

# When does private finance count as climate finance?

## Accounting for private contributions towards international pledges

### Introduction

In 2009, as part of the Copenhagen Accord, developed countries committed to “a goal of mobilizing jointly USD 100 billion dollars a year by 2020 to address the needs of developing countries” (UNFCCC 2009). In subsequent decisions, the Parties to the United Nations Framework Convention on Climate Change have said this includes from both public *and* private funds (see, e.g., UNFCCC 2011). Yet precisely which kinds of private finance might be counted still remains vague.

At least part of the challenge is that even delineating climate-relevant private finance can be difficult, since private investments are rarely, if ever, tagged as “adaptation” or “mitigation”. This is especially challenging for adaptation, as gauging the contribution of specific activities to adaptation requires a deep understanding of the local context. While renewable energy investments might be generalizable as consistent with mitigation objectives, making similar generalizations is not possible for adaptation.

This discussion brief, an output of the SEI Initiative on Climate Finance, examines different types of international private finance and asks questions about their suitability for being counted towards the Copenhagen commitment.

Globally, the scale of private finance that in some way may be supporting climate change objectives is estimated to be larger than public finance flows (Buchner et al. 2015). However, those estimates include in-country flows and a very broad range of instruments.

It is important to stress that decisions about the inclusion of private finance as a component of the 100 billion USD commitment, as well as what kinds of private finance should count towards it, are *political* rather than technical. We take no position here on the merits or risks of allowing private finance to count towards a commitment for international finance flows, nor do we imagine our findings to represent the only or indeed the best way forward. However, we see a clear need to better define the questions and understand the implications of different options, to inform decisions by the Parties. That is the goal to which we hope this brief contributes.



CAFOD, the Catholic aid agency in the UK, is helping farmers in the Kitui area of Kenya to become more resilient to increasing droughts.

We examine different private financial flows for climate-related activities on the basis of how the investors’ motives connect with the recipients’ objectives. We present an analysis of *accountability chains* (see Box 1), focusing on two accountability parameters: (i) the degree to which different actors in the finance chain share similar “end goals” for the funds; and (ii) the degree to which the final expenditure contributes to climate-related outcomes beyond a single private entity, which is of particular relevance for adaptation objectives. Different types of private finance can then be compared with the features of public finance, as a reference point.

### A crucial but difficult task

Climate finance has been a contentious issue in the lead-up to the Paris Climate Change Conference, with many developing countries pushing for greater certainty that they will get the support they need to curb emissions and reduce vulnerability to climate change impacts. In this context, the uncertainty about what counts as “private climate finance” undermines the purpose of the Copenhagen commitment, which was to lay out a clear path forward.

First of all, failing to define private finance obscures a clear view of the *public* finance component. If we do not know how

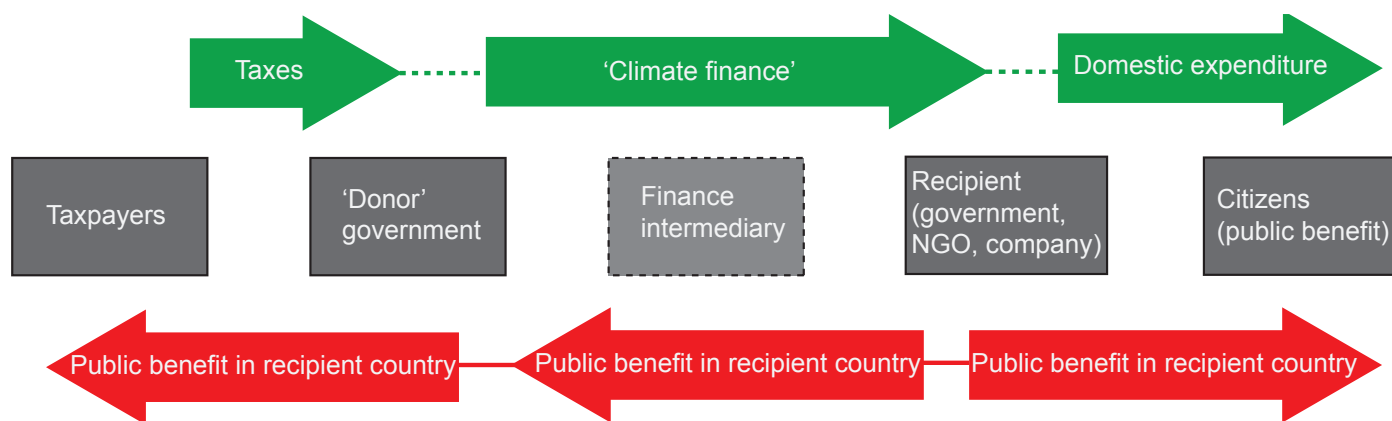
### Box 1: Definitions: ‘Accountability’, ‘countable’ and ‘accounting’

We use three similar, but distinct terms in this brief to convey key concepts:

“**Accountability**” is a broad term and means different things in different contexts. Here we use it to mean the requirement that a person or organization will give account of how specific duties were performed or progress was made towards a specific goal. This requires clarity, upfront, about what is expected of and by each actor. Accountability also requires transparency – hence there is a close link between the two in practice.

