1 What is meant by additionality? 30
4.2 What is meant by leveraging? 31
Chapter 5: Social, environmental and fiduciary standards 34
5.1 Existing standards, scope and implementation 34
5.2 Financial intermediaries: a particular concern 37
Chapter 6: Conclusions and recommendations 39
Endnotes 44

Executive summary

Before the Green Climate Fund (GCF) considers the role of the private sector in meeting the climate finance needs of developing countries, it should first ask: what are the needs of the people living in those countries as they confront the climate crisis, especially the poorest and most vulnerable? Second, can private finance and support for the private sector help to equitably and effectively meet those needs, in accordance with the GCF Governing Instrument and the United Nations Framework Convention on Climate Change?

This report attempts to respond to these questions by de-constructing ideological notions of "leveraging" and "crowding in" private finance and examining the track record of the private sector, private financiers and development finance institutions (DFIs) in developing countries. The report concludes that the GCF should approach private companies and financiers slowly and with a high degree of caution, and only engage them to the extent that they can guarantee compliance with high standards on environmental, social and development effectiveness; implement robust processes designed to address financial, social and environmental risks; and produce effective mitigation and adaptation outcomes.

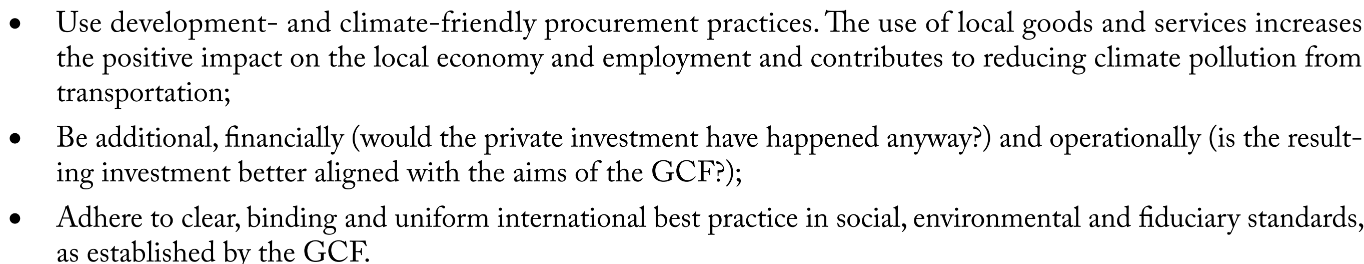
Private climate finance cannot be a substitute for direct public support, and adaptation in particular is likely to offer few commercially profitable opportunities for private financiers. Private finance will be especially difficult to deploy responsibly in low and lower-middle income countries, as well as in marginalized communities in all developing countries. That said, in limited circumstances and with a number of stipulations, GCF efforts to mobilize private finance may contribute to meeting developing countries' needs. Similarly, directing finance towards private companies has substantial limitations. Micro, small and medium enterprises (MSMEs) are the most important economic actors and provide most of the employment in developing countries. However, most MSMEs focus on subsistence, with high informality rates, low returns and low investment volumes. As a result, they are often ignored or bypassed by international donors and financiers. Without rigorous and well-articulated efforts to address this dynamic, the GCF would likely do the same in its private sector support.

Key lessons learned from DFIs and climate funds that support private finance:

- They tend to focus on large projects, most often involving foreign corporations.
- They deploy a wide arrange of tools to support private companies, but most do not reach the informal economy and they are frequently inadequate to support MSMEs in developing countries.
- Their preferred solution to challenges reaching MSMEs is to work through financial intermediaries. But a reliance on financial intermediaries frequently results in deeply inadequate monitoring and transparency, poor development outcomes, poorly implemented environmental and social standards and serious deficiencies in accountability to affected communities and other stakeholders.
- DFIs frequently fail to ensure that projects they support are truly additional, and inflate leverage ratios based on methodologies that are inconsistent within and between institutions. Reported leverage ratios frequently bear little relation to the efficiency of projects in achieving their goals.

GCF-supported projects and activities should:

- Be driven by government policies, reflecting a bottom-up process that especially targets and is responsive to the needs of the poorest and most vulnerable to climate change. Such policies include climate-friendly economic development and industrial policies, and adaptation and mitigation priorities identified in national plans and frameworks;
- Build domestic and local capacity and support the development of endogenous technology, with support for developing country MSMEs, including special efforts to reach the informal economy;
- Attain the consent of communities in a process free of disinformation or intimidation and according to the international principle of free, prior and informed consent;



- Use development- and climate-friendly procurement practices. The use of local goods and services increases the positive impact on the local economy and employment and contributes to reducing climate pollution from transportation;
- Be additional, financially (would the private investment have happened anyway?) and operationally (is the resulting investment better aligned with the aims of the GCF?);
- Adhere to clear, binding and uniform international best practice in social, environmental and fiduciary standards, as established by the GCF.

GCF support for mobilizing private finance: The following financial instruments offer some potential to equitably and effectively support development-friendly climate finance:

- Grants can be used to support a range of government-sponsored mitigation and adaptation activities. Grants and grant elements may also be added to loans to provide more favorable terms to governments, and, in limited circumstances, to appropriate private actors in developing countries.
- Loans and bond financing may be helpful, but they should not add to unsustainable national debt burdens.
- Loan guarantees could help to incentive the flow of credit towards government and private sector actors in developing countries, but excessive reliance on risk sharing instruments could give rise to accusations of privatization of profit, while the public shoulders financial losses.

Direct equity investments, quasi-equity instruments and investment guarantees (i.e. political risk insurance) are unlikely to be helpful for MSME financing, and generally should be avoided.

Further recommendations:

- **Standards:** The GCF should establish clear, uniform and binding international best practice in social, environmental and fiduciary standards for all its financing.
- **Financial intermediaries:** The GCF should take a highly cautious approach toward the use of financial intermediaries. To reach a large number of MSMEs, the GCF would have to rely on financial intermediaries as pass-throughs for loans and other financial instruments. Sub-projects financed by the GCF through financial intermediaries must be held to the same environmental, social, fiduciary and transparency standards as investments that are directly financed by the GCF. There should be an assumption in favor of disclosure, rather than commercial confidentiality, and intermediaries should not be allowed simply to self-report and self-regulate.
- **Prohibitions:** The GCF should prohibit the use of tax havens by private companies or financiers receiving support from the GCF, as well as establish an exclusion list that prohibits support for climate-polluting activities, such as fossil fuel-related activities.
- **Private sector governance:** Any private sector activities supported by the GCF should be subject to the same governance structure as GCF-supported public sector activities. The possibility of a private sector facility with its own governance structure, including the possibility of private sector board members, should be discarded. Private investment experts can be well-placed to provide technical advice, but they must not be placed in decision-making positions. The private sector facility should be a tool available to developing country governments, should they decide to deploy it.
- **Foreign direct investment (FDI):** The GCF should generally avoid support for multinational corporations except in very limited circumstances. Any support for FDI must require foreign corporations to build local partnerships and alliances, support local production and train and hire local workers.

Chapter 1: Introduction

In our current era of fiscal austerity, private finance has been widely held up as a panacea to a variety of monetary ills that the public sector faces worldwide. That same dynamic has entered the debate at the Green Climate Fund (GCF) of the United Nations Framework Convention on Climate Change (UNFCCC). But before private finance can be considered a solution, the appropriate questions must first be asked: what are the needs of people in developing countries as they confront the climate crisis, and how can the GCF equitably and effectively meet those needs? It is from this entry point that this report is written – that form follows function, and the function of the GCF is to meet the adaptation and mitigation needs of those most vulnerable to climate change. This approach does not necessarily leave out the private sector, but neither does it assume that the private sector will be a central solution.

With this in mind, two overarching points should be made at the outset:

1. This report does not deal in any way with how to capitalize or raise funds for the GCF. We strongly believe that the $100 billion[i] developed countries have promised to contribute for climate finance for developing countries by 2020 must be made up entirely of public funds. Therefore, this report only considers how the GCF spends the money it has or will have.
2. The focus of this report — the GCF and the role of private finance — should not be taken as an endorsement of private finance playing a predominant role in the GCF. Rather, it is a response to the often-exaggerated notions of "leveraging" and "crowding in" private finance that have permeated many climate finance discussions, including those at the GCF. Such notions are often based on ideology rather than experience in the fields of development and climate finance.

Acronym List

AfDB -- African Development Bank

CAO -- Compliance Advisor/Ombudsman

CDM -- Clean Development Mechanism

CTF -- Clean Technology Fund of the World Bank

DFIs - development finance institutions

EBRD -- European Bank for Reconstruction and Development

ECAs -- export credit agencies

EDFI -- Association of European Development Finance Institutions

EIB -- European Investment Bank

FDI -- foreign direct investment

GCF -- Green Climate Fund

GEF -- Global Environment Facility

GNI -- gross national income

IFC -- International Finance Corporation

IRR -- internal rate of return

LED -- local economic development

MDBs -- multilateral development banks

MIGA -- Multilateral Investment Guarantee Agency

MSMEs -- micro, small and medium enterprises

ODI -- Overseas Development Institute

SCF -- Strategic Climate Fund of the World Bank

UNFCCC -- United Nations Framework Convention on Climate Change

Parameters of the report

To establish a better understanding of how any GCF support for the private sector might work, we have examined the track record of multilateral development banks (MDBs), development finance institutions (DFIs) and a selection of existing climate funds. The experiences of these institutions should not be perceived as a model, but rather as a source of information to be analyzed and contextualized before possible application to the GCF. These institutions do not have the same mandate as the GCF, nor do they generally have environmental and social justice records that the GCF should emulate. For example, most of the energy projects supported by the European Investment Bank (EIB) are fossil fuel-based, including large coal power plants.[1] The International

i Unless otherwise noted, monetary figures used in this report are in U.S. dollars.

Finance Corporation (IFC) similarly has a troubling track record of financing large energy and other infrastructure projects with widespread negative environmental and social consequences (e.g. the Tata coal power plant in India and oil extraction in Ghana).[2]

1.1 Adaptation and mitigation needs

Cost estimates

Estimates of the price tag to address the climate crisis in developing countries span a wide range, but all of them are very large. Table 1 summarizes some of the most commonly-cited climate finance estimates for adaptation and mitigation. As indicated in the table, adaptation figures apply to developing countries, while mitigation figures generally apply to global needs. The UNFCCC suggests that 40 to 60 percent of all mitigation finance will need to be deployed in developing countries.[3]

A quick analysis of the figures suggests that the combined cost of mitigation and adaptation in developing countries is likely to be around $500 billion a year using a conservative approach, and that it could reach up to some $1 trillion, or more, if the higher end of the figures is used.

Terminology alert

Multilateral development banks (MDBs): Institutions with broad-based governmental membership/ownership that provide financial support and professional advice for economic and social development activities in developing countries. Examples include the World Bank Group, Asian Development Bank, African Development Bank and Inter-American Development Bank.

Development finance institutions (DFIs): Institutions with a development mandate that provide finance to the private sector. DFIs can be multilateral or bilateral. Among other roles, MDBs often function as DFIs and thus are multilateral DFIs. This role can be performed by divisions within MDBs such as the World Bank Group's International Finance Corporation (IFC). Examples of bilateral DFIs include Norway's' Norfund and the United States' Overseas Private Investment Corporation.

In this report, the term DFI will be used to refer both to institutions which are exclusively DFIs and to MDBs in their roles as DFIs. By extension and for the sake of simplicity, the concept of DFI has also been applied to climate funds when they support private companies in developing countries.

Table 1. Selected climate finance estimates

Purpose	Estimate	Scope	Source[4]
Mitigation	2 percent GDP annually ($1.4 trillion using 2011 GDP figures)	Global	United Nations Environment Programme (2011)
	$262-$670 billion annually, $105-$402 billion of which is in developing countries	Global and developing countries	UNFCCC Expert Group on Technology (2009)
	$36 trillion for 2012-2050 ($950 billion annually on average)	Global	International Energy Agency (2012)
Adaptation	$27-$66 billion annually	Developing countries	UNFCCC (2007)
	$54-$198 billion annually, additional $65-$300 billion annually for ecosystem protection	Developing countries	Parry et al (2009)
	$75-$100 billion annually	Developing countries	World Bank (2010)

Mitigation needs in developing countries

An important question to consider is not just how much climate finance will be required, but for what types of mitigation and adaptation needs. With the climate crisis upon us, the world cannot afford for developing countries to go down the dirty development road that industrialized countries took over the last few centuries, which has landed us in the throes of global warming. Not only is ecologically sustainable development a fundamental right that belongs to every country, the planetary emergency faced by humanity demands no less. Developing countries have enormous financial needs in terms of providing access to clean energy for all.

A comprehensive approach towards mitigation is necessary, including support for:

- Mitigation policies and activities for countries and sectors with existing high greenhouse gas emissions;
- Activities and policies to introduce and expand truly renewable energy systems, from local to industrial scales, for example, through feed-in tariffs;
- Ensuring that renewable energy comprehensively reaches and serves marginalized populations, for example, through off-grid renewable energy systems;
- Development and enhancement of endogenous capacity and environmentally-sound technology through policy changes and knowledge transfer, for example, through technical assistance and adapted research.

