Leveraging Private Finance: Lessons for Climate and Development Effectiveness

In the debate over the deployment of the Green Climate Fund (GCF), some Parties have emphasized the need to leverage and crowd in private finance. While there is an appropriate role for the private sector, years of experience in the fields of development finance and carbon finance (i.e. carbon markets) demonstrate that efforts to leverage private finance can reduce development and climate effectiveness.

This issue brief examines investment patterns and characteristics established by the Clean Development Mechanism (CDM) and the International Finance Corporation (IFC) -- both of which have tried to leverage the potential of private finance -- in order to draw important lessons and recommendations for the design of the GCF. It finds that an excessive focus on crowding in private finance can lead to an erosion of transparency, social and environmental standards, public accountability, and equity, ultimately undermining climate and development effectiveness.

International Finance Corporation

The International Finance Corporation, which specializes in leveraging the private sector, has a poor track record of ensuring robust development outcomes.

Failure to reach the poor: Private finance is generally motivated by profit, not the desire to ensure poverty alleviation. The World Bank Group's Independent Evaluation Group (IEG) found that of the IFC projects the IEG examined, less than half were designed with poverty alleviation objectives in mind, and only "13% of projects had objectives with an explicit focus on poor people."[1] The IEG also found that "the majority of [IFC] investment projects generated satisfactory economic returns but did not provide evidence of identifiable opportunities for the poor to participate, contribute to, or benefit from the economic activities that projects directly or indirectly support…..Only a few of the sample projects both delivered high levels of growth and demonstrated evidence of inclusion of the poor."[2]

Bypassing low income countries: Private finance is attracted to higher income countries. It is difficult to drive private investment towards poor countries, especially local companies in low income countries. Though these are the enterprises most subject to credit scarcity and high borrowing costs, they were the least served by the IFC. Indeed, 52.1% of all IFC investment in 2009 went to just 10 middle income countries; 36.9% went to Brazil, India, Russia, China, and Turkey alone.[3] According to publicly available data, from 2008 to November 2010, only 16% of all IFC investments were directed toward local companies in low income countries.[4] Where IFC investments do flow to low income countries, it tends to do so via financing for OECD-based multinational corporations (63%).[5]

The IFC ostensibly has tried to correct its bias towards OECD-based corporations by shifting more of its financing towards developing country-based or –focused financial intermediaries

---

[1] Independent Evaluation Group of the World Bank Group, *Assessing IFC's poverty focus and results,* 2011, at http://ieg.worldbankgroup.org/content/ieg/en/home/features/poverty.html.

[2] Ibid.

[3] Moody's Investors Service, *Credit Analysis, International Finance Corporation,* June 2010, at http://www.ifc.org/ifcext/about.nsf/AttachmentsByTitle/Moodys_IFC_Report/$FILE/Moodys_IFC_Report.pdf.

[4] This refers to IDA-only countries, those targeted by the World Bank's lending window for the poorest countries.

[5] Bodo, E., Molina, N., and Visa, T., Eurodad, *Development diverted: How the International Finance Corporation fails to reach the poor,* November 2010, at http://www.eurodad.org/whatsnew/reports.aspx?id=4304.

ISSUE BRIEF

Friends of the Earth

1100 15th St NW, Flr 11
Washington, DC 20005
202.783.7400 (p)
202.783.0444 (f)

311 California St NW Ste 510
San Francisco, CA 94104
415.544.0790 (p)
415.544.0796 (f)

www.foe.org

(such as banks and private equity funds), which can theoretically disburse those funds to smaller, developing country enterprises. But in 2010, only 8% of financial intermediary lending explicitly targeted low income countries.[6]

Questionable application of safeguards and lack of transparency: In an effort to leverage more private finance, the IFC has increasingly funneled its money through financial intermediaries; today the financial services sector is the largest in IFC's portfolio. But the outsourcing of development finance has led to a deterioration in transparency and implementation of safeguard standards. In 2009, 58% of IFC investments in financial intermediaries ultimately funded subprojects that were of high or medium social and environmental risk.[7] However, the IFC does not ensure that subprojects comply with safeguards. Instead, it largely relies on self-assessment, monitoring, and reporting from the financial intermediary itself. Further, no information is made public about medium or high risk projects in which an IFC financial intermediary invests, precluding even the possibility of knowing if safeguards are mandated.

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

Clean Development Mechanism

The Clean Development Mechanism is supposed to mobilize private investment in developing country climate mitigation (so as to meet developed country mitigation commitments), but it has been deeply ineffective and demonstrates problems similar to those of the IFC.

Accrual of benefits to a few large, middle income countries: Similar to the private sector trends in the field of development finance, private sector involvement in international carbon offset markets tends to bypass low income countries. As of April 2009, some 77% of CDM projects were located in China, India, Brazil and Mexico. China itself generated more than 55% of all carbon credits.[9]

Questionable environmental benefit: Buyers and sellers of carbon credits do not have an intrinsic motivation to ensure greenhouse gas reductions, but they do have an inherent interest in ensuring the creation and delivery of tradable carbon credits. This misalignment of interests opens the door to fraud, and it has caused many credits to be issued for projects that do not reduce or prevent greenhouse gas emissions. A Stanford University study estimates that up to two-thirds of CDM projects would have occurred without the finance provided by carbon credits and thus are not additional, in effect, leading to increased global emissions.[10]

Little-to-no development benefit: The same misalignment of interests that prevents CDM projects from delivering mitigation also prevents it from delivering sustainable development benefits. Few CDM projects actually provide anti-poverty and local environmental benefits, and some actually have harmful impacts.[11] For example, a 2007 analysis of a sample of CDM projects found that only 1.6% of credits went to projects that benefited sustainable