“**Countable**” here is used to mean specifically which financial flows may be included when reporting developed countries’ financial contributions towards the 100 billion USD commitment.

“**Accounting**” refers to the task of calculating whether “countable” components add up to the “accountability” expectation.



**Figure 1: Accountability chain for public finance**

much of the 100 billion USD will come from private sources, we cannot know the balance that must come from public sources, or verify whether developed countries (collectively) are fulfilling their commitments. Moreover, the lack of clarity obscures the risks that need to be managed and opportunities that need to be seized in order to mobilize the right kinds of private finance in the right places.

Relatively little has been written to date about how to account for private climate finance, but some ideas have been presented. Reflecting the language of the Copenhagen commitment, one key criterion that is often mentioned is that private flows should only count if they are “mobilized” by public intervention (see, e.g., Jachnik et al. 2015). This is generally understood to mean that the flows can be linked to deliberate action by the public sector to provide incentives and overcome barriers. Gauging this requires first knowing the existing incentives and private investments in climate-relevant sectors in each country, then examining how public support and actions might affect them (Whitley 2015; 2013).

The UN Secretary General’s High Level Advisory Group on Climate Change Financing (UN 2010) identified several issues to consider and different governments’ views on them, without taking a position. They include whether gross flows or only the grant equivalent<sup>1</sup> of private flows might be considered consistent with the finance targets under the UNFCCC; whether finance generated by policy instruments such as carbon markets ought to be countable; and whether only private finance mobilized by specific interventions by developed countries (i.e. connected to public-sector action and North-South) might count.

Stadelmann et al. (2013) assessed the suitability of different kinds of private finance against four criteria: that they have been mobilized by governments; involve North-South flows;<sup>2</sup> avoid double-counting with emissions targets; and pay for incremental costs. They found no types of private finance met all of four criteria. Bodnar et al. (2015), in turn, highlighted five variables to consider in identifying the countable components of both public and private finance: motivation, concessionality/source, causality, geographic origin, and recipient. They also suggested

different scales of “countability” for each variable, based on the level of perceived consensus in the political discourse.

Discussions about financing of the Sustainable Development Goals also offer useful insights. For example, Schmidt-Traub and Sachs (2015) distinguish between, on the one hand, private funds mobilized through domestic budget revenues, official development assistance (ODA) or other official flows that support sustainable development, and on the other, commercial finance such as foreign direct investment that does not rely on public co-financing and may not intentionally target sustainable development.

Below we present our own analysis, which highlights that different instruments have different accountability characteristics. For some, such as “green bonds”, the goals of different actors along the finance chain may be reasonably aligned with the effectiveness of the investment in generating climate-related benefits, and this consistency may allow the possibility for shared accountability metrics to emerge between “investors” and “recipients”. For other types of private finance there appears little consistency in goals along the finance chain. Recognizing these differences may be a useful step in clarifying whether and how various private financial flows might be suitable for counting towards the Copenhagen commitment.

### Accountability chain analysis

Accountability is a broad and frequently used term within climate finance discussions. In the UNFCCC talks, it is often used to emphasize that developed countries should be accountable for meeting their commitments to developing countries. At the point of delivery, it generally means that developing countries that are implementing projects and activities should be accountable for ensuring the funds are spent wisely, transparently and without corruption.

A demand for accountability drives various transparency initiatives to illuminate, for instance, who provides what kind of financial support to whom and for what (see Bird et al. 2013 for a good overview, as well as Jachnik et al. 2015). It also prompts analysis of how finance decisions are made (see, e.g., Remling and Persson 2014; Elges and Martin 2013). At the same time, among developed countries it has created some resistance to using delivery mechanisms such as direct budget support that give recipients more control over how resources are managed and used.

Figure 1 presents our first “accountability chain”, for *international public climate finance*. It shows a chain of actors extending from taxpayers in developed countries all the way to

<sup>1</sup> “Grant equivalent” relates to the level of concessionality of the finance. It involves a calculation of “the percentage by which the present value of the expected stream of repayments falls short of the repayments that would have been generated at a given (commercial) reference rate of interest” (see [http://www.oecd.org/dac/stats/dac-glossary.htm#Grant\\_Element](http://www.oecd.org/dac/stats/dac-glossary.htm#Grant_Element)). In other words, market-rate loans have a zero grant element, while a portion of the total amount of a concessional loan can be calculated as grant equivalent.

<sup>2</sup> Buchner et al. (2015) find that up to 92% of climate-relevant private finance in 2014 was raised and spent within the same country, not internationally.