Adaptation needs in developing countries

Adaptation measures can reduce vulnerability, build resilience to the unavoidable impacts of climate change and help countries adjust to expected change. They cover a wide range of sectors, including health, agriculture, infrastructure, ecosystem protection, land rights, political empowerment, water and other natural resources upon which communities depend.

Income groups

This report uses the World Bank's classification of income groups, which divides all countries into four groups according to their level of gross national income (GNI) per capita. The four groups are:

Low income countries: GNI per capita ≤ $1,025

Lower-middle income: $1,025 > GNI per capita ≤ $4,035

Upper-middle income; $4,035 > GNI per capita ≤ $12,475

High income: GNI per capita > $12,476 or more

Within any country, it is usually those who are the poorest who are the most vulnerable and therefore most likely to have the greatest adaptation needs. A comprehensive approach toward adaptation supports climate-resilient development and sustainable livelihoods and involves support for:

- Social measures, which focus primarily on decreasing the vulnerability and building the resilience of communities to climate change. Examples of social measures include improved access to health services, the introduction of new agricultural and land management techniques and raising awareness about the importance of protecting ecosystems. One key social measure is increasing access to social protection in developing countries, especially among those more likely to feel the impact of climate change – people living in rural areas and small landholders. Social protection systems should guarantee access to a mini-

mum level of income as well as basic services such as healthcare. Those without social protection are very vulnerable to external shocks;

- Technical measures, which aim to build resilience by primarily targeting the physical infrastructure of the country. Examples include reforestation of coastal areas, developing early warning systems and building irrigation systems.

The chair of the UNFCCC's Least Developed Countries Group elaborated on some of the infrastructure needs of those countries in particular in an open letter to the U.S. president. Priorities include:

> *"… moving drinking water and irrigation wells away from coasts, where saltwater is intruding into aquifers; it includes developing drought-resistant crops and helping small farmers in fragile, semi-arid regions survive. We have to prepare roads and cities, villages and farms for floods, hurricanes and heat waves. We need to equip people with the weather prediction, early warning systems and emergency response that citizens of the developed countries take for granted."*[ii]

It is these types of mitigation and adaptation activities that the Green Climate Fund was conceived to finance; any consideration of the role of the private sector (both financial and corporate sectors) in the GCF must begin with a firm understanding of what activities the Fund should support and an acknowledgement of the potential and limitations of the private sector to finance and meet these needs.

Rural women storing water to adapt to climate change, Ghana. Photo credit: Gia Nabio.

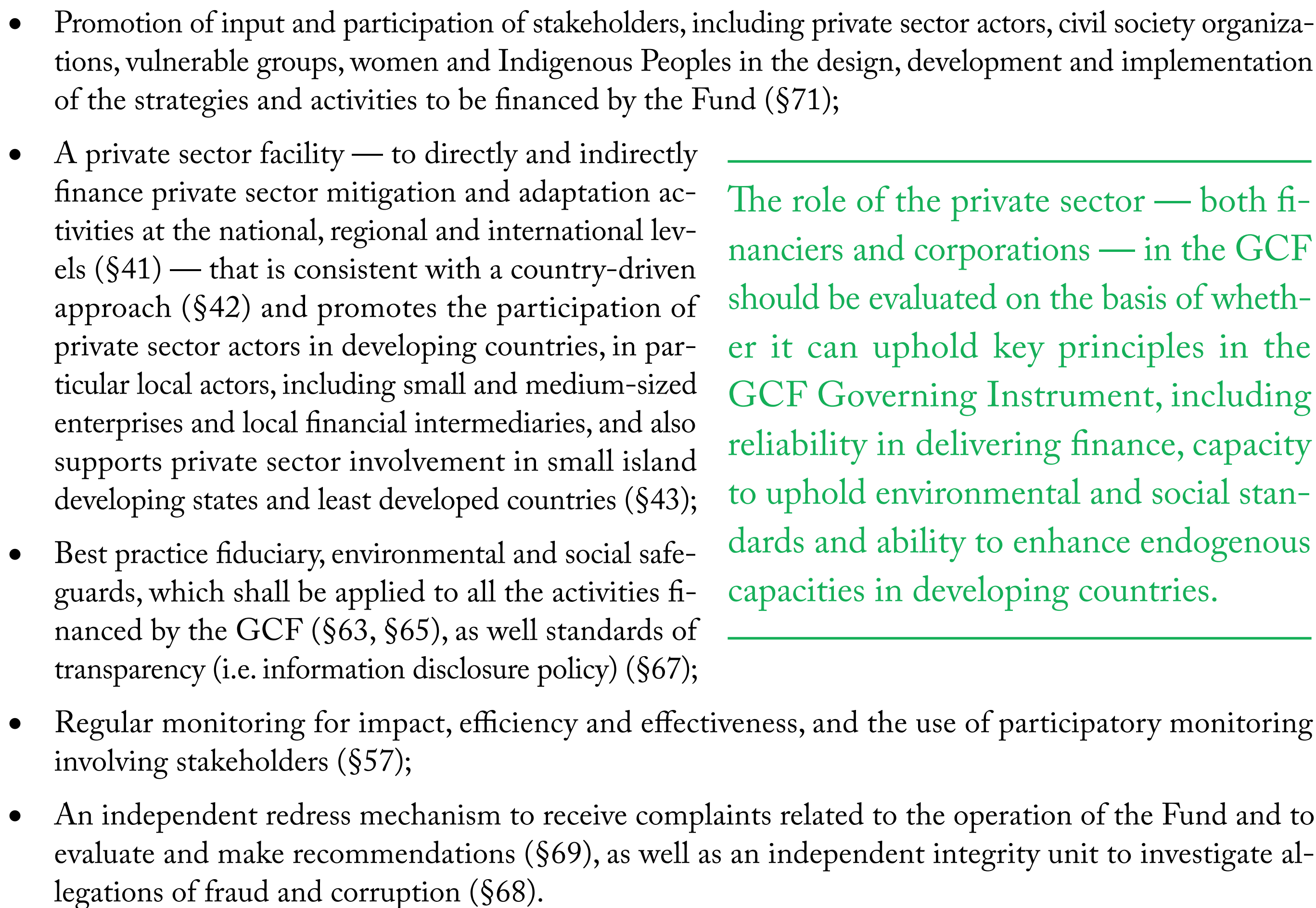
1.2 Legal framework[iii]

To understand the types of mitigation and adaptation activities the GCF should support, it is also important to look to the legal framework elaborated in the GCF Governing Instrument and the UNFCCC. The Governing Instrument sets out basic principles to guide the GCF's support to developing countries, including private sector support:

- A clear mandate to work within a sustainable development framework (§2);
- Support for developing countries to mitigate greenhouse gas emissions and adapt to climate change (§2);
- New, additional, adequate and predictable financial resources for developing countries (§3);
- A country-driven approach, and promotion and strengthening of engagement at the country level through effective involvement of relevant institutions and stakeholders (§3);
- Alignment with developing countries' climate change strategies and plans, such as low-emission development strategies or plans, nationally appropriate mitigation actions (NAMAs), national adaptation plans of action (NAPAs), national adaptation plans (NAPs) and other related activities (§36);

ii Jarju, P. O. (2012) An Open Letter to Obama from the World's Poorest Countries. The Guardian, 8 November.

iii Some of the cited paragraphs of the GCF Governing Instrument and the UNFCCC are abridged or paraphrased.



- Promotion of input and participation of stakeholders, including private sector actors, civil society organizations, vulnerable groups, women and Indigenous Peoples in the design, development and implementation of the strategies and activities to be financed by the Fund (§71);
- A private sector facility — to directly and indirectly finance private sector mitigation and adaptation activities at the national, regional and international levels (§41) — that is consistent with a country-driven approach (§42) and promotes the participation of private sector actors in developing countries, in particular local actors, including small and medium-sized enterprises and local financial intermediaries, and also supports private sector involvement in small island developing states and least developed countries (§43);
- Best practice fiduciary, environmental and social safeguards, which shall be applied to all the activities financed by the GCF (§63, §65), as well standards of transparency (i.e. information disclosure policy) (§67);

The role of the private sector — both financiers and corporations — in the GCF should be evaluated on the basis of whether it can uphold key principles in the GCF Governing Instrument, including reliability in delivering finance, capacity to uphold environmental and social standards and ability to enhance endogenous capacities in developing countries.

- Regular monitoring for impact, efficiency and effectiveness, and the use of participatory monitoring involving stakeholders (§57);
- An independent redress mechanism to receive complaints related to the operation of the Fund and to evaluate and make recommendations (§69), as well as an independent integrity unit to investigate allegations of fraud and corruption (§68).

Parameters for GCF support for developing countries' private sector can also be found in Articles 4.5 and 4.7 of the UNFCCC:

- Developed countries shall promote, facilitate and finance the transfer of, or access to, environmentally-sound technologies and know-how, particularly to developing countries, to enable them to implement the provisions of the UNFCCC. Developed countries shall support the development and enhancement of endogenous capacities and technologies of developing countries.
- The extent to which developing countries will effectively implement their commitments under the Convention will depend on the effective implementation by developed countries of their commitments under the Convention related to financial resources and transfer of technology and will take fully into account that economic and social development and poverty eradication are the first and overriding priorities of the developing countries.

The role of the private sector — both financiers and corporations — in the GCF should be evaluated on the basis of whether it can uphold key principles in the GCF Governing Instrument, including reliability in delivering finance, capacity to uphold environmental and social standards and ability to enhance endogenous capacities in developing countries.

Chapter 2: The private sector in developing countries

The GCF's mandate to contribute to equitable economic and social development and environmental protection, as an integral part of adaptation and mitigation efforts, has important implications for the way the GCF should work with private companies. As will be demonstrated, in order to fulfill this mandate, the GCF should prioritize support for domestic micro, small and medium enterprises (MSMEs) in both the formal and informal economies of developing countries. Without adopting intentional measures to steer its funding, GCF efforts to invest in the private sector will virtually ignore those countries with the greatest needs. Nevertheless, significant amounts of direct public support will be required to meet the adaptation and mitigation needs of low and lower-middle income countries.

2.1 Characteristics of developing countries' private sector

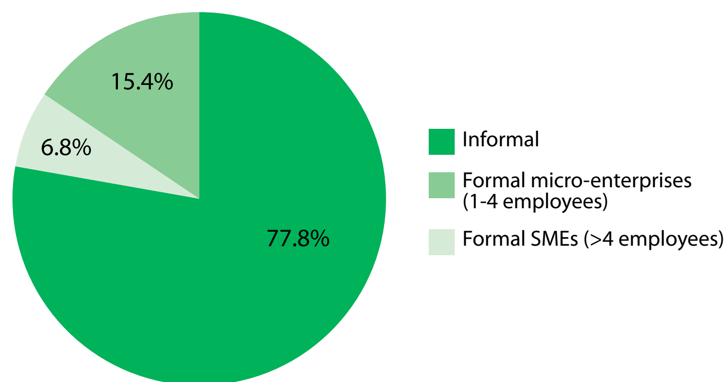
Informal versus formal economies and benefits on the ground

MSMEs are the major economic forces in developing countries. Unlike in developed countries, most MSMEs in developing countries operate in the informal economy. As a consequence, any credible efforts to support private companies in developing countries must target MSMEs, including those in the informal sector. This is especially the case for adaptation, as the informal economy is particularly dominant in rural areas and in climate-vulnerable sectors such as agriculture.

Supporting MSMEs in the informal economy is crucial to ensure penetration of adaptation and mitigation efforts. According to the International Labor Organization, it is essential to work with MSMEs in the informal economy in order to "[upgrade] informal economy workers and economic units and [improve] their access to mainstream services, social protection and markets."[5] Formalization is one of the most effective ways of increasing economic resilience to climate change while contributing to sustainable development. For example, allowing farmers to access social protection systems, as well as bigger markets, is crucial to help them cope with the impacts of climate change. In addition, formalization of the economy would help developing countries raise additional income and taxes that can be re-invested in climate change and sustainable development programs.

Climate-resilient handloom factory, Bangladesh. Photo credit: Brandon Wu, ActionAid USA.

Graph 1. Distribution of the estimated 365-445 million enterprises in developing countries



Source[6]

Graph 1 shows that most enterprises operating in developing countries belong to the informal economy. MSMEs, including in the informal sector, "account for over 60% of GDP and over 70% of total employment in low income countries, while they contribute over 95% of total employment and about 70% of GDP in middle income countries."[7] By region, "the nonagricultural employment share of the informal workforce is 78% in Africa, 57% in Latin America and the Caribbean, and 45–85% in Asia."[8]

From a sustainable development perspective, supporting domestic, rather than international, companies results in greater benefits for ordinary people in developing countries. Local companies are more likely to use local labor, increase productive capacities and reinvest a greater share of their profits at home, contributing to more resilient local economies that are better able to cope with a changing climate. The contribution is even more significant when private companies are supported within the framework of a local economic development initiative.

