

# Private Climate Finance 101

## What is climate finance?

Climate finance usually refers to national, regional and international public sources of funding transferred from Northern developed to Southern developing countries. The UN Framework Convention on Climate Change (UNFCCC) calls on industrialized countries to provide “new and additional financial resources” for the “full incremental costs” of addressing climate change. Put simply, we know that climate change will cost developing countries a lot of money both in terms of addressing the problems caused by existing climate change (adaptation) and in helping them to avoid the unsustainable reliance on fossil-fuels that was central to the industrialization of Northern countries (mitigation).

References to private climate finance are part of an effort to widen this framework to encompass all forms of “climate-related” finance. Rather than focusing only on public financial flows, the climate finance investment landscape is being mapped as one that includes any grants, loans or risk guarantees, and equity (ownership stakes in companies), private as well as public money.

## How much climate finance is needed?

Estimates vary from a few hundred billion US dollars per year up to \$1.5 trillion per year. These figures vary in terms of what types of finance they count and how much action they assume is necessary to avert dangerous climate change. By way of comparison, world military spending exceeds \$1.5 trillion per year (and \$600 billion in the USA alone).

## How much climate finance is there now?

Climate Policy Initiative (CPI) estimates that US\$39-62 billion in climate change-related financing flowed from North to South in 2012, of which \$35-49 billion was from public sources. A large part of that figure was from Development Finance Institutions lending at near commercial rates, or require recipients to purchase technology from the donor country. Around \$11 billion was in the form of grants.

## What is private sector climate finance?

The phrase private sector climate finance is used to refer to three different activities.

- **Providing capital.** Private money is invested or lent to companies or countries engaged in climate-related activities, mainly by the financial sector).

- **Receiving capital.** Public or private money is invested in the activities of private companies.

- **Foreign Direct Investment.** Corporations sending their own money “overseas”, eg. to build new production plants.

The “private sector” includes any part of the economy that is not controlled by the state, including individuals, cooperatives and philanthropic foundations. But efforts to attract private finance focus mainly on the financial sector (e.g. banks, investment funds).

This factsheet is focussed on the role of the financial sector as capital providers.

## Who are the main financial sector actors?

First, there are the owners of capital. A lot of this money belongs to ordinary people through their pensions, savings or insurance policies. Other major capital owners include “high net worth” individuals (the very rich), and some countries, especially those with oil revenues invested in Sovereign Wealth Funds.

Asset managers make decisions on where the money is spent, and so help connect the people that have the money with the people who want the money. This group includes what are called “institutional investors”: mutual funds, endowments pension funds, sovereign wealth funds, insurance funds, in fact, any entity that collects a lot of wealth and decides how to invest it. Asset management also includes the role of banks.

## Equity and Debt

There are two basic ways that companies raise money from private sector investors: equity and debt.

In the world of finance, equity means ownership, most commonly in the form of “stocks” or shares. What you really get is a share of that company’s profits if it makes profits. Payments that represent a share of company profits are called dividends. If there are no profits, you don’t get dividends. And if the company goes bankrupt, the shareholders (equity owners) are the last to be repaid, and often lose all of their money.

The second way to raise money is to borrow it, by taking out a loan or selling a bond. Creditors (or lenders, as they’re also called) make money by charging regular interest payments on the money they lend. So the value of the investment for the lender comes from the interest they can accrue - it’s a form of “rent”.

Loans are the most basic form of borrowing money that

is paid back with interest. A loan usually comes from a “financial intermediary,” most typically a bank.

Bonds are the other main type of debt. A bond is just a piece of paper or record on a computer screen that acknowledges a debt and agrees in advance how long it will take to pay back, and at what interest rate. It’s an IOU (‘I owe you’) issued by governments or corporations who want to borrow money.

## The capital providers view

The relationship between “risk” and “return” is at the centre of thinking for capital providers, the people investing or lending money. As Michelle Chan of Friends of the Earth USA points out, this is the dynamic between fear and greed. Fear is the risk, and greed is the return.

As an investor, the higher the risk I take, the greater the return I expect. It’s a bit like gambling odds on dogs or horses – if I back the outsider, I’m taking a greater risk but if I win I win big.

Capital providers look at various kinds of risks, since fear can be fairly all encompassing. But for climate-related projects some of the most relevant are the following list:

- **Commercial risk.** Will the thing being proposed actually work? For example, are mean annual wind speeds sufficiently strong to make the site suitable for wind turbines? (or likewise, with solar power)
- **Political risk.** How stable is the host country? Is there a risk a private company would be nationalized (and on what terms)? More detailed questions of political risk sometimes get called “policy risk” or “regulatory risk”, and include such questions as: will incentives such as feed-in tariffs suddenly be withdrawn or slashed (as in Spain, the UK or the Czech Republic)?
- **Exchange risk.** This relates to fluctuations in local currencies. For example, if a US investor takes an equity stake in a company, dividends are paid in the local currency, and the value of that currency declines, they lose money. Related to this is “commodity price” risk – if fossil fuel prices were to plummet (say, because of the exploitation of shale gas), then renewables would become less competitive.
- **Execution or “operational” risk.** Does a local project have the capacity and experience to execute the project effectively?
- **Technology risk.** Will relatively new technology, or systems not deployed in a particular region or country before, work as expected?

Once investors have identified all of the risks they determine the “cost of capital”: how much it costs a

particular borrower to raise the money they want. Companies and governments will do a lot to reduce the cost of capital, because the differences can be massive.

But there are limits to of thinking in terms of risk. We can spend lots of time and money sweetening the deal for private companies, but misidentify the risks. Risk assessments can end up being poor proxies for the things we actually really value, such as a transformation away from fossil fuels towards renewables, people’s safety, land and cultural rights, access to clean water and public health.

## Key considerations

- The “cost of capital” is a major factor in determining whether a climate-related project is commercially viable or not.
- Unlike conventional climate finance, where money flows from donors to recipients, private finance involves money flowing both ways. There is an expectation of significant returns on investment, much of which flows straight out of the countries hosting the climate projects.
- Private finance is more often domestic than international. According to CPI, over 70 per cent of climate-related finance in developing countries originated in the same country in which it was spent.

## Drawbacks of private climate finance

- Developed countries have a clear obligation under the UN Convention, as well as a huge ethical responsibility, but they are invoking private sector finance to avoid that responsibility.
- A focus on attracting private investment leads to a strong bias to mitigation over adaptation because adaptation projects often do not offer profit opportunities.
- Money will also go to middle income countries not the poorest, because that’s where most of the profit opportunities are located – as reflected by existing investment patterns.
- Privately financed projects, including those supported by public international financial institutions, generally offer few development benefits (eg. poverty reduction, or increasing energy access). There are also few checks to ensure that environmental, social and human rights standards are applied.
- A reliance on private finance reduces transparency and accountability. Companies hide key information behind a wall of “commercial confidentiality,” often using complex investment structures and passing money through “secrecy jurisdictions” (offshore tax havens).