## Box 2: The ‘accountability chain’ figures

The figures in this brief are intended to illustrate – for different financial instruments – whether actors along the chain of finance share a common objective about how the funds will achieve a climate-related objective. In the case of adaptation responses, the figures also identify whether the ultimate beneficiaries are a single private entity or a wider group (i.e. public benefits). For mitigation it is assumed that all GHG reductions involve a global public benefit, while any local benefits will follow the same pattern as for adaptation.

- The **black** boxes indicate the different actors involved along the finance chain, from the “upstream” source to the “downstream” point of expenditure on adaptation or mitigation.
- The **green** arrows indicate the flow of finance between different actors and the particular instruments involved.
- The **red** arrows indicate “flows” of accountability, depicting which actors are accountable to whom and for what. The direction of the arrows shows which way the accountability flows, i.e. who is accountable to whom. The label indicates what they are accountable for. Arrows going two directions meet for some actors, for instance where a recipient government is accountable to both an investor/financial institution and to its citizens for certain outcomes. *What we are looking for in these diagrams, then, is where these accountabilities relate to the same outcome, i.e. different actors have a common goal.*
- The **orange** arrows indicate whether the benefits delivered are public or private.
- In cases where investors may have some interest in the final expenditure creating climate-related outcomes, but where this is less clear, these arrows have a **dashed** boundary line rather than a firm boundary.

Where both the providers and the recipients of finance share common, climate-related goals, there may be a stronger argument for counting those private finance flows towards the international climate finance commitment. Where a common goal is present, a dark red arrow is used. Where this is not present, a light red arrow is used to identify the non-climate objective of particular actors. Note that a “profit expectation” is a prerequisite from all private finance except philanthropy and remittances, but it is possible that private actors in some cases also have other objectives; this is what we look for.

citizens in developing countries. As explained in more detail in Box 1, the green arrows indicate the direction of financial flows and the instruments, while the red arrows describe who is accountable to whom and how “effective use” of finance is defined in each case.

According to our analysis, the expressed objective that each actor has for what the finance should achieve turns out to be

relatively consistent along this chain, from “upstream” taxpayers to “downstream” citizens in recipient countries. There is a shared expectation that it contributes effectively to reducing greenhouse gas (GHG) emissions and/or to reducing vulnerability by supporting adaptation.<sup>3</sup> For public finance, this expectation is relatively consistent regardless of the financial instrument. This is because the rationale for public finance and expenditure is, either directly or indirectly, the delivery of public goods, which holds true even for more commercial types of public finance, such as loans that are also expected to deliver a financial return. It is also the case where finance is channelled through an intermediary such as a development bank or development cooperation agency.

We describe this as a *continuous accountability chain*, since the actors have at least one shared goal throughout its length – in the case of climate finance, the fulfilment of climate change objectives (and, in many cases, also the achievement of development priorities).

There are subtle but important differences between adaptation and mitigation finance that should be highlighted here. While the chain in Figure 1 can be applied to both, mitigation finance is also expected to deliver a global public good: reducing global GHG emissions. That is not the case with adaptation, whose benefits are narrower and more local.

## Accountability of private climate finance

There are a number of important differences between public and private finance. The latter involves a wider spectrum of actors, some of whom may be motivated by something other than the delivery of a public good (e.g. profit only). It is therefore interesting to look at the motivations for different kinds of private finance and the accountability relationships this creates (or not) with respect to climate change outcomes.

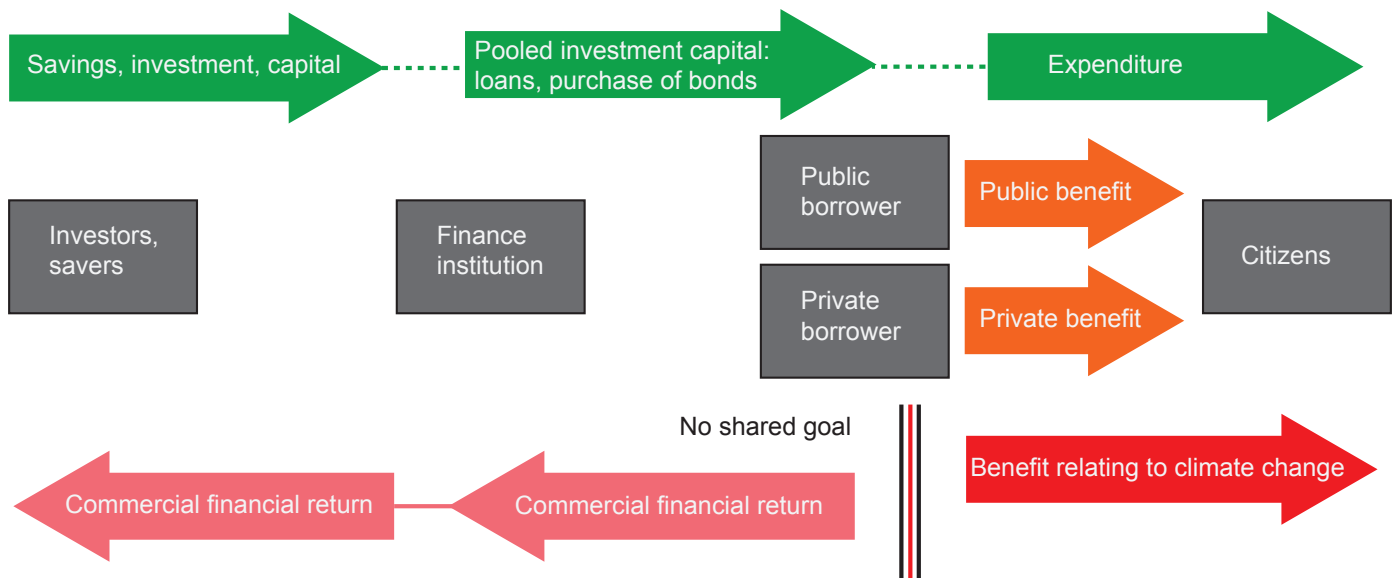
The money involved in private finance comes from many different sources: banks aggregate funds from their depositors; investment funds use individual funds, pensions, and institutional investments; businesses use their own revenues, equity finance and loans. Philanthropy (including corporate social responsibility) and remittances from individuals also play major roles. In all but the latter two cases, the upstream “investors” will expect a financial return – a profit. However, the investors’ interest in *how* the profit is generated – and whether the recipient’s climate-related objectives are achieved – will depend on the context.