Local economic development (LED) initiatives

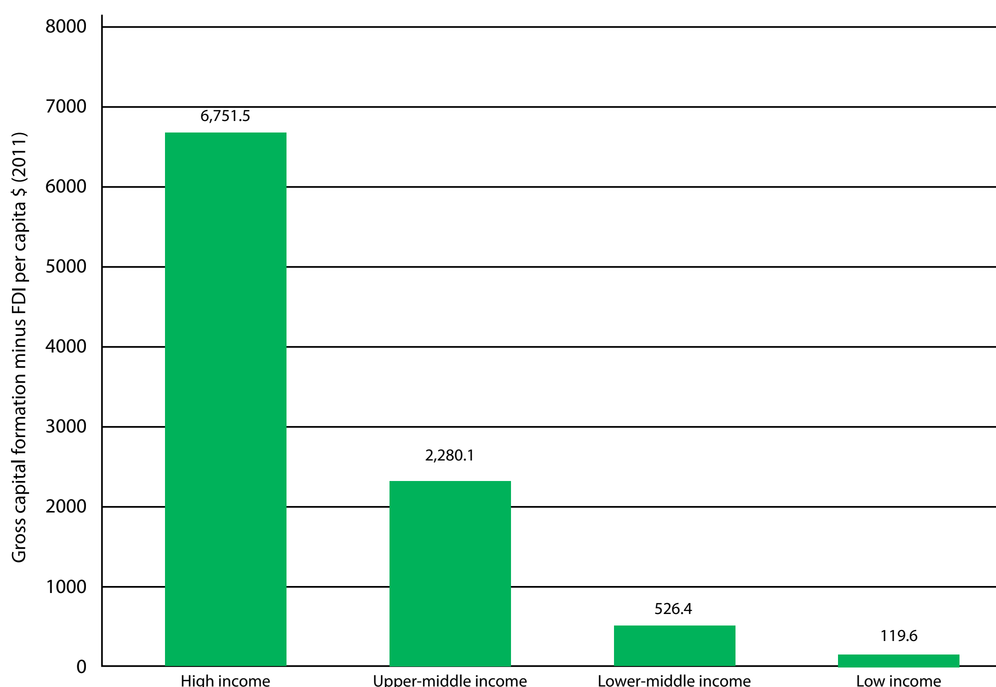
The concept of LED is based on social dialogue including workers, government, civil society and the private sector in order to agree on development opportunities and identify challenges and barriers to be tackled. For example, the International Labor Organization has implemented an LED program in Ghana which has helped to increase the income of farmers and allowed them to access social protection schemes,[9] making them less vulnerable to climate change.

One of the main advantages of using an LED approach in developing countries is that it can help redress inequality between rural and urban regions, a major problem in developing countries exacerbated by domestic and international policy frameworks that discriminate against agriculture in developing countries.[10] Inequality makes societies more vulnerable to climate change both directly, by "constraining the options of households and individuals when faced with external shock," and indirectly "through its links to poverty and other factors."[11]

Small-sized private sector in poorer countries presents limited investment opportunities

Examining the levels of gross capital formation in developing countries provides insight into the investment opportunities in these countries. Gross capital formation is defined as "outlays [expenditure] on additions to the fixed assets of the economy plus net changes in the level of inventories."[12] In other words, it measures the volume of investment in fixed assets (e.g. infrastructure, livestock, equipment, etc.) and inventories (stock of goods) made by public and private companies operating in a country. Gross capital formation includes investments in a country resulting from foreign direct investment (FDI). In order to provide a more accurate picture of domestic investment, FDI flows have been subtracted from the figures in Graph 2.

Graph 2. Gross capital formation per capita by level of income, excluding FDI



Elaborated by the author with data from the World Bank's World Development Indicators database (2012)

Low levels of capital formation indicate small public and private sector investments. Graph 2 suggests that the formal private sector is very small in lower income countries and, thus, there are fewer formal investment opportunities in these countries compared to higher income countries. Given the comparative lack of opportunities in lower income countries, if the GCF decides to support private companies – whether domestic or foreign – without adopting well-articulated measures to steer its funding equitably, there is a significant risk that these investments will mostly benefit upper-middle and high income countries, where there are more immediate "investible" opportunities.

If the GCF decides to support private companies — whether domestic or foreign — without adopting well-articulated measures to steer its funding equitably, there is a significant risk that these investments will mostly benefit upper-middle and high income countries.

Research on the distribution of DFI support to developing countries affirms this. A report examining the distribution of private sector projects among six DFIs, including the IFC, European Investment Bank and three bilateral finance institutions (Norfund in Norway, FMO in the Netherlands and Bio in Belgium), found that, despite their greater needs, low income countries received less than 10 percent of money flows from the DFIs' portfolios.[13] In addition, Graph 2 suggests that, compared with wealthier countries, there may be limited opportunities to mobilize domestic climate finance from developing country-based investors and companies.

Foreign direct investment

The GCF should only support multinational corporations in very limited circumstances – when no domestic option can fulfill a particular need, when it is done at the request of the government of the respective developing country and only in the context of equitable and sustainable development.

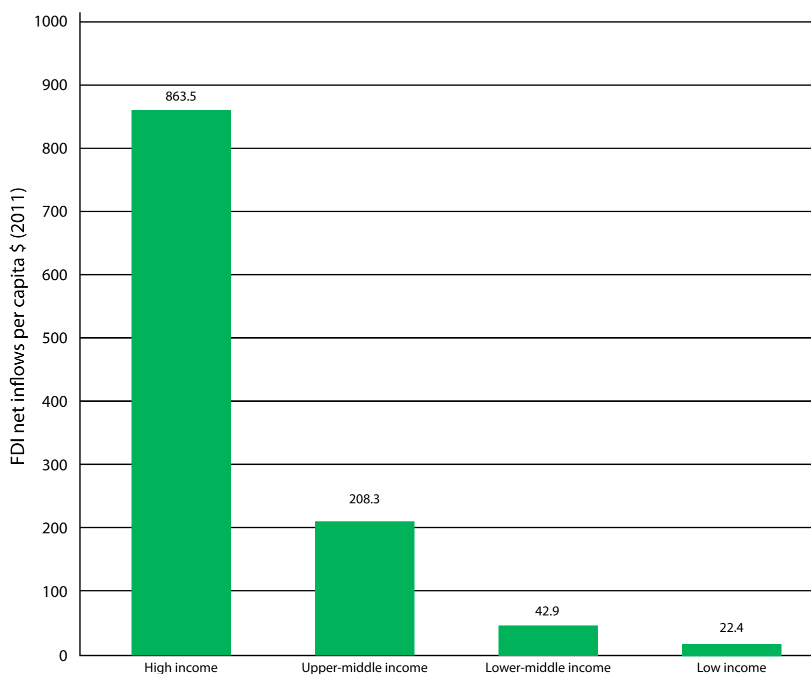
Foreign direct investment flows reflect the investment preferences of corporations investing abroad. Graph 3 suggests that private sector interest in foreign investment decreases in line with the countries' level of income. While high income countries attract an average of $863 per inhabitant, lower-middle and low income countries only attract $43 and $22, respectively, in investment per citizen, in other words, 20 to 40 times less. Without specific efforts to ensure otherwise, support for foreign companies is more likely to benefit higher income countries.

The GCF should only support multinational corporations in very limited circumstances – when no domestic option can fulfill a particular need, when it is done at the request of the government of the respective developing country and only in the context of equitable and sustainable development.

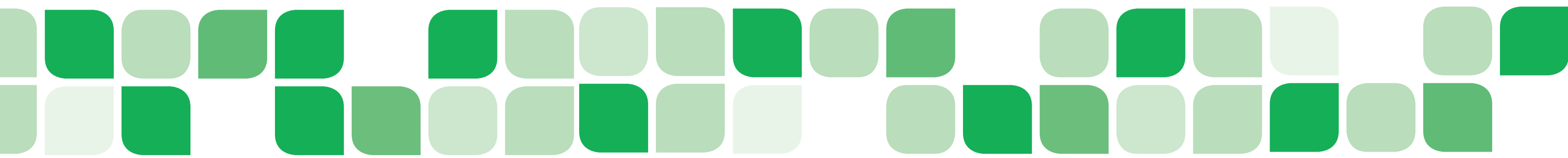
Foreign companies operate in a complex environment and usually select countries on the basis of the competitive advantages they offer. For instance, all other conditions being equal or similar, private foreign investors gravitate toward countries with lower tax rates and/or better access to markets. In addition, countries with a developed financial system, which is not the case for many of the poorest countries, are in general more likely to benefit from FDI.[14]

DFIs generally do not help overcome this bias of foreign companies. Instead of actively seeking investors in poorer countries, they tend to operate as passive recipients of project proposals submitted to them by private companies – a modality that, if not addressed directly, could be repeated in the GCF private sector facility. Incentivizing support to and applications by domestic companies in the

Graph 3. FDI net inflows per capita by level of income



Elaborated by the author with data from the World Bank's World Development Indicators database (2012)



target countries can help steer investments and ensure that "less attractive" countries also benefit from efforts to mobilize private climate finance.

2.2 What do good private sector investments look like?

There are certain circumstances in which supporting private companies in developing countries may contribute to meeting adaptation and mitigation needs in the context of sustainable development. A number of features can help maximize the positive impact of investing in the private sector. Notably, the GCF Governing Instrument and the UNFCCC, to varying degrees, mandate that GCF investments exhibit these features.

Driven by government policies

It is essential that GCF financing for the private sector is driven by host government policies, including climate-friendly industrial and agricultural policies. These include government plans designed to encourage the development or growth of a given sector of the economy by identifying and proposing actions to tackle existing barriers and bottlenecks. This could include measures such as pilot projects, subsidies and incentives for new industries, and public investment to provide basic infrastructure and improve market access.

Similarly, GCF support for private finance must support and respond to national climate change policies. These include initiatives such as national adaptation programs of action (NAPAs) and national adaptation plans (NAPs), in which developing countries identify their most urgent and immediate adaptation needs, as well as nationally appropriate mitigation actions (NAMAs), in which developing countries identifiy mitigation measures that can be funded by external actors.[15]

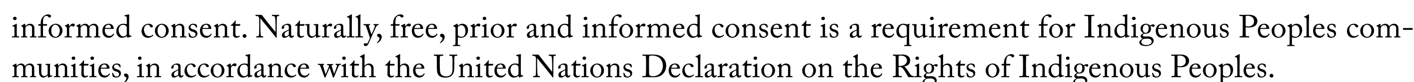
Social dialogue with local stakeholders

Broad social dialogue that includes civil society, workers and government should be an essential element of any private sector activity supported by the GCF. Indeed, the GCF Governing Instrument requires the effective involvement of stakeholders, including vulnerable groups, women and Indigenous Peoples, in the design, development and implementation of the strategies and activities to be financed by the Fund.

Social dialogue helps to ensure projects respond to local adaptation and mitigation needs, increases accountability and contributes to long-term sustainability. It is one of the key pillars of LED,[16] acts as an important driver of economic development[17] and helps maximize the impact of climate and development projects by identifying gaps, contributing to consensus-building and ensuring local ownership. In the case of larger projects – such as regional agriculture investment plans – it allows strategic planning and helps all actors work together towards a common goal.

Social dialogue leads to better quality jobs, stronger local civil society and greater transparency of private and public actors.[18] It also helps to improve relations within and between social actors, which, in the long term, improves "the prospects for sustainable, equitable growth and just, participatory governance."[19]

Effective social dialogue requires public consultations with stakeholders, especially affected communities, in accordance with international best practice. Stakeholders must have sufficient time to understand and raise objections to a potential GCF-supported project. The consent of the majority of stakeholders must be obtained in a process free of disinformation or intimidation and according to the international principle of free, prior and



informed consent. Naturally, free, prior and informed consent is a requirement for Indigenous Peoples communities, in accordance with the United Nations Declaration on the Rights of Indigenous Peoples.

Use of local, pro-poor and climate-friendly procurement practices

The GCF Governing Instrument also requires the Fund to promote the participation of private sector actors in developing countries, in particular local actors such as small and medium-sized enterprises. One key way to achieve this is for GCF-supported investments to incentivize the use of local goods and services. Very often, private companies, especially multinational corporations, have profit maximization strategies that result in the use of foreign goods and services when local options are available. There are several reasons behind this behavior, including the provision of goods and services from subsidiaries of the same company, concern about the risk of using untested service providers and, especially in the case of transnational companies, aggressive profit maximization strategies that include the centralization of procurement. These practices effectively prevent developing countries from reaping the full benefits of private sector investments and can result in a significant transfer of resources back to the country of origin of the foreign companies.

