Friends of the Earth

Initial Approaches to Private Finance:

Recommendations to the Board of the Green Climate Fund

The Setting

In our time of fiscal austerity, private finance has been widely held up as a panacea to a variety of monetary ills that governments face worldwide. But before private finance can be seen as a solution in the context of the GCF, the appropriate questions must first be asked — what are the adaptation and mitigation needs of people in developing countries, especially the poorest and most vulnerable, and how can the GCF effectively and equitably meet those needs through mobilizing private finance and supporting the private sector?

In limited circumstances and with a number of stipulations, GCF efforts to mobilize private finance may help. But it is not a "silver bullet," and it will be especially difficult to deploy in low and lower middle income countries. Further, private climate finance cannot be a substitute for direct public support. The $100 billion developed countries have promised to contribute for climate finance by 2020 must be made up entirely of public funds. And, as far as how the GCF spends its share of the $100 billion, grant-based financing for the public sector must play a prominent role. Many areas in need of funding, especially adaptation, will not turn a profit.

Similarly, directing finance towards the private sector has 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 and low returns. 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 Development Finance Institutions

Development finance institutions (DFIs) — public institutions with a development mandate that often also provide finance to the private sector — provide important lessons for the GCF.

- DFIs tend to focus on large projects, most often involving foreign companies. Without an extensive local infrastructure to disburse finance, MSMEs are significantly more difficult to reach.
- DFIs deploy a wide arrange of tools to support private sector actors, 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 represent nearly 78 percent[1] of the total. Also, DFIs frequently use instruments that expect high rates of return (e.g. private equity funds) and require clear exit strategies. Many lower income countries do not have many investible high-return opportunities, nor the legal and financial frameworks to support these investments.
- DFIs frequently fail to ensure that projects they support are truly additional. They often 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.
- DFIs' preferred solution to challenges in working with local MSMEs is to work through financial intermediaries.[2] But extensive evidence demonstrates that a reliance on financial intermediaries 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.

1 Dalberg (2011) Report on Support to SMEs in Developing Countries Through Financial Intermediaries. Dalberg, November 2011.
2 Financial intermediaries may include commercial and investment banks, private equity and venture capital funds, microcredit institutions, insurance and other financial institutions which, in the case of the GCF, would ostensibly invest money in developing countries in climate-friendly sub-projects.

GCF Support for Appropriate Private Sector Actors

The GCF should prioritize support for domestic private sector actors, in particular MSMEs, in both the formal and the informal economy. 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 and 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, improves the transfer of knowledge and capacity, and contributes to reducing greenhouse gas emissions derived from the transport and import of goods and services.
- Be additional, which includes two components — financial additionality (would the private investment have happened anyway?) and operational and institutional additionality (is the resulting investment better aligned with the aims of the GCF?).
- Adhere to clear, binding and uniform internationally best practice social, environmental, and fiduciary standards, as established by the GCF.

GCF Use of Various Financial Instruments

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 demonstration projects; help capitalize, provide reserves, or otherwise strengthen microfinance institutions; provide technical assistance; and provide loans on more favorable terms to governments and appropriate private sector actors in developing countries.
- Among debt instruments, the use of credit lines through financial intermediaries is the most likely to reach a large number of beneficiaries. However, the GCF should take a highly cautious approach toward the use of financial intermediaries. 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 for 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.
- Loan guarantees could help to incentive the flow of credit towards governments and private sector actors in developing countries. But again, in order to reach a large number of MSMEs, the GCF will have to rely on financial intermediaries, which would require many precautions.

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Equity Instruments — Unlikely to be Helpful

Direct equity investments by the GCF are unlikely to reach a significant number of companies from low and lower middle income countries, particularly MSMEs. The market is small, opportunities are scarce, local knowledge is usually insufficient and the level of uncertainty is high. Relying on investment funds may help improve the penetration in developing countries, but they tend to be extremely opaque and are often based in tax havens. This undermines the tax base of developing countries, compromises compliance with environmental and social standards and poses substantial challenges to accountability.