Below we analyse the accountability chains for debt instruments (including bank loans, traditional bonds and “green bonds”), equity instruments, and grant and grant-like instruments (philanthropy and remittances). It is possible to further extend this kind of analysis to other instruments, such as insurance, but here we focus on a narrower set of examples.

## Debt instruments

Figure 2 depicts the accountability chain for traditional loans and bonds. In finance terms a distinction is often made between short-term debt (which has an original maturity of one

<sup>3</sup> The desire for a public good to be generated in developing countries is not the only objective at play in the delivery of international climate finance (see Persson and Remling 2014 for an overview of different rationales that climate finance is described as having). Here we concentrate on the “shared objectives” only, to demonstrate the possibility of a common accounting framework and to contrast with various forms of private finance.



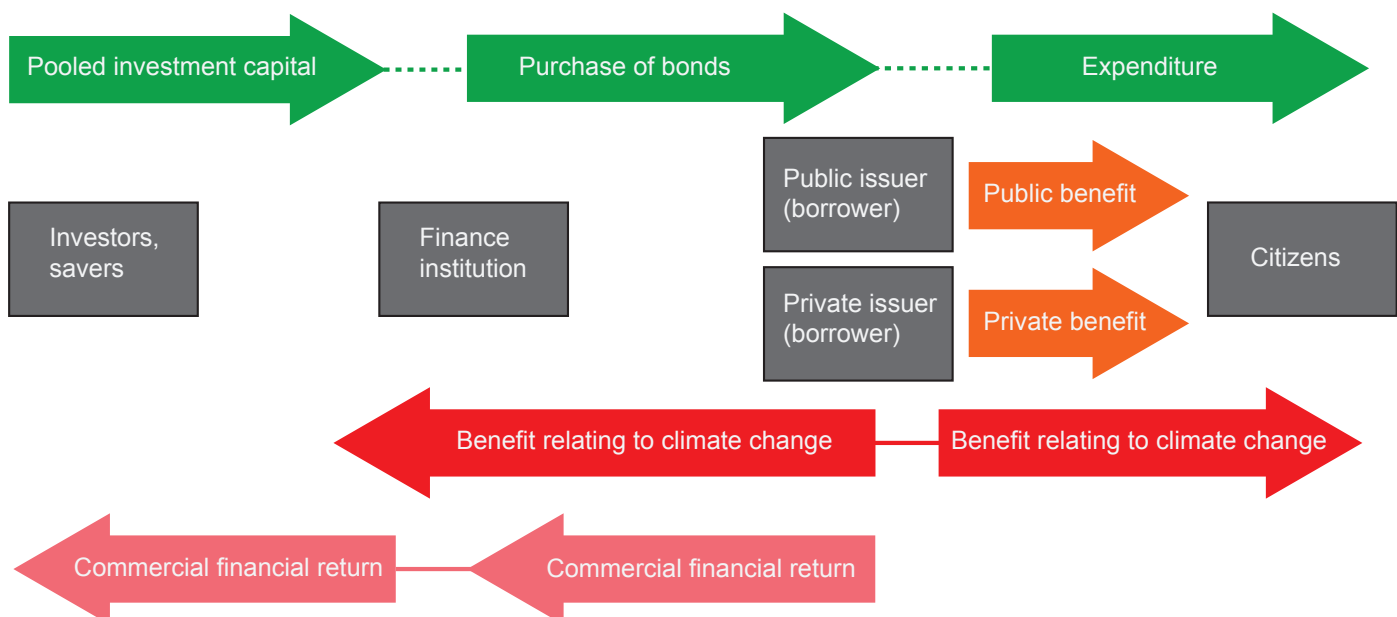
**Figure 2: Accountability chain for private debt – lending and traditional bonds**

year or less and is commonly used for trade financing) and medium- to long-term debt. However, for the purposes of this analysis, we find no practical difference between these and thus no need to treat them separately. Similarly, in practical terms, bond finance works in much the same way as a loan for its recipients. Both public and private entities are able to issue bonds as a way of raising capital for their finance and expenditure needs.