Similarly, GCF-supported investments should obviously use climate-friendly procurement practices. This fits hand-in-glove with the economic development benefits of local goods, services and labor, which minimize greenhouse gas emissions related to the transport or import of goods that instead can be acquired locally. For example, a study conducted by the National Health Service in the UK found that 60 percent of their emissions were attributable to procurement.[20]

Build domestic and local capacity and support development of endogenous technology

Capacity building and training are essential components if investing in the private sector is to contribute to sustainable development, adaptation and mitigation. The UNFCCC provisions pertaining to technology transfer require local knowledge-building, which is critical to ensure the real transfer of mitigation and adaptation capacities and a sustained impact. This is especially important when working with foreign corporations; if there is no capacity building or transfer of knowledge to the local economy, the impact of the activities will not be sustainable. Although using GCF funds to finance foreign companies generally is not advisable, there may be limited circumstances in which it might be considered due to a lack of domestic productive or technical capacity.

Given our assumption that FDI will only be supported by the GCF in cases in which no local or domestic alternatives exist, the effects of competition and demonstration/imitation on domestic companies can be discarded because there is no local private sector to compete with or imitate the foreign actor, at least in the short term. In such circumstances, FDI may contribute to enhancing local capacity and knowledge by promoting linkages (collaboration or partnerships) with local companies and building the capacity and knowledge of local workers through training. Building linkages with local partners increases the transfer of knowledge to local companies.[21] Similarly, the use of local labor trains local workers and upgrades their capacities.[22] Both linkages and training are usually related, such as when a foreign company collaborates more closely with local companies and provides technical assistance to upgrade their skills. In practical terms, both linkages and training can be promoted by requiring foreign corporations to build partnerships and alliances and support local production under licensing agreements (rather than importation, for example) when implementing projects in developing countries.

Chapter 3: Private finance in the GCF

3.1 Risk versus return

The typical investment decisions of international private financiers and corporations, particularly when considering developing country investments, are not generally driven by their desire to enhance endogenous capacity or eradicate poverty – important goals of the GCF. Rather, investment decisions are based on expected returns, or profits, balanced against the risks that threaten the success of a project or activity. As rule, these concepts are often directly correlated: investors willing to take higher risks also expect higher returns.

Risk is a complex concept that encompasses a range of elements which are difficult to control.[23] Different types of risk include: political risks (e.g. unstable governments and changes in legislation), macroeconomic risks (e.g. exchange rate volatility) and technology risks (e.g. untried technologies and new breakthroughs). The returns or profitability of a deal are usually measured by the internal rate of return (IRR), which expresses the earnings from an investment in the form of an annual interest rate.[24]

Rationale behind public support for the private sector

For certain projects or activities that serve the public interest, public institutions such as DFIs may decide to join with private financiers to co-finance a transaction, often helping to reduce risks or enhance returns for private investors. Public institutions usually try to provide just enough support to mobilize private finance. For example, they may offer investor guarantees against political risks, provide loans for a project which commercial banks might consider too risky or make early investments in a project to send an encouraging signal to other potential investors. Because public institutions are supposed to use scarce taxpayer resources to advance the public good (in the case of the GCF, to fulfill a particular climate mission and meet specific legal requirements), they must be particularly careful about which private sector projects to support, and under what conditions.

Risk appetite — are all investors the same?

Given the limited amount of GCF financing available, how much of a financing gap might the GCF be expected to bridge in order to mobilize a private financier or corporation to invest in a climate adaptation or mitigation project in a developing country?

This is a difficult question to answer, but one key factor is investors' perception of the instability and volatility of the country where the money is being invested. Research suggests that based on financiers' perception of country and sovereign risks, transactions in some nations require minimum acceptable rates of return of up to 70 percent.[25] Furthermore, rates of return can vary significantly within countries depending on the nature of the project, the region and a number of other factors.

In addition, banks and institutional investors may have different risk appetites; some may not be comfortable allocating very much – or any – funds to high risk opportunities, despite the promised returns. Table 2 shows the main features of different types of equity-based collective investment vehicles, professionally-managed funds to which institutional investors such as pension funds can allocate capital. Expected returns in the table are based on climate mitigation activities and do not focus on developing countries in particular. If only investments in developing countries were included in the table, higher rates of returns could be required. For example,

infrastructure funds show an IRR of 15 percent in the table, but the figure can be significantly higher in many developing countries. To illustrate, one biofuel infrastructure investment in West Africa had an expected IRR of 40 to 60 percent.[26]

Table 2. Selection of different equity-based funds: common investments, rates of return and investment horizons expected, based on climate mitigation activities globally (not only developing countries)

Investment vehicle	Common investments	Rate of return	Investment horizon
Venture capital funds	Target new technology, new markets. Interested in early stage companies. Generally, all cash is realized at the end of the investment period through a sale.	50%	5-7 years
Private equity funds	Target companies with possibility for enhanced returns. Interested in companies with more mature technology (compared to venture capital), including those preparing to raise capital on public stock exchanges ('pre IPO'), demonstration companies or under-performing public companies. Generally, all cash is realized at the end of the investment period through a sale.	35%	3-5 years
Infrastructure funds	Investment, often in the form of equity, that targets infrastructure projects with fixed assets, long duration and steady lower risk cash flow. Interested in roads, railways, power-generating facilities, etc.	15%, depending on the country	7-10 years

Sources[27]

3.2 Leveraging private finance in the GCF

Private finance for developing countries' private sector

As mentioned previously, when it comes to support for the private sector, financing for MSMEs is critical for the GCF to achieve its mission and meet its legal obligations under its Governing Instrument and the UNFCCC. However, both corporate and financial investors seeking high returns are unable to invest in the largest share of MSMEs in developing countries, which largely operate in the informal economy. In addition, the proportion of MSMEs with significant growth potential is much smaller than in developed economies. Most MSMEs in developing countries are family businesses or small cooperatives that focus on generating immediate income, with little potential to grow into large-scale competitive businesses.[28] Finally, investors have limited interest in MSMEs in developing countries because the investments usually required are small and transaction costs high. In contrast, minimum investments for institutional investors and funds are generally around $2 million,[29] an astronomical figure for most MSMEs in developing countries. Managing the small investments required to support MSMEs in developing countries, in the range of hundreds of thousands of dollars (and sometimes even less), is considered impractical because it entails approximately the same transaction cost per investment (identification, negotiations, monitoring), but increases by several times the amount of resources consumed.

Private finance for the public sector

The GCF could also mobilize private finance for climate projects sponsored by developing country governments. For example, it could organize a group of commercial banks to lend to a government mitigation project, or incentivize investors to purchase climate-related sovereign debt with GCF credit enhancements (see section 3.7, "risk instruments"). However, there are several potential concerns with mobilizing private finance for developing country governments. Most important is the danger of driving them further into debt, as they struggle to adapt to and mitigate climate change; this is antithetical to the spirit and intent of climate finance. In fact, many developing countries rightly insist that adaptation finance be grant-based.

> Given the structure of the micro, small and medium enterprise sector in developing countries, there appears to be, and historically has been, a greater role for simple and lower risk instruments, such as micro and direct loans, to promote private sector development, especially in lower income countries.

The remainder of this chapter explores which leveraging techniques and which financial instruments, in general, are more likely to contribute to fulfilling the GCF's mitigation, adaptation and sustainable development mandate. It finds that, given the structure of the MSME sector in developing countries, there appears to be, and historically has been, a greater role for simple and lower risk instruments, such as micro and direct loans, to promote private sector development, especially in lower income countries. More complex debt-based instruments, such as commercial-rate mezzanine loans, imply much higher premiums, which make them not well-suited for most MSMEs in developing countries, with their low growth and revenue potential. And like equity financing, these instruments are usually only accessible to companies in the formal economy. With respect to the public sector, there may be a range of worthwhile mitigation projects that local or national governments may want to finance (e.g. public transportation improvements in large cities), but GCF attempts to mobilize private finance for these needs should be treated with caution, and should focus on grants, concessional loans and other ways of mobilizing below-market debt for lower income governments.

Table 3 reviews the main types of financial instruments used by a sample of DFIs and climate funds. It should be noted that some of the institutions listed have different mandates than the GCF. Further, just because certain institutions use a specific instrument or set of instruments does not necessarily mean that they can be used by the GCF.

Table 3. Instruments used by selected DFIs and climate funds

	Grants	Debt instruments	Equity instruments	Quasi-equity instruments	Risk instruments
Global Environment Facility Trust Fund	Yes, different types, including technical assistance and grants linked to results	Yes, including hard, concessional and contingent loans	Yes, direct equity (participation in companies) and investment funds (equity)	No	Guarantees, including loan guarantees and risk guarantees
Clean Technology Fund	Yes	Yes, works through MDBs	Potentially yes, works through MDBs	Potentially yes, works through MDBs	Potentially yes, works through MDBs
Strategic Climate Fund	Yes	Yes, works through MDBs	Yes, works through MDBs	Potentially yes, works through MDBs	Yes, works through MDBs
Adaptation Fund	Yes	No	No	No	No
International Finance Corporation	Yes (but few)	Yes, loans and syndicated loans	Yes, direct equity and investment funds (equity)	Yes, different instruments	Yes, loan and risk guarantees
European Investment Bank	Yes, technical assistance	Yes, loans and syndicated loans	Yes, direct equity and investment funds (equity)	Yes, different instruments	Yes, loan and risk guarantees
African Development Bank	Yes	Yes, including concessional loans and syndicated loans	Yes, direct equity and investment funds (equity)	Yes, diverse instruments	Yes, guarantees for loans and other debt instruments
Multilateral Investment Guarantee Agency	No	No	No	No	Risk and loan guarantees

Sources[30]

3.3 Grants

A grant is a transfer "made in cash, goods or services for which no repayment is required."[31] Grants are common tools for providing climate finance. For instance, all adaptation projects funded through the UNFCCC's Least Developed Countries Fund, Special Climate Change Fund and Adaptation Fund are entirely grant-based. Grants for government-sponsored adaptation and mitigation activities, especially those that are critical but not revenue-generating, are clearly appropriate for the GCF. Grant-based financing for governments can also indirectly mobilize private sector investment, for example, by establishing feed-in tariffs to subsidize and incentivize the production of renewable energy. However, direct grants to the private sector are not a common tool to leverage private climate investment.

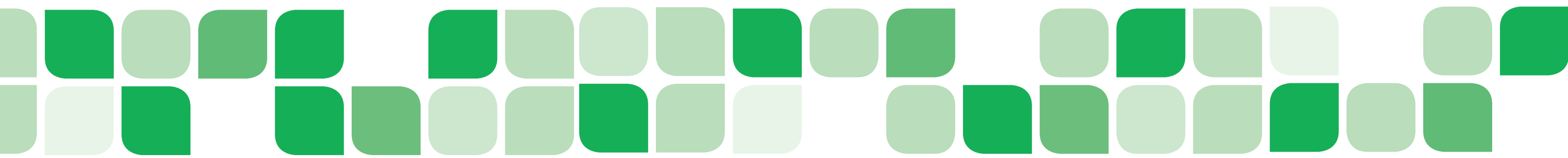


Table 4. Main types of grants

Type	Main features
Direct grants	A direct subsidy that does not have to be repaid.
Technical assistance grants	Provision of technical assistance free of charge. It can be a grant for third-party technical assistance, or the provision of internal expertise free of charge.
Grant elements in loans	Grants elements are commonly used in loans in order to make them concessional (provide the borrower with more advantageous conditions than those offered on the market). In reality, the grant element is not an actual transfer of resources. It is measured as the difference between the repayment of the loan with the grant element and the repayment if a reference interest rate would have been used. The grant element can be linked to a loan provided by the same or a different institution in order to make it concessional. The latter case is known as blending.

The use of direct grants for the private sector can be problematic because public institutions, especially those working with the private sector (such as the IFC), aim to help establish projects and activities which are self-sustaining in the long term. Using grants to subsidize activities that are not commercially viable may not help to stimulate additional private sector investments or similar projects beyond the project itself. Nonetheless, DFIs or climate funds may sometimes award small direct grants for demonstration projects whose commercial viability has not yet been established. Grants may also be used to help capitalize, provide reserves or otherwise strengthen private sector microfinance institutions.

Grants for government-sponsored adaptation and mitigation activities, especially those that are critical but not revenue-generating, are clearly appropriate for the GCF.

Grants in the form of technical assistance could play a potentially larger role. Technical assistance grants can help tackle some of the main limiting factors for domestic private companies discussed previously, in particular those related to the transfer of knowledge. For instance, technical assistance can be provided in order to install, produce or repair solar panels. In turn, this can encourage new businesses in developing countries. Technical assistance is usually provided in combination with other types of financial support. Thus, the potential of technical assistance by itself to leverage climate finance is difficult to estimate, but it can make an important contribution to assuring the success of private sector initiatives.

A third option is to include a grant element for a transaction which might or might not be linked to the fulfillment of a given set of objectives. This option helps to soften a loan (reduce its interest rate). It is discussed in the next section.

