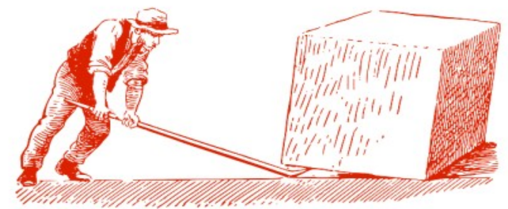
Private Climate Finance and International Financial Institutions



From the halls of international climate change negotiations to the board rooms of international financial institutions (IFIs), there is a growing tendency to see the main role of public institutions as being to encourage greater private sector investment. This is happening for several reasons:

- National budgets in industrialized countries are constrained by the debt taken on to bail out the financial sector in 2008, as well as by austerity policies imposed in the course of the financial crisis
- A failure to reduce greenhouse gas emissions has increased the projected costs of climate finance
- Political opposition in industrialized countries to financing climate-related projects in "competitor" countries, often driven by right-wing ideologues questioning climate change, but affecting the whole spectrum of mainstream political parties
- The rebranding of international trade flows as climate finance, including finance backed by export credit agencies.
- The continued efforts of international financial institutions (IFI) to find new avenues to promote liberalization, pressurizing countries to privatize national industries privatization and open markets to international competition
- A broad tendency towards "financialization" in the global economy, with greater power concentrated in the hands of the financial sector, and a greater emphasis on creating value from the production of new commodities (things that can be bought and sold).

What are IFIs?

International financial institutions (IFIs) are public agencies whose role is usually to provide money for development in the global South. These include multilateral development banks, such as the World Bank and its private sector arm, the International Finance Corporation (IFC), as well as regional development banks. We're using a broad definition of IFIs that includes bilateral development finance institutions, as well as bilateral institutions such as the US Overseas Private Investment Corporation (OPIC) and Export-Import Bank, that do not have a development mandate at all. These are included in our survey as they are increasingly being invoked by donor governments as providers of climate change-related financing, and because the instruments they offer are amongst those now being adopted by multilateral agencies.

What is leveraging?

'Leveraging' refers to public finance (e.g. from international financial institutions) that is used to encourage private investment in climate-change related projects. The aim is to reduce the perceived level of risk taken by the private sector.

How is it done?

IFIs encourage private investment through equity finance, loans or the use of risk management tools.

Equity finance means buying a share of ownership in a company or project. Often that's done by investing in "private equity" funds, which act as a middle man between the IFI and the companies that they are buying into. These funds can be run by investment banks or specialist firms, which invest according to the perceived profitability of their clients, rather than according to strict environmental or development criteria.

There are various ways for IFIs to use loans to encourage private sectors to join them in financing projects or companies. Syndication is one of the most common, with IFIs organizing a collective of private lenders to join them in backing a project.

Company debt can also be separated into higher and lower risk segments, with the IFI taking on the riskiest parts (known as "subordinated debt"). The remaining, lower-risk loans or bonds may then be sold to private investors. Sometimes, the higher and lower risk debt of several companies or projects is packaged together before being sold to private investors, a process known as securitization.

Making loans via financial intermediaries is also increasingly frequent. Typically, this involves the IFI lending money to a domestic bank which, in turn, lends that out to other companies. It's a way to "outsource" lending decisions, but at the cost of undermining the ability to directly apply environmental and social safeguards on how money is invested.

De-risking/risk instruments

De-risking instruments try to reduce the perceived riskiness of investments in developing countries.

- Loan guarantees are commitments by public institutions to (partially) repay loans that are provided by a bank or other financial intermediary if the borrower "defaults" (cannot meet their repayments).

- Export credit guarantees are similar in structure, the key difference being that they are conditional upon the purchase and import of equipment from the country providing the guarantee.

- Political risk insurance tries to address the fears that a lot of international investors have about engaging in developing countries by providing insurance against various possibilities. These typically cover political violence, as well as risks that limits could be imposed on foreign firms' ability to take profits out of a project host country. They may also include other types of "policy risk", such as sudden regulatory changes that could make energy investments less competitive.

This is far from an exhaustive list of "derisking" instruments. For a longer run through, including short definitions, go to: U-RL URL

What's wrong with leveraging?

There are several common criticisms of the use of leveraging.

- Effectiveness: it is very difficult to measure whether public money has encouraged private investment, or whether that would have happened anyway. There is also no clear means of telling whether IFI involvement leads to improvements in the social, environmental or corporate governance standards of a project.

- Distraction: the focus on leveraging distracts from the need for industrialized countries to provide "new and additional" finance in the form of grants and concessional loans, as stated in the UN Climate Change Convention.

- Balance: A focus on encouraging private investment drives money towards projects that can achieve significant financial returns, which is far more true of mitigation projects rather than adaptation.

- Distribution: International flows of private investment in the global South are concentrated on a handful of larger countries, notably China, India and Brazil. Focusing public efforts on attracting private finance will further disadvantage the poorest countries, where climate finance is often most needed.

- Transparency: Pooling public with private money often results in the details of projects being hidden behind a veil of commercial confidentiality, in particular when companies or private equity funds are based in secrecy jurisdictions (tax havens).

- Accountability: The use of financial intermediaries, and handing control of equity investments to private fund managers, outsources responsibility for ensuring that social and environmental safeguards are applied. The result is often that few checks are made.

- Macro-economic impact: Tying climate financing to exports can undermine the development of domestic industries in project host countries. More generally, an emphasis on attracting private investment is often accompanied by pressure for economic liberalization, which can increase costs and limit access to basic services, and make economies more susceptible to global economic pressures.

What are the alternatives?

- There are various controls that can, and should, be applied to investments that seek to leveraging private finance. For example, IFIs should avoid investment in companies that are housed or majority owned by companies based in secrecy jurisdictions. Strict transparency rules should apply down to the level of sub-projects and sub-contractors. If it is not possible to ensure that level of reporting, the investment should not be made.

- Beyond that, it is important to recognize that "leveraging" private finance is only one version of how to make investment greener. Another way to approach these is to separate out "greening investment" from "climate finance."

- "Greening investment" first needs to address the role of the financial sector in bankrolling fossil fuels. The main instruments for doing so, such as shifting fossil fuel subsidies into renewables, or tough direct regulation on greenhouse gas emissions, would require changes to domestic policies in industrialized countries rather than financial support from IFIs. At the same time, the majority of private finance in China, India and Brazil is provided domestically, where measures such as China's "green credit" policy (which promotes sustainability standards amongst private banks) need to be implemented more aggressively.

- Public "climate finance," by contrast, should focus on activities that are unable to attract private finance, focused on mitigation measures in low-income countries, as well as financing across the global South for adaptation and "loss and damage" (compensation for the costs of impacts of extreme weather events and irreversible losses such as sea level rise).