In the case of direct lending and bonds, the upstream investors (lenders or bond buyers) are seeking competitive commercial returns over the period of the loan or bond. For these actors it is not a direct concern whether the borrower's objectives are fulfilled, only that the debt is repaid. The debt can be repaid from different revenue streams that may not be linked to the activity in question, such as consolidated tax revenue in the case of public borrowers, or balance sheets in the case of private borrowers. The public or private borrowers, by contrast, clearly want the finance be used productively to achieve the goals that led them to seek the finance in the first place. In the case of expenditure on climate change, the borrower expects the finance to deliver effective GHG reductions and/or adaptation benefits.

Given the different priorities of the upstream and downstream actors in the finance chain, it might be argued that there is no continuity in the accountability chain, and thus the link between the provision of finance and its expected climate outcomes is weaker. The lender is responsible to its investors only for financial return, the borrower is responsible to lenders only for financial return, but the borrower is simultaneously responsible to its citizens (in the case of a public-sector borrower) or shareholders (in the case of private-sector borrower) for achieving the desired climate outcomes.

The other interesting feature of this figure is the difference it highlights in the borrowers' expected outcomes, depending on whether they are public or private entities. For public entities, the primary objective is the delivery of public goods. By contrast, the primary aim for private borrowers is to achieve private benefits – even if public benefits also accrue. For example, a government that borrows money to build irrigation systems to help farmers adapt to a drier and warmer climate will be focused primarily on reducing vulnerability across the community and ensuring food security.



**Figure 3: Accountability chain for private debt – 'green bonds'**



An individual farmer who does the same will be focused primarily on boosting farm revenue – even if the community also benefits.

## Green bonds

The concept of “green bonds” has emerged as a tool for channeling finance specifically to climate-related activities – to date mostly mitigation (renewable energy, energy efficiency, sustainable transport) but also some adaptation activities. Although they are structured in essentially the same way as traditional bonds, the key difference with green bonds is that they explicitly seek to support the achievement of climate objectives.

In terms of accountability chains, this creates quite a different picture from other forms of private debt, because the investor and intermediary financial institution both have an expressed interest in supporting climate-related outcomes. This creates a shared notion from investor through financial institution to borrowers about what “effective finance” looks like, which is connected to GHG reductions or adaptation outcomes (Mathews and Kidney 2012). As with most private finance, the upstream investors also have a profit expectation, but this is in parallel with an expectation of achieving climate objectives. Thus, for green bonds there appears to be a continuous accountability chain in place.

At this stage the field of green bonds is still relatively young, and there are ongoing efforts to define and delineate these from regular bond instruments. Voluntary Green Bond Principles have been published by the industry (ICMA 2015) in an effort to promote and maintain integrity in the term as new products become available. The criteria by which bonds might qualify as “green” or climate-related will of course influence the character of the accountability chain. What we present above and in Figure 3 is therefore an “idealized” type.

## Equity instruments

Equity flows involve transactions which acquire either an ownership interest or a stock holding in a foreign enterprise, and generally consist of net foreign direct investment (FDI) and portfolio equity (stock purchase). On a balance sheet,

equity represents capital contributed by the owners or stockholders plus any “retained earnings” (net earnings from an investment that are not paid out as dividends, but are retained by the company for reinvestment or debt repayment), minus any accumulated losses.

An important feature of equity that differs from debt is that it seeks out investment opportunities where the production of goods or services generates benefits which can be monetized and privately captured (by investors). Debt can be repaid with financial returns from different revenue sources that may not be directly connected to the expenditure of the loan. Equity, by contrast, is an instrument for which financial performance (the key metric) is more directly linked with the success of the resulting expenditure doing whatever it is supposed to do (i.e. generating goods and services for which there is some demand).

This means that “upstream” equity investors should have some interest in the use of the finance generating specific outcomes on the ground. If an investment has some relevance for climate change, this means delivering climate-related benefits. In other words, from an accountability chain perspective, there appears to be a difference between equity and debt, and arguably a slightly stronger sense of connection along the chain in terms of shared outcomes.

Considering equity in the context of a private contribution to climate finance does pose other challenges, however. Partly these relate to the fact that equity is almost exclusively directed to private assets and production, rather than the public sector. Thus, the focus of resulting expenditure is on generating private benefits. Defining what kinds of equity might be climate-related is therefore difficult, especially in the case of adaptation, where needs and outcomes are highly context-specific and where adaptation by one actor – a private company, for instance – may generate vulnerability for others.