3.4 Debt

Debt instruments are "transfers for which repayment is required."[32] Debt instruments can include bonds (issued by governments or corporations) or loans.

Bonds

Direct GCF investment in corporate bonds generally may not be appropriate, considering the importance of targeting GCF financing for MSMEs in lower income countries. However, in particular circumstances, GCF bond financing for state-owned enterprises based in lower income countries could be contemplated. For example, the GCF could be involved in a structured bond offering issued by a public utility, particularly if revenues raised would help deliver renewable energy for the poor (structured bonds, as opposed to general obligation bonds, dedicate revenue to particular activities). The GCF could also be involved in low income government bonds, for example, through creating a bond fund for government-sponsored climate mitigation projects. However, as previously mentioned, climate finance should not lead to unsustainable debt burdens, and sovereign debt financing should be provided on a concessional basis. A second concern relates to the growth of secondary sovereign debt markets, and the rise of "vulture funds," collective investment schemes which purchase distressed debt and initiate a crushing cycle of litigation to recover the face value of the bonds. Any GCF attempts to mobilize private debt financing — whether through bonds or loans — for lower income governments should be approached with caution.

Climate finance should not lead to unsustainable debt burdens, and sovereign debt financing should be provided on a concessional basis.

Finally, there has been some discussion about the GCF following the World Bank "green bond" model, in which the GCF could assume certain risks and use the strength of its own credit rating to raise low-cost debt for climate projects sponsored by developing country governments. Although the majority of World Bank green bond financing goes to mitigation and adaptation projects in middle income countries, this model, with caution, could potentially be adapted for lower income countries.

Loans

Loans are a much more common debt instrument in the portfolio of DFIs. For example, loans represented 62 percent of all IFC disbursements in 2010,[33] and almost 94 percent of the private sector operations approved by the AfDB in 2011.[34] Loans also accounted for 47 percent of the total portfolio of the 15 development finance institutions that are members of the Association of European Development Finance Institutions (EDFI).[35] Loans were also the most important financing tool in a sample of climate finance projects profiled by the Overseas Development Institute (ODI).[36] The table below explains the main types of loans that are used to support private sector projects in developing countries.

Table 5. Main types of loans

Type	Main features
Direct loans	A direct loan to governments, companies, activities or projects in developing countries. Also known as 'A' loans among some DFIs.
Syndicated loans	A large direct loan in which a group of banks work together to provide funds to a single borrower.
Credit lines	According to the IFC, credit lines are defined as loans for a fixed amount, or for a maximum amount, extended to financial intermediaries for on-lending. They are used to incentivize lending to sub-projects by financial intermediaries.
Concessional loans	Any of the loans above that have been softened with a grant element. In practice, the "concessionality is achieved either through interest rates below those available on the market or by grace periods, or a combination of these."

Sources[37]

Concessional loans are essentially loans provided under more favorable terms than those available on the market. For example, by applying an interest rate that is lower than the market rate, a DFI is providing a loan at a discount, which, averaged over the life of the loan, is called the "grant element." Grace periods can also be used to make loans concessional (e.g. no payments during the first two years). Incorporating grant elements into loans or other financial instruments can be particularly appropriate for public sector mitigation and possibly adaptation projects. Concessional loans may also be used to soften interest rates for microfinance institutions, in the interest of reaching MSMEs. Finally, they may also prove useful in providing an extra push for particularly challenging private sector projects, but their use needs to be calculated carefully so that they do not become wasteful subsidies.

Direct commercial lending for private companies is unlikely to directly reach MSMEs in either the formal or informal economy. DFIs, such as the IFC, do not have branches in developing countries where farmers, for example, or MSMEs can apply for loans. In addition, they generally do not work with loans of a size that would be suitable for these types of actors. The average size of an IFC loan is $21.7 million. Out of a total of 189 loans examined, only two were under $2 million.[38] An ODI database that looks at bilateral private climate finance reveals an average loan size of $79.9 million.[39]

The alternative to direct lending is to extend loans to financial intermediaries, which then use those funds to finance sub-projects. At the IFC and the World Bank, this is known as a credit line. Financial intermediaries are often suggested as the best option to support MSMEs in developing countries. (Financial intermediaries may include commercial and investment banks, private equity and venture capital funds, microcredit institutions, insurance and other financial institutions.)

However, important concerns have been raised about the use of such credit lines. An evaluation by the World Bank's Independent Evaluation Group found that only 52 percent of all the operations involving credit lines were satisfactory.[40] Credit lines for private sector development were particularly ineffective, with only 10 percent deemed satisfactory. These concerns are elaborated in more detail in chapter 5.

There are also specific concerns regarding the use of microfinance institutions. Although often seen as an obvious choice to support small businesses in developing countries, microfinance does not always benefit the poor. Some figures suggest that only 10 to 25 percent of the money spent by international organizations on microfinance actually reaches the poorest.[41] There are also many examples of microfinance institutions which have aggressively sold microloans that have buried poor people in debt, with interest rates in the range of 20 to 30 percent.[42] In addition, it should be noted that microfinance is no longer necessarily a synonym for microcredit. Microfinance has become a major business with interests in insurance, savings, mobile payments and other sectors.

3.5 Equity

Equity investments "are all those investments that involve the ownership of shares in a company."[43] Equity investments by public financiers can leverage private investment through several ways. First, they increase the company's own capital. This can in turn mobilize private creditors, who may wish to see (more of) a borrower's own money invested in the enterprise before extending debt financing. In addition, by making early equity investments in a company or project, a DFI may convince other potential (private) investors to participate, thus mobilizing more capital. Finally, a sufficiently large equity investment typically grants investors access to the company's management, enabling them to help steer the company. This power can attract investors who believe that their expertise and influence can increase the value of the company and, consequently, the value of their equity stake.

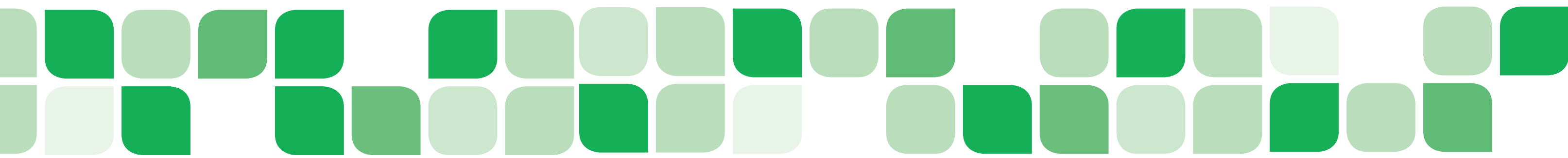
Equity investments tend to be the second most common instrument used by DFIs to support the private sector in developing countries. Equity investments accounted for 28 percent of all disbursements made by the IFC in 2011 (loans represented 67 percent).[44] Equity and quasi-equity instruments (no disaggregated figures were available) also represented 52 percent of the total portfolio of the 15 development finance institutions that are members of EDFI.[45] In the case of the AfDB, equity investments only represented a little over six percent of all private sector operations approved in 2011; loans made up almost 94 percent.[46]

Table 6. Main types of equity instruments

Type	Main features
Private equity	Purchase of shares of a company not publicly listed on a stock exchange. Typically purchased through specialized investment funds such as venture capital, private equity or hedge funds, or funds of funds.
Public equity	Purchase of shares of a company listed on a stock exchange. Can be purchased directly or through investment funds.

Sources[47]

The use of equity instruments in developing countries faces a number of problems. "Equity investments are appropriate in markets with an up-side potential promising higher reward compared to other instruments [debt]."[48] Equity investments imply higher risk than loans (in cases of default, all debt has to be repaid first), and investors expect higher rates of return compared to debt instruments. As discussed previously, most com-



panies in lower income countries are informal subsistence and family businesses with little potential to grow into major companies, and therefore of little interest to most equity investors, particularly international investors.

Most companies in lower income countries are informal subsistence and family businesses with little potential to grow into major companies, and therefore of little interest to most equity investors, particularly international investors.

Moreover, equity investments usually require a strong legal framework, which tends to be weaker in low and lower-middle income countries, as well as in fragile states.[49] A survey of a number of equity investors in developing countries found that they gave top priority to (i) a legal framework defining investors' rights and obligations, and (ii) payment discipline and enforcement.[50] To an extent, these concerns might also apply to other types of investments, but equity investors are more likely to seek reassurance that they can operate within a clear legal framework governing capital markets, which are generally weak in lower income countries. For example, the CTF has recognized that uncertainty about the legal framework surrounding investors' rights and operations is one of the main reasons why equity investments are not possible in all countries.[51] Further, equity investments require the existence and enforcement of regulations that provide for the repatriation of profits and a 'safe' exit strategy for the investor.

Like debt instruments, equity investments require substantial exploratory work and in-depth knowledge of the private sector in the country of interest. This can be a major challenge for DFIs and climate funds that do not have a significant presence in developing countries. There are investment funds that specialize in MSMEs in developing countries and/or specific sectors and can help bridge knowledge gaps, bringing more experience working in various developing countries and different perceptions of the actual risks and institutional and legal frameworks. For example, the EIB has invested in Convergence Partners, an investment fund based in South Africa that specializes in communication networks and technology in Africa.[52] Similarly, the IFC has invested in MUSE Capital Advisors Limited, an investment fund based in Mauritius that specializes in high-growth Indian SMEs.[53]

Developing country equity funds

The use of investment funds is not a silver bullet, raising serious transparency and ethical concerns similar to those of credit lines for financial intermediaries, including weak monitoring and evaluation, and inadequate environmental and social protections (as described in chapter 5).

Corruption, fraud and money laundering can also be a problem. For example, the IFC invested in Emerging Capital Partners (ECP),[54] a private equity firm, despite knowing that the firm had hired a private investigator to look into the life of a whistleblower who alerted ECP's institutional investors about corruption allegations in Nigeria. That whistleblower now lives outside the country for fear of retribution.

In addition, many investment funds are based in tax havens, or secrecy jurisdictions. For example, 90 out of the 134 investment funds supported by the CDC Group, a British DFI formerly known as the Commonwealth Development Corporation, and 29 out of the 35 funds used by Norfund, Norway's DFI, are based in jurisdictions considered tax havens.[55] Many of these jurisdictions have regulations that allow registered companies to

operate behind a veil of secrecy. This obviously poses significant barriers to monitoring and evaluation and undermines accountability, particularly for communities affected by a company financed by the fund. Many tax havens "have established systems that make the storage of information on ownership and activities voluntary for the owners and managers of these enterprises."[56] Thus, often even the investors in the fund cannot be identified.

By supporting investment funds based in tax havens, development finance instutions and climate funds are very likely helping to erode the tax base of developing countries.

Finally, by supporting investment funds based in tax havens, DFIs and climate funds are very likely helping to erode the tax base of developing countries. For example, many tax havens have treaties to prevent double taxation. Thus, an investment fund could set up shop in a tax haven (such as Mauritius, which has treaties with many African countries) and then invest in a number of developing countries. The fund would then ensure that the revenue generated in the developing country, where the tax rate is likely to be substantially higher, is instead taxed at a very low rate in the tax haven, depriving the developing country of much needed funds for healthcare, education, infrastructure and other essential public goods and services. Further, tax havens play a central role in illicit capital flows from developing countries, estimated at $725 to $810 million annually.[57]

3.6 Quasi-equity

Quasi-equity instruments have both equity and debt features. They are designed to fill in the gap between debt instruments (which are considered safer in case of liquidation because debts are the first to be repaid) and equity (which is considered riskier in case of liquidation because all creditors have to be paid first). These instruments can be based on either debt or equity. When based on debt instruments, they are usually loans with a lower repayment priority. When based on equity instruments, they offer greater protection than normal stock by making reimbursements or payments preferential compared to normal shareholders. The IFC usually defines quasi-equity investments as 'C' loans. Table 7 summarizes the main types of quasi-equity investments used by DFIs.

Table 7. Main types of quasi-equity instruments

Type	Main features
Subordinated or junior loans	A loan that has a lower repayment priority than other loans in case of liquidation.
Mezzanine loans	Junior loans with a very low priority of repayment and which can be repaid in equity, in addition to cash.
Preferred stocks	Equity investment with some characteristics of a debt instrument. Preferred stock gives an investor a higher dividend (closer to the rate of the company's bonds) than the company's common stock and places an investor before a common shareholder in bankruptcy. However, owning preferred stock typically does not give a holder voting rights in a company.
Convertible bonds	A bond that can be converted into shares of common stock or into cash of an equivalent value. Interest is paid before any dividends, and it is therefore safer than an equity investment.

Sources[58]

It is difficult to find accurate data about the volume of quasi-equity investments for different DFIs. Some, such as the IFC, usually include quasi-equity instruments together with loans in their annual accounts, while EDFI reports them together with equity investments. It is generally believed that they are smaller than the size of debt and equity instruments. For example, out of the almost $6.9 billion the IFC disbursed in 2010, only $926 million (13.6 percent) was in the form of quasi-equity instruments.[59] Within quasi-equity instruments, those based on debt were more common and accounted for $857 million, while those based on equity instruments represented $69 million.