---

[6] The Bretton Woods Project and 'Ulu Foundation, *Out of sight, out of mind? The International Finance Corporation's investments through banks, private equity firms and other financial intermediaries*, November 2010, at http://www.brettonwoodsproject.org/FI2010.
[7] Ibid.
[8] See for example, Arnold, M., Financial Times, "*Development banks attack planned EU fund rules",* 2 May 2010 at http://www.ft.com/intl/cms/s/0/256b7704-55fe-11df-b835-00144feab49a.html#axzz1THLDCcBK.
[9] CDM Watch, Shortcomings of CDM, at http://www.cdm-watch.org/?page_id=24.
[10] Vidal, J., The Guardian, "*Billions wasted on UN climate programme: Energy firms routinely abusing carbon offset fund, US studies claim*," May 26, 2008, at http://www.guardian.co.uk/environment/2008/may/26/climatechange.greenpolitics.
[11] McCully, P., International Rivers, *Bad deal for the planet, why carbon offsets aren't working and how to create a fair global climate accord*, 2008, at http://www.internationalrivers.org/node/2826.

development.[12] The CDM is strongly biased towards large-scale projects that produce large numbers of credits; smaller-scale projects, which would be more likely to have sustainable development benefits, would not generate offsets as cheaply.

Little accountability: With such deep environmental integrity problems plaguing the CDM, there have been calls to hold market participants responsible for the failure of projects to reduce emissions or comply with regulations. But private financiers have resisted accepting liability for such failures, since it would increase their financial risks and potentially reduce profits. Project developers have sought to block stakeholders from appealing CDM Executive Board decisions to issue credits for projects that fail to reduce emissions or result in human rights violations. At the same time, lobbying groups like the International Emissions Trading Association want an appeals process that would work in their favor only, by allowing them to challenge CDM Executive Board decisions that do not issue credits.

A Word of Caution: Co-financiers, Financial Intermediaries, and the Magic of Leveraging

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

Over-excitement about leveraging the private sector has pervaded the discourse on climate finance. Many questions remain as to what extent public money has actually leveraged private finance and whether such investment would have happened anyways. As the Overseas Development Institute notes, "Increased transparency in the use of international public finance would elucidate the current and potential role of public finance in leveraging private finance, and would increase understanding of the effectiveness and success rates of such efforts. Metrics to measure leverage and to count the impact of public sector finance in leveraging private capital need to be developed and agreed (AGF, 2010)."[13]

The **Equator Principles** are a set of voluntary environmental and social financing norms for private project finance. Experience with this industry initiative provides insights for the GCF.

- *Poor transparency:* Citing client confidentiality, Equator Principles financial institutions have refused to disclose the names of transactions that are subject to the Equator Principles, let alone which particular environmental or social performance standards are required of clients in loan agreements.

- *Little accountability for ensuring environmental, social and climate effectiveness:* Equator financial institutions have refused to adopt any kind of accountability mechanism that would allow affected communities to hold the institutions accountable for failing to implement their own commitments.

[12] Sutter, C. & Parreno, J.C., Climate Change, *Does the current clean development mechanism (CDM) deliver its sustainable development claim? An analysis of officially registered CDM projects,* July 2007, at http://www.cleanairnet.org/caiasia/1412/articles-72508_resource_1.pdf.
[13] Brown, J. and Jacobs, M., Overseas Development Institute, *Leveraging private investment: The role of public sector climate finance*, April 2011, at http:/www.odi.org.uk/resources/download/5701.pdf.

Recommendations: Criteria for Use of GCF Resources to Mobilize the Private Sector

The Transitional Committee (TC) of the GCF should approach the private sector with a high degree of caution. Prior to committing to a private sector strategy, the TC should arrive at a better understanding of the private sector's efficacy in generating pro-poor, climate friendly investment. In light of decades of experience in development and carbon finance, the GCF should establish minimum criteria for private sector engagement, including:

- *Requiring private initiatives to make demonstrable contributions to sustainable, vibrant local economies in developing countries, including low income countries, that stimulate local entrepreneurship*
- *Requiring private investments to be driven by and responsive to country need and equitable geographic distribution*
- *Requiring private investments to adhere to rigorous environmental and social safeguards and the highest standards of transparency and accountability*
- *Excluding carbon offset projects from GCF financing*
- *Prohibiting the use of risky financial instruments*

More specifically, the TC should:

- *Only engage private finance to the extent that private financiers can guarantee (1) transparency and accountability for complying with robust standards on environmental, social, and development effectiveness; and (2) the implementation of robust due diligence processes designed to address financial, social, and environmental risks, and produce effective mitigation and adaptation outcomes.*
- *Design the GCF so as to ensure it steers clear of excessively risky investments from a financial or environmental perspective.*
- *Design the GCF to uphold best practices in financial oversight and governance practices, including, but not limited to, prohibiting the use of tax havens for all GCF-related investments and financing.*
- *Stipulate that climate finance disbursed to the private sector should only go to developing country companies, in order to support endogenous development.*
- *Ensure the prioritization of financing for small, medium and microenterprises in developing countries, particularly low income countries.*
- *Prohibit carbon offset projects, including sectoral crediting schemes, from receiving GCF funds.* Carbon markets serve to meet the mitigation commitments of developed countries. A strict firewall must be enacted between financial flows resulting from international offsetting schemes and the provision of climate finance for, and the use of climate finance by, developing countries.
- *Prohibit the practice of tied climate finance* (requirements that funds are to be spent on donor country-based procurement of goods and services).

The TC should NOT:

- *Establish an independent private sector window in the GCF.* Such an approach threatens to bypass the priorities and strategies of developing country governments, as informed by sovereign, participatory planning processes.
- *Add to unsustainable debt burdens of low income countries.*

For more information, please contact: Karen Orenstein, korenstein@foe.org, +1-202-222-0717.