Another feature of equity that is challenging to integrate is its reversible nature (i.e. disinvestment can follow investment, and disinvestment might undermine any earlier climate

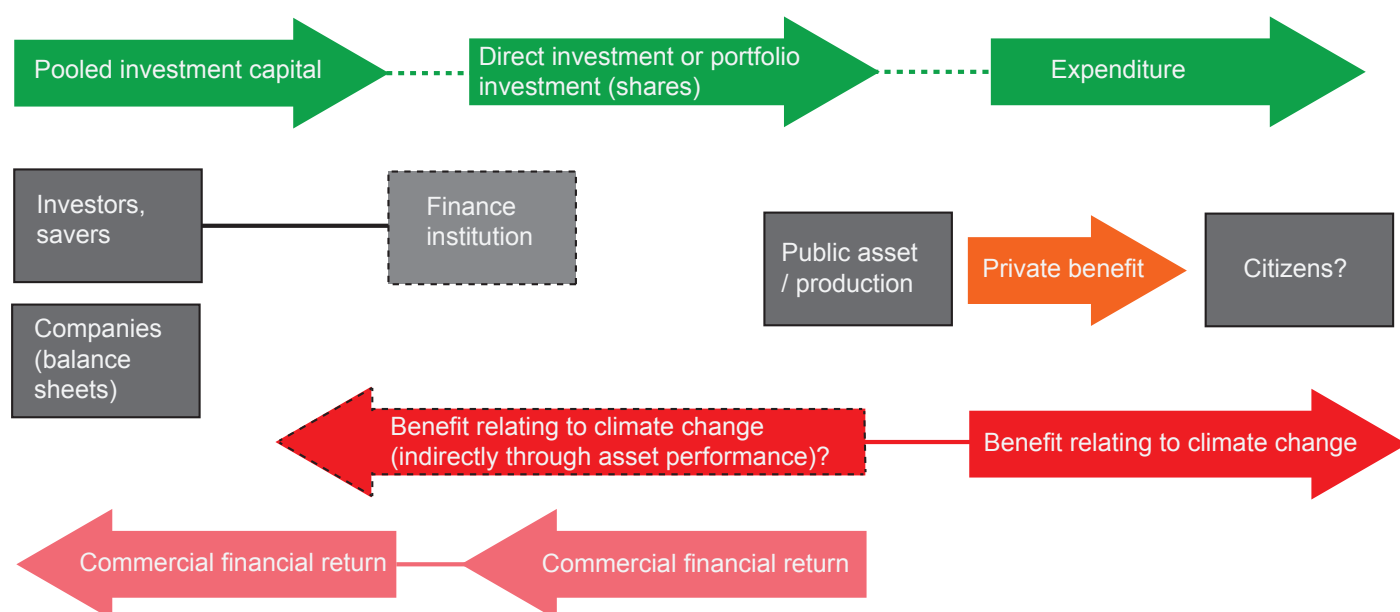
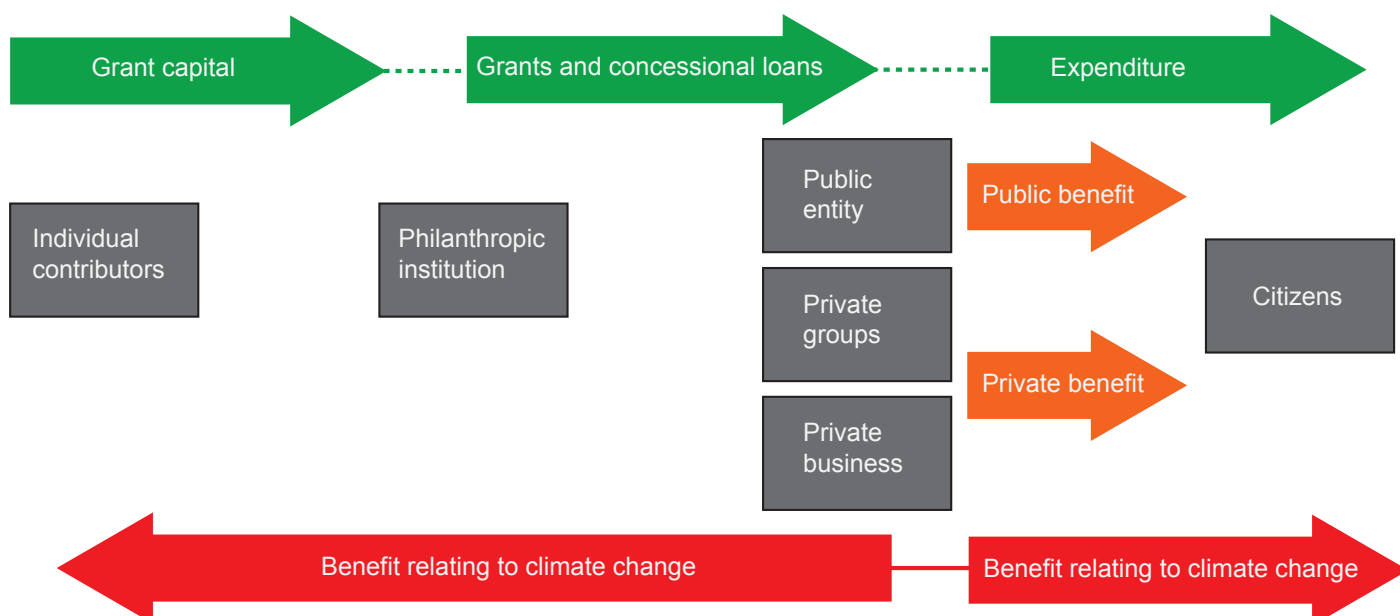