Like all relatively sophisticated financial instruments, equity-based quasi-equity investments, such as preferred stock and convertible bonds, are not adequate to target private companies in most developing countries, as they only cater to companies in the formal economy and are inadequate for MSMEs. The use of equity-based quasi-equity instruments requires an elaborate legal framework, including clear company regulations on the exercise of options, shareholder rights, etc. Such a framework does not exist in all countries.[60] Moreover, equity-based quasi-equity instruments require advanced financial management and accounting systems. MSMEs have rather limited capital needs and cannot afford to issue preferred stocks or convertible bonds. As a consequence, MSMEs usually find it very costly and impractical to use equity-based quasi-equity instruments as a form of finance. [61]

Debt-based quasi-equity instruments usually have high interest rates that make them unsuitable for most micro, small and medium enterprises in developing countries.

The use of equity-based quasi-equity instruments requires an elaborate legal framework, including clear company regulations on the exercise of options, shareholder rights, etc. Such a framework does not exist in all countries.

Debt-based quasi-equity instruments are simpler to use. However, they appear to have limited potential for the private sector in low and lower-middle income countries, as they pose the same problems of limited distribution and high transaction cost posed by direct lending and bond financing. Therefore, it is more likely that debt-based quasi-equity will support large multinational companies than MSMEs.

In addition, debt-based quasi-equity instruments usually have high interest rates that make them unsuitable for most MSMEs in developing countries. Theoretically, GCF money could be used as subordinated debt, in order to leverage private debt at a lower interest rate. However, past experience shows that subordinated debt, even when provided by DFIs, comes at a price. For instance, the EIB applies an interest premium of 10 to 13 percent over reference interest rates when using mezzanine loans.[62] An Estonian DFI that supports projects within the country applies rates of 9 to 18 percent, plus a 2 to 7 percent "success fee" on the profits at the end of the loan.[63] A more affordable way that the GCF could offer debt-based quasi-equity is to do so at below-market rates.

3.7 Risk instruments

The instruments examined below are designed to tackle one or more specific risks in developing countries. They can operate in several different ways: they can protect investors directly, they can protect a third party involved in a project (e.g. bank lenders) or both.

Many "de-risking" instruments deployed by DFIs are intended to lower the cost of capital for developing countries, and thus mobilize private companies and financiers who otherwise would require higher returns to be involved. By bridging this gap, and making previously unviable investments "bankable," they are considered one of the most high-leverage instruments to mobilize the participation of private financiers and foreign direct investors. Risk instruments can be deployed for both government-sponsored and private sector activities, and they tend to focus on crowding in private finance. For example, partial risk and partial credit guarantees (discussed below) provided by the World Bank's International Bank for Reconstruction and Development are typically extended to government borrowers to implement public infrastructure; however, the guarantees actually cover payments to private creditors in the case of government default.

Table 8. Main types of risk instruments

Type	Main features
Credit guarantees	A commitment to fulfill loan or bond payments if a borrower cannot meet the payments.
Investment guarantees	Mainly political and macroeconomic risk insurance for investments in developing countries. This includes risks such as violence, revolution, expropriation and currency inconvertibility.

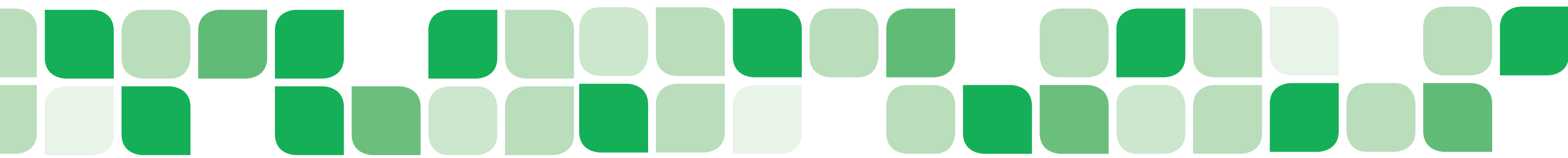
Sources[64]

Credit guarantees help public and private sector borrowers to access loans or bond financing by ensuring creditors the repayment of all or part of their debt. They can also be used to extend loan maturities or to compensate for a lack of creditworthiness or collateral, thus alleviating credit constraints in developing countries. Credit guarantees can take various forms. For example, guarantees can be provided to investors who have bought bonds issued by a government utility. A loan guarantee can be provided to a commercial bank lending to a farmers' association, in order to allow the association to borrow more cheaply.

Loan guarantees are provided by many DFIs, including the IFC, EIB and AfDB. In 2011, the European Investment Fund, a branch of the EIB, approved a total of 47 loan guarantee operations with a total value of €1.46 billion ($1.96 billion).[65] That same year, the IFC issued approximately $529 million in loan guarantees.[66]

The main limitation of loan guarantees for the private sector is penetration. As discussed throughout the report, it is very difficult for DFIs and climate funds to target MSMEs directly in developing countries. A potential solution is the use of guarantees to incentivize lending by intermediaries, for example, by guaranteeing a portion of the loans provided to private companies by a domestic bank. Most of the guarantees provided by the EIB's European Investment Fund fall within this category and are intended to increase loans to MSMEs. But, as has been mentioned, working through financial intermediaries poses large challenges in terms of transparency, tracking, monitoring, evaluation, accountability, and as discussed in chapter 5, social and environmental standards.

Investment guarantees cover risks of private financiers in developing countries and are typically used in foreign direct investment operations. Most guarantees cover political and macroeconomic risks, including war and terrorism. They are usually available from specialized bilateral and multilateral institutions. Export credit agencies (ECAs), as the bilateral institutions are usually known, have been designed to promote and protect



the commercial interests of companies in the ECA's home country. The World Bank's Multilateral Investment Guarantee Agency (MIGA) is an example of a fully specialized multilateral guarantee agency. As a multilateral agency, it has a broader mandate than ECAs and focuses on promoting FDI in developing countries. In 2011, MIGA issued a total of 50 new guarantee contracts, insuring $2.1 billion.

The track record of investment guarantees suggests that they are not optimal tools to leverage private climate finance for developing countries for two main reasons. First, investment guarantees (i.e. political risk guarantees) apply essentially to FDI, and we have concluded that the GCF should focus on developing countries' domestic private sector. There are practically no examples of political risk guarantees covering foreign financiers of domestic companies.

Investment guarantees (i.e. political risk guarantees) apply essentially to foreign direct investment, and we have concluded that the GCF should focus on developing countries' domestic private sector.

Secondly, investment guarantee agencies can contribute to odious debt and unsustainable debt loads. Guarantors can seek reimbursement of payments made to companies when a guarantee is triggered, even for badly-designed or corruption-laden projects. For example, at the end of the Suharto regime, Indonesia signed a contract to build 27 power plants that received guarantees from the U.S. and Germany. The contract required the government to buy electricity at a high price, despite suspicions that Suharto's family had personal interests in the enterprise.[67] When the Suharto regime collapsed, the new government cancelled some of the remaining contracts, triggering significant political risk insurance claims. In another Indonesia-related example, in the 1990s both MIGA and the U.S.-based Overseas Private Investment Corporation provided investment guarantees to the Freeport McMoRan gold and copper mine in West Papua, which created significant environmental impacts, undermined local livelihoods and relied on the Indonesian military to provide security for the project. The provision of political risk insurance for this project contributed to increased human rights violations and security risks, thus aggravating the very political risks that the agencies were supposed to insure against.

Under certain circumstances, such as in cases of civil unrest that severely damage a project's assets, the guarantor may compensate a private company and then subsequently try to claim the money back from the developing country's government, through requiring host government counter-guarantees. This liability can become part of the country's official debt. The problem is compounded because resolving claims is usually a lengthy process, and often interest continues to accrue. For instance, in 2003, investors in Ethiopia were still litigating 27-year-old claims due to expropriation of their assets.[68] When Denmark cancelled Sudan's debt, all of which was related to investment guarantees, 90 percent of the debt was interest accrued after 1984.[69]

Chapter 4: Deconstructing additionality and leverage

Proponents of using GCF resources to "leverage" private finance point to all of the abovementioned financial instruments as a way to mobilize "additional" capital. But what do "additionality" and "leverage" actually mean?

4.1 What is meant by additionality?

The Governing Instrument of the GCF includes a mandate for the GCF to provide "additional" finance. However, the meaning of "additional" has been the subject of rigorous debate, with questions raised about what it means and how it can be consistently measured.[70] Determining additionality is particularly important when public institutions deploy scarce financial resources in conjunction with private finance or for private sector activities.

Additionality is frequently characterized by two main components: [71]

- Financial additionality: Would the private investment have happened anyway? This is the most common approach to define additionality. Without financial additionality, instead of leveraging private finance, the public institution is simply subsidizing private financiers and companies, or competing with them.
- Operational and institutional additionality: Is the resulting investment better aligned with the aims of the public institution backing it? Have there been improvements in, for example, the environmental or social performance of the investment as a result of the public institution's involvement?

A lack of financial additionally is common among DFIs. For example, an audit of projects supported by the Swedish DFI, Swedfund, found that 8 out of the 12 companies they interviewed stated that the investment would have gone ahead without public support.[72] Operational additionality also is often inadequately addressed by DFIs. An evaluation of IFC lending by the World Bank's own Independent Evaluation Group found that "at least one form of operational or institutional additionality was identifiable in about one-third of the cases."[73] A more recent report focusing on financial intermediaries concluded that around 30 percent of the projects did not show any improvements as a result of the IFC's involvement and that figure increased to 60 percent in the case of sub-projects.[74] (More analysis of the use of financial intermediaries can be found in chapter 5.) This casts doubt on the ability of the IFC, and potentially other DFIs, to improve the private investments they support.

> An audit of projects supported by the Swedish development finance institution, Swedfund, found that 8 out of the 12 companies they interviewed stated that the investment would have gone ahead without public support.

When DFI investments are evaluated, additionality is usually considered as one of multiple criteria, rather than as a *condition* the private sector project must fulfill, thus contributing to approval of projects that are not actually additional.[75] GCF support for the private sector must demonstrate financial and operational/institutional additionality.

Monitoring additionality requires comprehensive ex-ante and ex-post assessments and an evaluation system that looks at both financial and operational/institutional additionality. Existing ex-ante assessment systems appear unable to account for operational/institutional additionality. While they usually measure the relevance of the project and its expected performance (measured through variables such as effectiveness, efficiency, sustainability and envi-

Community members raise a 1KWh turbine, South Africa. Photo credit: Jane Harley.

ronmental impact), they do not look at these issues from an operational/institutional additionality perspective. Ex-ante evaluation systems could be improved by including new criteria such as, for example, how does the involvement of the DFI contribute to increasing the company's environmental, social or fiduciary standards?

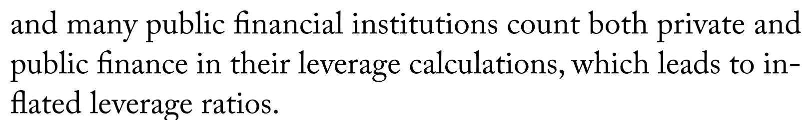
4.2 What is meant by leveraging?

In the context of the GCF, the concept of "leverage" can be generally defined as the ability to use public money to mobilize other funds for investment in a specific project or activity. However, beyond this basic principle, there are important differences that affect the way leverage ratios are computed. Further, many questions have also been raised about assumptions behind whether public funds really did, in fact, mobilize private investment.

The majority of project costs supported by development finance institutions tend not to be shouldered by private financiers, a fact that is unclear in the use of most leverage ratios.

Calculating leverage ratios — failure to differentiate between public and private money

When it comes to leveraged private finance, one would presume a leverage ratio of 1:2 means that one unit of public investment leverages two units of private sector investment. However, this is often not the case. There are multiple methodologies for estimating leverage ratios,



and many public financial institutions count both private and public finance in their leverage calculations, which leads to inflated leverage ratios.

For instance, the World Bank's Clean Technology Fund (CTF) and the Global Environment Facility (GEF) calculate leverage ratios as the ratio between the finance they provide to the project and the total amount of funding provided by other financiers, without differentiating between public and private sources.[76] Thus, a project with a total cost of $100 million that has a CTF contribution of $10 million would have a leverage ratio of 1:9, regardless of whether the other $90 million comes from public sources (such as other multilateral development banks and governments) or private sources.

The same project can also have different leverage ratios depending on which institution's methodology for leverage calculation is used. For example, the World Bank uses a different approach in its infrastructure projects and simply divides the total costs of the project by its contribution to the project.[77] Using the same example provided above, its leverage ratio would instead be 1:10. Here, also, the World Bank fails to differentiate between public and private finance. MIGA uses the same approach, although it uses guarantees. Thus, MIGA divides the total amount of private investments by the amount of the guarantees provided.[78]

Playing with math: Clean Technology Fund project in Colombia

The total funding for a CTF project in Colombia was $2,996 million, split among the following:[79] CTF ($150 million), Colombian government ($770 million), private sector ($1,250 million), MDBs ($726 million) and other ($100 million).

