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Beyond grants: climate finance in developing countries

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'the international community needs to give careful thought to options that could generate funding, and financial instruments that will deliver that funding at country level'

Developing countries need massive amounts of investment to support a shift to low carbon and climate resilient growth and development. According to the *World Development Report 2010*, mitigation in developing countries could cost between $140 to 175 billion per year over the next 20 years, with adaptation investments rising to an average of $30 to $100 billion a year between 2010 and 2050. Yet efforts to raise funding for mitigation and adaptation have been inadequate, and, to date, amount to less than 5% of projected needs (see Figure 1).

Given the scale of investment needed, the international community needs to give careful thought to options that could generate funding, and financial instruments that will deliver that funding at country level.

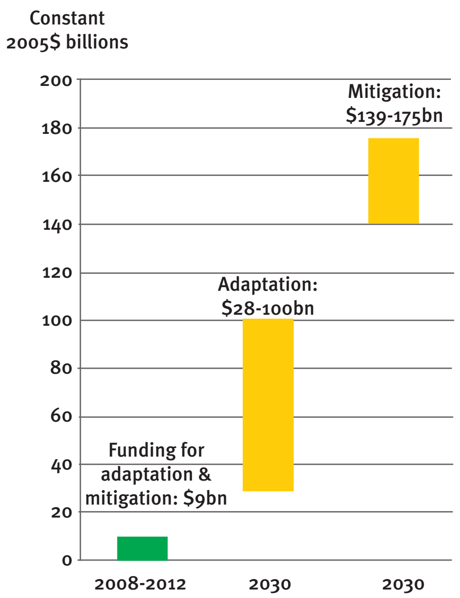
There have been strong arguments that climate finance should be provided in the form of grants, in line with the 'polluter-pays principle' of compensating developing countries for the damage done by developed countries. While delivering on the moral case, these arguments do not take into account the sheer volume of funds required, or the range of climate-related activities to be funded. The contexts in which investments take place are often overlooked, as are the comparative advantages of potential funders in providing different types of financial instruments. Indeed, a more refined assessment of the supply of, and demand for, future climate financing is needed, alongside sector and country-specific analyses to identify the best financial instruments for each investment, and the best institution or actor to provide them.

One major concern is that, given the budgetary constraints of many donors, allocating a large share of funding in the form of grants is likely to have a negative impact on the overall level of official development assistance. As a result, donors should consider using grants as a way to leverage larger funding volumes, notably through the use of concessional loans, rather than viewing grants as an end in themselves. If they have a value equivalent to grants, concessionary loans allow donors to front-load more capital, which can be adapted more readily to projects that require large investments up front.

The right combination of pure grants and concessionary funding has to be guided by project-specific criteria based on the financial profiles of the project (commercial and technical), and country-specific criteria based on the macroeconomic and institutional contexts of recipient countries.

Indeed, in the case of public projects, donors need to consider the potential impact of these additional financial flows, the absorptive capacity of the recipient country, and the financial sustainability of the instruments used, to avoid the excessive exposure of recipient countries to risk that could lead, for example, to future indebtedness.

Figure 1: Estimated annual climate funding required in developing countries for a 2°C rise in global temperatures, compared with current resources



Source: *World Development Report 2010*, Ch. 6.

But the debate on the type of support required needs to go way beyond traditional forms of international public assistance, to include efficient ways to leverage additional sources of finance, notably from the private sector. Private sector finance could come in the form of equity investments and commercial loans. Some activities, of course, are unlikely to attract private investors because they are not profitable enough or because the type of investment is seen as novel and may carry risks that are difficult to assess. And climate finance does indeed present risks, such as those linked to new technology, as well as the uncertainties around new regulatory environments.

As a result, donors should look at ways to encourage and incentivise private investors, through direct financial support, but also through risk coverage. The objective for donors should be to cover the incremental costs and risks linked to climate-related activities, even partially, through risk-sharing agreements with the private sector. In addition to grants, some existing donor financial instruments, such as long-term concessionary loans, equity investments and guarantees, can be used for this purpose.

Pure grants may be best suited to the funding of specific technical assistance, capacity-building and training needs. But concessionary loans, equity participation, and partial-risk guarantees with similar grant-equivalent value can often be more cost-efficient for both donors and recipients and effective in addressing specific market failures. Concessionary loans can, for example, be adapted to fund projects that show rates of return below market rates, but positive nonetheless, through the provision of cheaper credits. Partial-risk guarantees can be used to cover specific risks related to the regulatory framework. Equity support can help to decrease the debt-to-equity ratio, lowering the project's financial risks and, potentially, the cost of capital. Indirect support can also be provided to private sector projects by creating an enabling environment for climate change adaptation and mitigation activities, including the funding of, for example, feed-in tariffs.

Climate change raises unparalleled challenges and associated financial needs that cannot be left to the international donor community alone, with grants seen as the sole compensation for developing countries. Because climate change is more than just an environmental matter – with profound impacts in the economic and social realms – private and public sectors from developed and developing countries should join forces to address these new challenges. As a major link between the developed and the developing world, the international donor community can provide invaluable support to address this global issue. However, this community needs to think beyond the donor-recipient relationship that has, to date, shaped the aid industry, finding innovative ways to leverage public and private funds to meet the financial needs of climate change adaptation and mitigation.

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