Figure 4: Accountability chain for equity instruments



**Figure 5: Accountability chain for philanthropy**

benefits). These features certainly need further consideration in the context of counting equity finance towards international climate finance commitments.

FDI and portfolio equity are generally viewed as different in character in terms of what they mean for recipients. From an accountability chain perspective we see no obvious difference, but further scrutiny of this question is needed.

### Philanthropy and remittances

Private philanthropy typically provides grant finance, or in some cases uses a capital grant to support concessional lending programs (which has the benefit of maintaining and even growing the original capital grant over time). The purpose of philanthropy is very closely connected to the end needs of recipients, so the accountability chain appears as continuous.

Personal remittances play an often-underappreciated role in poor countries' economies. For Least Developed Countries (LDCs), for example, remittances accounted for 4.2% of GDP in 2012, while net FDI was only 2.8% of GDP.<sup>4</sup> Money sent to relatives or friends might best be described as “grant-like” finance: there are usually no expectations of financial returns. Unlike most grants, however, remittances typically come with no conditions or specified end-uses. In the context of climate, remittances are likely to play a particularly valuable role in supporting adaptation where this is a priority for individuals and households, given that the money goes directly to people who may not have access to other finance sources.

The accountability chain is not straightforward, however. As noted above, many remittances come with “no strings attached”, so there is no real “accountability” of the recipient to the sender. In such cases it may be difficult to identify a continuous shared goal. For flows within households (e.g. a parent abroad sending cash to spouse and children at home), we might expect the money will be used to achieve shared household priorities. Yet such cases also highlight a key argument against counting remittances as “finance”: for many families, they are just another source of regular income – not additional funds.

Perhaps even a greater challenge is in tracking the final use of funds. Recipients are unlikely to account for their expenditures to the sender, much less make this information public. Thus, meaningfully assessing remittances' contribution to climate objectives would be quite difficult.

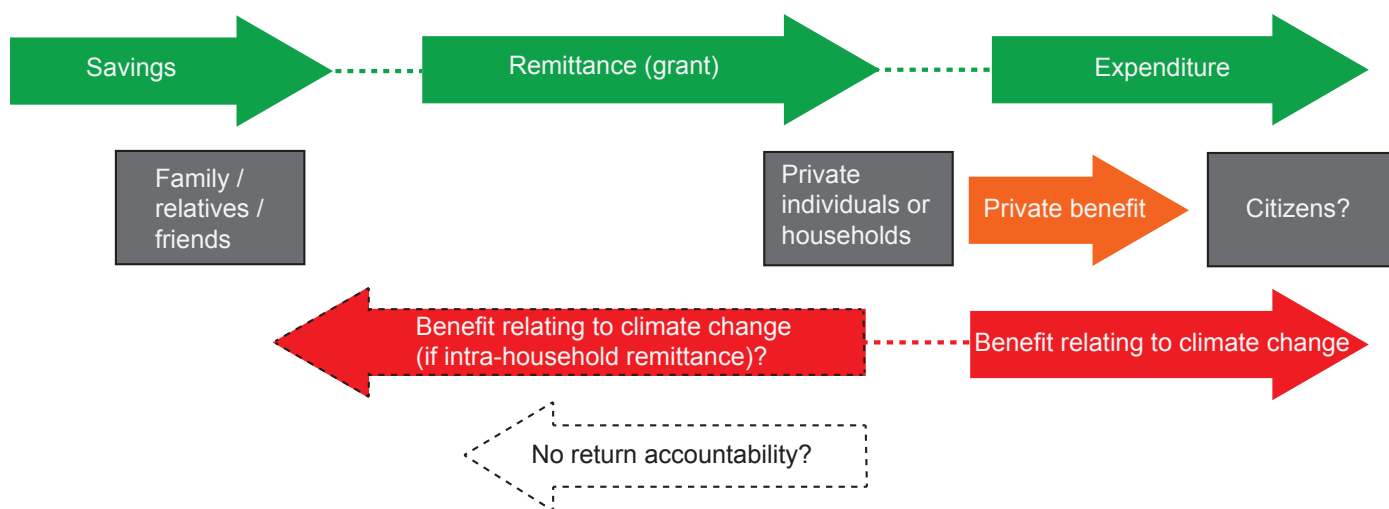
### Discussion

This preliminary assessment using accountability chains reveals notable differences among the various types of private finance that may support climate activities. It shows that establishing a sense of common purpose (or what we have called a continuous accountability chain) is difficult for some kinds of private finance. It also highlights differences based on who receives the finance (a public or private entity), and who benefits from the outcomes.