The CTF claims a leverage ratio of 1:19 for the project.[80] But by including the contribution of the Colombian government and the MDBs, the World Bank assigns a misleadingly outsized role to the leverage potential of CTF money. The actual public to private finance leverage ratio, calculated using the CTF's methodology, at 1:8 is less than half of the CTF's claimed ratio.

Inflated claims of leverage

The actual potential to raise additional private climate finance is significantly less than what the leverage ratios of institutions like the CTF and IFC would suggest. The majority of project costs supported by DFIs tend not to be shouldered by private financiers, a fact that is unclear in the use of most leverage ratios. For example, private finance in private sector projects supported by the GEF and CTF averages 35.6 percent and 23.7 percent respectively (or, alternately, the public component is much larger – 64.4 percent and 76.3 percent, respectively).[81]

> When multiple public actors are involved in a project, they may end up claiming to have leveraged each other's money, which leads to double counting.

Public funds often already earmarked

Public funds generally cannot be "leveraged" in the same way as private funds because they are usually earmarked for specific purposes or belong to specific budget lines. Governments tend to have detailed national budgets and money cannot be easily moved from one budget line to another; funds designated for adaptation, for example, would have "happened anyway." This is probably the case of the $770 million contributed by the Colombian government to the CTF project. Similarly, MDBs contributed a total of $726 million, but it is likely they would have spent part of the money on climate projects regardless.

Double counting

When multiple public actors are involved in a project, they may end up claiming to have leveraged each other's money, which leads to double counting. Co-financing of a project in collaboration with another DFI is quite common. For example, the GEF may contribute $100 million, the IFC another $200 million and the private sector a further $300 million. Using the CTF methodology, the leverage ratio of the GEF is 1:5, while the leverage ratio of the IFC is 1:2. Moreover, the GEF could claim to have leveraged the IFC money, while the IFC could make a corresponding claim on GEF money. The leverage potential of each institution's money is thus further inflated.

In the case of the Clean Development Mechanism, researchers even found evidence of a paradox in which projects with lower leverage ratios achieved better results than those with higher leverage ratios.

Are high leverage ratios better?

Existing literature often suggests that high leverage ratios are better because of the implication that public funds are being invested more effectively.[82] However, this only holds true in a very limited number of cases and only if the additionality of the leveraged funds can be proven.

When a public institution claims a project has a high leverage ratio, this simply means that a large share of the cost is coming from other sources, with that particular public institution's contribution only representing a small part. Using the previous example from Colombia, the CTF's contribution to the project is a little over five percent of the total costs. It is possible that the CTF provided the first five percent of the funding and actively recruited new financiers for the remaining sum, but in all likelihood, most, if not all, of the remaining 95 percent of the funds required for the project were already available. A project with so much funding already raised is likely to go ahead regardless of the CTF, either in its current form or with some minor modifications to account for the gap — yet the CTF claims to have mobilized 19 times its own contribution.

In addition, projects with high leverage ratios tend to show greater discrepancies between what public institutions intend to fund and what the projects actually accomplish; high leverage ratios generally mean that the influence of the DFI is significantly diluted, particularly with respect to improving the environmental or social performance of a deal (operational additionality). Using the example above, a five percent contribution is unlikely to grant the CTF a lot of say over the project. A survey of GEF projects with high leverage ratios found that, in reality, most of the total project funding went to activities the GEF would not normally fund.[83] Research looking at 232 Clean Development Mechanism (CDM) projects and 370 GEF projects failed to find a correlation between leverage ratios and mitigation efficiency. In the case of the CDM, researchers even found evidence of a paradox in which projects with lower leverage ratios achieved better results than those with higher leverage ratios.[84]

That said, there are a limited number of circumstances in which public institutions contributing small amounts of finance might be able to claim significant leverage ratios. For example, the signal a public institution sends to potential private investors by putting itself forward as the first investor to commit to a new venture may lead to truly additional private investment, though the project itself should also be operationally additional.

Chapter 5: Social, environmental and fiduciary standards

5.1 Existing standards, scope and implementation

Environmental and social standards are commonly known as safeguards, and usually include a set of minimum criteria, as well as indicators or guidelines, to measure performance. They play a number of important roles within DFIs and climate funds, including:

- Prevention: minimum procedures and standards help to prevent and mitigate harm.
- Decision: standards are used as a reference to compare projects and take funding decisions.
- Steering: standards help to ensure that projects respond to the mandate of the institution and help steer investments in a given direction. The better aligned a project is with the standards, the greater the chances are that it will be approved.
- Monitoring and evaluation: standards provide the basis for monitoring and evaluations systems.
- Accountability: standards are used to monitor compliance and to trigger sanctions in cases of non-compliance. In addition to internal accountability, standards also increase external accountability by providing stakeholders with compliance or grievance mechanisms.

Fiduciary standards represent another key category of standards that pertain to financial management and integrity, and include key areas such as anti-corruption and transparency measures. Additional standards often apply, like the exclusion of certain activities (e.g. weapons manufacturing).

Environmental and social standards

These standards generally include a minimum set of criteria and both ex-ante and ex-post evaluation mechanisms to ensure a minimum level of performance in a number of areas. For example, in the case of the IFC, environmental and social standards include eight different areas: assessment and management of environmental and social risks and impacts; labor and working conditions; resource efficiency and pollution prevention; community health, safety and security; land acquisition and involuntary resettlement; biodiversity conservation and sustainable management of living natural resources; Indigenous Peoples; and cultural heritage.

The World Bank's Strategic Climate Fund (SCF), CTF and the Adaptation Fund do not have their own social and environmental standards but rely on those of their implementing entities (an entity that implements the project on their behalf). The CTF and SCF work through MDBs and rely on MDB standards. The Adaptation Fund may also operate through national implementing entities (i.e. direct access) and regional implementing agencies, in addition to MDBs and other multilateral implementing entities (for example, UN Development Program). The Adaptation Fund does not require implementing entities to have their own environmental and social safeguards in place.

The lack of a common set of standards and procedures for the SCF, CTF and Adaptation Fund makes it difficult to ensure all projects have consistent social and environmental performance and align with the funds' goals. Similarly, sector and general performance reviews and evaluations can become unwieldy and of diminished meaning because of the use of different monitoring and evaluation methodologies and systems.

Table 9. Summary of standards and safeguards used by a sample of DFIs and climate funds

The GCF Governing Instrument requires the establishment of robust fiduciary, social and environmental standards. The table below provides basic information about how a sample of climate funds and DFIs employ such standards. It also includes information about responsibility for monitoring individual projects, whether financed directly or through financial intermediaries.

	Environmental & Social	Fiduciary	Monitoring responsibility for directly-financed activities	Monitoring responsibility for financial intermediaries
Global Environment Facility Trust Fund	Yes	Financial management	Implementing entity, GEF has an overview role across agencies and focal areas	Implementing entity
Clean Technology Fund	Individual operations covered by safeguards of implementing MDBs	Individual operations covered by safeguards of implementing MDBs	Implementing entity	Implementing entity
Strategic Climate Fund	Individual operations covered by safeguards of implementing MDBs	Individual operations covered by safeguards of implementing MDBs	Implementing entity	Implementing entity
Adaptation Fund	No institutional safeguards, use safeguards of implementing MDBs if they are the chosen implementing entity (often operates through national implementing entity)	Financial management	Implementing entity, Adaptation Fund provides general overview	Depends on implementing entity
International Finance Corporation	Yes	Financial management, tax havens, exclusion list	IFC's own project management, monitoring and evaluation systems	Primarily self-assessment and reporting by intermediary based on IFC's standards
European Investment Bank	Yes	Financial management, exclusion list	EIB's own project management, monitoring and evaluation systems	Primarily self-assessment and reporting by intermediary based on EIB's standards
African Development Bank	Yes, but less detailed than EIB or IFC, currently working on an Integrated Safeguards System similar to IFC	Financial management, exclusion list	AfDB's own project management, monitoring and evaluation systems	Primarily self-assessment and reporting by intermediary based on AfDB's standards
Multilateral Investment Guarantee Agency	Yes	Financial management, exclusion list	MIGA's own project management, monitoring and evaluation systems	Primarily self-assessment and reporting by intermediary based on MIGA's standards

Sources[85]

Fiduciary and other standards

The most common fiduciary standards are related to financial management practices. They typically have a purely fiduciary purpose and try to guarantee that the project partner has systems in place to ensure the money is spent as planned. Examples include robust accounting and auditing systems. Again, the CTF and SCF do not have their own fiduciary standards, with the lack of a common set of standards potentially causing difficulty ensuring consistent performance across projects.

DFIs also commonly use exclusion lists to guide their private investment decisions. Excluded activities often include production of or trade in weapons, tobacco, radioactive materials and, more generally, the production or trade of illegal products or activities covered under international agreements. In some cases, specific activities related to the environment are excluded, such as drift net fishing.[86] The lack of clear exclusion lists for climate funds examined in the table is concerning. Given the climate crisis and the mandate of climate funds, a number of activities should clearly be off limits – for example, financing fossil fuel-related projects.

Finally, it is worth highlighting the IFC's policy on the use tax havens. As discussed previously, the use of tax havens leads to an erosion of the tax base of developing countries, serious transparency deficits, potential money laundering and a host of other criminal and ethical concerns. Although the IFC's policy is very weak – it is based on the Global Forum process which has failed to identity and curb the impact of tax havens[87] – it does help to set a nascent precedent for other DFIs. Several DFIs work with a large number of partners based in tax havens, especially investment funds.

Monitoring and evaluation

Monitoring and evaluation systems are essential to provide regular information on the implementation of standards for supported projects and provide the data necessary for subsequent evaluations. Unfortunately, evidence suggests that monitoring and evaluation of projects implemented by DFIs is poor. For example, an evaluation of the World Bank's performance recently concluded that "more than a third of World Bank projects had inadequate environmental and social supervision, manifested mainly in unrealistic safeguards ratings and poor or absent monitoring and evaluation. Results varied significantly by region, with East Asia and Pacific having the best and Sub-Saharan Africa having the worst record."[88]

An evaluation of the World Bank's performance recently concluded that "more than a third of World Bank projects had inadequate environmental and social supervision."

In the case of the IFC, the evaluation concluded that more than a quarter of the projects had "inadequate supervision." Poor monitoring is also a common problem in projects funded by the AfDB. Evaluations based on a sample of projects pointed to the weaknesses of monitoring and evaluation systems and the poor quality of the data they generate.[89]

Monitoring and evaluation are further complicated when projects are channeled through different implementing entities. This is the case for the CTF, SCF, Adaptation Fund and GEF, for example. The lack of a common, consolidated set of standards and monitoring and evaluation systems can make it difficult to ensure consistency among projects. For example, the GEF has reported discrepancies between narrative and quantitative ratings it has received from its implementing agencies.[90] Thus, the same project could receive a different performance

rating depending on the monitoring system used. In one example, the GEF concluded that the Romanian Energy Efficiency Fund was an example of an unsuccessful project,[91] while the World Bank's final evaluation concluded it was satisfactory.[92]

Without common standards, a public financial institution has less influence over the monitoring and evaluation activities being performed by its implementing entities.

5.2 Financial intermediaries: a particular concern

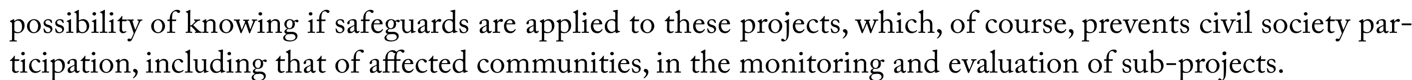
As discussed previously, any attempt to meaningfully reach MSMEs in developing countries would likely require the prolific use of financial intermediaries. More than 40 percent of the IFC's portfolio now includes investments in financial markets, private equity funds and trade finance.[93] But financial intermediaries pose substantial challenges when it comes to implementing social, environmental and fiduciary standards, as well as transparency and accountability.

> Financial intermediaries do not necessarily have the capacity, knowledge or willingness to assess and monitor the development, social and environmental impact of these sub-projects.

When the IFC wants to work through a financial intermediary, it assesses whether the intermediary has an environmental and social management system. Depending on the IFC's assessment of the risk of the intermediary's portfolio, it will then require that the intermediary comply with either national laws; national laws and an IFC exclusion list; or national laws, an exclusion list and performance standards (i.e. safeguards). In practice, it is rare for the IFC to require the application of the performance standards.

Once the approval process is complete, DFIs predominantly rely on the information provided by the intermediary itself, even for sub-projects with medium and high levels of risk for harmful social and environmental impacts. For example, the IFC delegates most responsibility for assessment, categorization, monitoring and oversight responsibilities for sub-projects and other activities to the financial intermediary and relies on self-reported data. In 2009, 58 percent of IFC financial sector investment went toward projects of high or medium risk of harmful social and environmental impacts.[94] Yet financial intermediaries do not necessarily have the capacity, knowledge or willingness to assess and monitor the development, social and environmental impact of these sub-projects, or to take corrective measures, should they be necessary. Some IFC financial intermediaries themselves have even expressed doubts on these points.[95]

Further, while the overall disclosure and transparency of DFIs have improved significantly over the years,[96] this is not true for the financial intermediaries they finance. DFIs disclose little information about the sub-projects that their intermediaries finance. In fact, a recent report looking at the debt and equity instruments used by six major DFIs — including the IFC, AfDB and EIB — found that they do not generally disclose any information about the final beneficiaries, the amounts invested and the standards they apply, and in the limited cases where disclosure did occur, it was only with the consent of the intermediary.[97] Indeed, for high risk sub-projects, the IFC provides information about the locations, sectors and names of the projects only once a year. No information is made public about medium risk subprojects. This lack of transparency precludes even the



possibility of knowing if safeguards are applied to these projects, which, of course, prevents civil society participation, including that of affected communities, in the monitoring and evaluation of sub-projects.

The fall-out from the plethora of shortcomings of DFI financial intermediaries was recently in full view in an audit conducted by the Compliance Advisor-Ombudsman (CAO) — the independent recourse mechanism of the IFC and MIGA — on the IFC's financial market lending. The CAO found that the IFC conducts "no assessment of whether the [environmental and social] requirements are successful in doing no harm," and that, "The result of this lack of systematic measurement tools is that IFC knows very little about potential environmental or social impacts of its [financial market] lending." In other words, the CAO criticized the IFC for focusing on financial intermediaries' development of social and environmental management systems, instead of real-life social and environmental outcomes. The CAO found that "the proportion of cases of non-improved performance was around 60 per cent at the subclient [i.e. sub-project] level, which is where IFC seeks to really have an impact." Further, the CAO pointed out that most financial intermediaries do not have a development mandate, so they often cannot justify any additional measures to ensure a positive development outcome — and the IFC does not provide them with the "business case" for doing so.

The greater the use of financial intermediaries, the more difficult it will be for the GCF to confront the proclivity of the financial sector to desire less disclosure, less liability and less accountability for the environmental and social outcomes of their transactions.

The CAO additionally found that 10 percent of the projects they examined were not compliant with the IFC's already compromised environmental and social requirements, and in a further 25 percent, compliance was partial or unclear.[98] Remarkably, the IFC seems to have made little effort to correct the problem. The CAO report states that it was "surprised to find a number of examples where failure to comply with E&S [environmental and social] covenants in legal agreements did not cause IFC to refuse additional IFC financing." Even in some cases where noncompliance was undeniable, the IFC failed to use the provisions that would allow it to exit the project.

The European Bank for Reconstruction and Development's (EBRD) own evaluation department found that at least 25 percent of financial intermediaries did not implement the EBRD's standards as expected and acknowledged that the figure could be much higher.[99] In the case of sub-project monitoring, the evaluation found that only 55 percent of the intermediaries monitored environmental requirements in a proactive way, even though "proactive monitoring" only requires "checking documents at the higher risk sub-projects at least once per year."[100]

The greater the use of financial intermediaries, the more difficult it will be for the GCF to confront the proclivity of the financial sector to desire less disclosure, less liability and less accountability for the environmental and social outcomes of their transactions.

Chapter 6: Conclusions and recommendations

This report has sought to begin to answer the question: can the GCF effectively and equitably meet the adaptation and mitigation needs of people in developing countries through mobilizing private finance and supporting the private sector, and, if so, how? As has been demonstrated, the GCF should approach private companies and financiers slowly and with a high degree of caution, and only engage them to the extent that they can guarantee compliance with high standards on environmental, social and development effectiveness; the implementation of robust due diligence processes designed to address financial, social and environmental risks; and produce effective mitigation and adaptation outcomes.

In limited circumstances and with a number of stipulations, GCF efforts to mobilize private finance may contribute to meeting developing countries' needs, but it is no silver bullet and will be especially difficult to deploy in low and lower-middle income countries. Private climate finance cannot be a substitute for direct public support, and adaptation in particular is likely to offer few commercially profitable opportunities for private financiers. At least in the short term, low and lower-middle income countries will offer few opportunities for private financiers, compared to higher income countries. Without intentional steering, GCF efforts to mobilize private finance are likely to bypass low and lower-middle income countries, as well as marginalized communities in all developing countries.

Similarly, directing finance towards private sector companies has limitations. Micro, small and medium enterprises are the most important economic actors and provide most of the employment in developing countries. However, most MSMEs focus on subsistence, with high informality rates, low returns and low investment volumes. As a result, they are often ignored or bypassed by international donors and financiers. Without rigorous and well-articulated effort to address this dynamic, the GCF would also be likely to do the same in its private sector support.

Key lessons learned from DFIs and climate funds that support private finance:

- They tend to focus on large projects, most often involving foreign corporations. Without an extensive local infrastructure to disburse finance, MSMEs are significantly more difficult to reach.
- They deploy a wide arrange of tools to support private companies, but many of them are inadequate to support MSMEs in developing countries. Often, they deploy financial instruments that only reach MSMEs in the formal economy, while businesses in the informal economy, which represent nearly 78 percent of the total, are bypassed. Also, DFIs frequently use financial intermediaries that expect high rates of return (e.g. private equity funds) and require robust legal regimes. Many lower income countries do not have many investible high-return opportunities or the legal and financial frameworks to support these investments.
- They frequently fail to ensure that projects they support are truly additional and claim to maximize leverage ratios based on methodologies that are inconsistent within and between institutions, and that tend to include money provided by other public investors in their calculations. As a result, leverage ratios frequently bear little relation to the efficiency of projects in achieving their goals.

- Their preferred solution to challenges in working with MSMEs is to work through financial intermediaries. But extensive evidence demonstrates that a reliance on financial intermediaries frequently results in deeply inadequate monitoring and transparency, poor development outcomes, compromised environmental and social standards and serious deficiencies in accountability to affected communities and other stakeholders.

Recommendations — GCF support for appropriate private sector actors:

The following recommendations are offered with the caveat that, first and foremost, the GCF should prioritize meeting needs that, although urgent, are not profitable and therefore cannot be met by the private sector.

- All GCF financing should be driven by the adaptation and mitigation needs of developing countries, reflecting a bottom-up process that especially targets and is responsive to the needs of the poorest and most vulnerable to climate change.
- Any private sector activities supported by the GCF should be subject to the same governance structure as GCF-supported public sector activities. The possibility of a private sector facility with its own governance structure, including the possibility of private sector board members, should be discarded. Private investment experts can be well-placed to provide technical advice, but they must not be placed in decision-making positions. The private sector facility should be a tool available to developing country governments, should they decide to deploy it.
- The GCF should prioritize support for developing country micro, small and medium enterprises, with special efforts implemented to reach the informal economy.
- The GCF should refrain from using leverage ratios as criteria to guide funding decisions at least until:
    - A common methodology is established to calculate leverage ratios, and its usage mandated;
    - Leverage ratios only reflect private, not public, funds mobilized;
    - Only private flows that are truly additional — both financially and operationally/institutionally — are counted;
    - Public actors are not allowed to claim that they have raised each other's money. If different public institutions support the same project, leverage ratios should be calculated using the amount of private finance that is proportional to their contribution in order to avoid double counting.
- GCF-supported projects and activities should:
    - Be driven by government policies. These include climate-friendly economic development and industrial policies, and adaptation and mitigation priorities identified in national plans and frameworks;
    - Build domestic and local capacity and support the development of endogenous technology. This is essential to ensure long-term, sustainable development;
    - Attain the consent of communities in a process free of disinformation or intimidation and according to the international principle of free, prior and informed consent;
    - Use development- and climate-friendly procurement practices. The use of local goods and services increases the positive impact of the project on the local economy and employment (leading to com-

munities that are more resilient to the impacts of climate change), improves the transfer of capacity and knowledge and contributes to reducing climate pollution from transportation;
    - Be additional, which includes two components — financial additionality (would the private investment have happened anyway?) and operational/institutional additionality (is the resulting investment better aligned with the aims of the GCF?);
    - Adhere to clear, binding and uniform social, environmental and fiduciary standards, in line with international best practice, as established by the GCF.

- Although using GCF funds to finance foreign companies is not advisable, there may be limited circumstances in which it might be considered:
    - The GCF should only support multinational corporations in very limited circumstances — when no domestic option is available and at the request of the government of the respective developing country, and only in the context of demonstrable contributions to equitable and sustainable development;
    - Any support for foreign direct investment must require foreign corporations to build local partnerships and alliances (i.e. linkages) and support local production under licensing agreements (rather than importation, for example) so as to increase the capacity and knowledge of local actors, including through training and employment.

- The GCF should establish clear, uniform and binding social, environmental and fiduciary standards, in line with international best practice. Barring this, monitoring, reporting and evaluation of GCF-supported activities — and, as a consequence, accountability to affected communities and other stakeholders — cannot be optimally effective. All private finance supported by the GCF must uphold these standards, including sub-projects financed through financial intermediaries. Proposals that fail to comply with the minimum accepted performance in any of these standards should not be approved for GCF support.

- All private finance supported by the GCF must uphold financial oversight and private sector governance standards in line with international best practice, including, but not limited to, prohibiting the use of tax havens by private companies or financiers receiving support from the GCF.

- The GCF should establish an exclusion list that prohibits support for climate-polluting activities, such as fossil fuel-related technologies, in addition to banning what DFIs already typically exclude (i.e. the production or trade of illegal products or activities under international agreements).

- The GCF should take a highly cautious approach toward the use of financial intermediaries, and should consider implementing a cap on their usage. Sub-projects financed by the GCF through financial intermediaries must be held to the same environmental, social, fiduciary and transparency standards as investments that are directly financed by the GCF. A high bar should be set to invoke commercial confidentiality on a strictly necessary basis. Assessment, categorization of risk, monitoring and oversight of sub-projects should be a shared responsibility and not delegated solely to the financial intermediary. Any self-reported data should be shared with affected communities and other stakeholders to verify its quality.

Recommendations — GCF support for mobilizing private finance:

The GCF should focus on mobilizing financiers and using financial instruments that primarily target governments and MSMEs in developing countries. Risk instruments, such as loan guarantees, are considered among the most effective ways to leverage private investment, but an excessive focus on leveraging private investment (and an overemphasis on deploying risk instruments) can lead to an unhealthy dynamic of "leveraging for leveraging's sake," rather than a focus on what types of financing are best suited to meet the concrete needs of poor countries.

The following financial instruments offer some potential to equitably and effectively support development-friendly climate finance in developing countries:

- Grants can be used to support a range of government-sponsored mitigation and adaptation activities. For the private sector, grants could support important demonstration projects; help capitalize, provide reserves or otherwise strengthen microfinance institutions; and provide technical assistance. Grant elements may also be added to loans to provide more favorable terms to government and, in limited circumstances, to appropriate private borrowers in developing countries.
- Loans and bond financing can be effective instruments to deliver climate finance, but they should not add to unsustainable debt burdens of developing countries. For the private sector, the use of credit lines through financial intermediaries is the most likely to reach a large number of beneficiaries, although, as previously noted, many precautions must be taken in to ensure the subprojects financed through financial intermediaries comply with the environmental and development mandate of the GCF.

Recyclers' cooperative "Coopersoli" in Belo Horizonte, Brazil. Photo credit: Leslie Tuttle.

- Loan guarantees could help to incentivize the flow of credit towards government and private sector actors in developing countries. But, again, in order to reach a large number of MSMEs, the GCF would have to rely on financial intermediaries, which would require many precautions. Additionally, excessive reliance on risk sharing instruments could give rise to accusations that climate funds serve to privatize profits, while letting the public shoulder financial losses.

The following financial instruments are unlikely to equitably and effectively support development-friendly climate finance in developing countries and should be de-prioritized or avoided:

- Direct equity investments by the GCF are unlikely to reach a significant number of companies from low and lower-middle income countries. The market is small, opportunities are scarce, local knowledge is often insufficient and the level of uncertainty is high. Relying on investment funds may help improve penetration in developing countries, but they are subject to challenges similar to financial intermediaries; they tend to be extremely opaque, and are often based in tax havens. This often undermines the tax base of developing countries, compromises compliance with environmental and development mandates and poses substantial challenges to accountability.
- Quasi-equity instruments are unlikely to find many applications in low and lower-middle income countries. In addition to the difficulties faced by equity instruments in general, equity-based quasi-equity instruments, such as preferred stocks and convertible bonds, are not adequate to support MSMEs. Debt-based quasi-equity instruments might be useful to support MSMEs with relatively high growth potential, but the market is likely to be very small because the number of businesses with these characteristics is significantly restricted in low and lower-middle income countries.
- Investment guarantees (i.e. political risk insurance) have a track record of largely targeting foreign, rather than domestic, companies.

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