As noted already, this approach does not by itself provide a robust framework for defining what constitutes “accountable” private finance – nor should it, considering that this is a political question. Accountability chain analysis looks only at the concept of shared goals for the finance, but there are other aspects of private finance that also need consideration in the context of this discussion. These include, for instance:

- **The fact that some private finance may exacerbate vulnerability or increase GHG emissions, thus creating additional adaptation costs in the long run:** Thus, the contribution of private finance needs to be considered in the context of its overall impact, and not just in terms of individual transactions that may contribute to climate-related goals.
- **The relatively un-transparent nature of some private financial flows:** This has implications both for evaluating how private finance contributes to climate-related objectives, and for the narrower question of which kinds of private finance might be counted towards the 100 billion USD commitment.
- **The context-specific nature of adaptation:** poses additional challenges. For mitigation, the common metric of tonnes of GHG emissions makes it possible to identify, at least generically, some relevant investment types (e.g. in energy efficiency or renewable energy). For adaptation, however, there is no equivalent measure for gauging the role of an

<sup>4</sup> See World DataBank, <http://data.worldbank.org/indicator/BX.TRF.PWKR.DT.GD.ZS>.



**Figure 6: Accountability chain for remittances**

investment or action in reducing or increasing vulnerability. The impact of an investment depends on the local context, and evaluating this can be difficult and not at all straightforward. The challenge of distinguishing between development and climate benefits further complicates accounting.

Most of these issues are relevant for public finance streams, but the ways in which public funds are allocated and accounted for can clarify things. Public finance may be explicitly labelled as “climate finance” or channeled through a climate-specific fund, or climate-related objectives may be clearly specified at the outset. This does not mean that the stated objectives will be achieved effectively, but it does narrow down the set of financial flows to examine.

## Conclusions

Our analysis is based on the notion that not all finance is the same, and that the characteristics of different types of finance are important to consider in discussions about “what counts” towards the 100 billion USD commitment. Our analysis is not meant to advocate for the use of any one or more specific criteria, but rather to contribute to ongoing discussions by highlighting one issue in particular: the extent to which actors along the finance chain have shared or disparate objectives for the use of the funds.

We used a simple “accountability chain analysis” to examine different types of private financial flows from this perspective: traditional debt instruments, “green bonds”, equity instruments, philanthropy and remittances. Our goal was to understand

whether there is shared (and hence “continuous”) notion along the chain of actors about what “effective finance” looks like. In international public climate finance, such a shared expectation does exist: while any one investment may have multiple objectives, all actors, from taxpayers in developed countries, to citizens in the recipient countries, expect a meaningful contribution to achieving public benefits related to climate change mitigation, adaptation, or both.

Our analysis shows that the degree to which actors in the private finance chain share goals depends on the type of financial flow. For commercial debt, actors along the chain do not share a common goal, as the investors’ focus is on achieving financial returns, not on how the money is actually used. For other types of private finance, such as green bonds and philanthropy, the different actors’ goals appears to be more consistent. Private equity needs further consideration, since there appears a stronger link between the investor’s finance and its effectiveness in delivering meaningful outcomes on the ground, but there are perhaps other complexities that need to be unpacked, such as transparency and reversibility.

Our findings, while very preliminary and explorative, suggest the need for closer consideration of differences among private financing instruments and the circumstances in which they are applied. Policy-makers may find these issues relevant both to the question of which financial flows should be “countable” towards the 100 billion USD commitment, and what logistical issues might arise in trying to account for those flows.

The discussion on “what counts” as private finance is important because it directly affects the amount of public finance that developed countries still need to provide to meet their Copenhagen commitment. It will also help governments to understand what types of private flows may best help them achieve climate objectives, so they can develop policies and incentives to mobilize such investments. That, in turn, will require a better understanding of what motivates climate-related private investments in different contexts.

At the same time, we need to focus on an equally important question: How do we ensure that climate finance – public and private alike – actually achieves its purpose? This will require a much broader conversation about the effectiveness and efficiency of climate finance, with a strong focus on the needs and priorities of developing countries.



The Synergos Institute is working to connect ‘social entrepreneurs’ with stakeholders in countries (here, Ethiopia) to help address local priorities.





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The Clean Technology Fund is helping India to catalyse investment in clean energy, off-grid access, and energy efficiency.

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