GCF MONITOR

Frankfurt School
FS-UNEP Collaborating Centre
for Climate & Sustainable Energy Finance

Edition 6, November 2021

Understanding private sector finance

While 23 trillion USD has been invested in the global real economy in tangible and intangible assets in 2019, only a small fraction of around 800 billion USD can be identified as climate-consistent flows. So, without questioning the vital role of the public sector in the transition to sustainable economic development, private sector engagement is required (and available) to shift and mobilise existing and new investment flows toward the climate agenda. The Green Climate Fund (GCF) is considered as the multilateral flagship fund for financing private sector climate activities. Despite the interest from the private sector in cooperation with the GCF, so far only a limited number of private sector actors have achieved GCF accreditation as Accredited Entities (AEs) and only a few private sector projects are approved by the GCF. In the light of the development of the private sector strategy with the overall purpose of ensuring a more proactive engagement of private sector entities, this GCF Monitor discusses current engagement and options to foster private sector activities.

Key messages

- There is an interest among the private sector in partnering with the GCF on climate-related projects, however, only less than a fifth of all 178 approved projects are tagged as private sector projects, incl. only two adaptation private sector projects.
- The governance structure of the GCF, the accreditation requirements and the process is not appealing for all private sector players The current accreditation framework is more in favour for partners from the financial sector compared to the non-financial real economy partners that also have a large potential to increase the GCF's impact.
- The development of the private sector strategy is important to define how and whom the GCF shall and can effectively promote to achieve private sector-led growth in the overall project portfolio.
- For the private sector strategy, a clear identification of different types of private sector partners is needed as it represents the basis to design differentiated engagement strategies and adjust terms and conditions for engaging them.
- Portfolio analysis reveals that co-finance leverage is similar for private and public sector projects, while private sector projects are on average much larger. In impact terms, reduced emissions per invested dollar through private sector mitigation projects have a lower impact compared to public sector projects.

About the GCF

The Green Climate Fund (GCF) is the largest dedicated multilateral climate fund. It was set up in 2013 by the 194 countries who are parties to the United Nations Framework Convention on Climate Change (UNFCCC). It aims to deliver equal amounts of funding to limit or reduce greenhouse gas emissions in developing countries and to help vulnerable societies adapt to unavoidable climate change impacts.

The GCF's initial resource mobilisation in 2014 received pledges worth US$ 10.3 billion. As part of the ongoing replenishment of the GCF, 31 countries and two regions pledged to provide an additional US$ 9.99 billion for the next four years (status: May 2020).

The GCF Secretariat is based in Songdo, South Korea. The fund is governed by a board of 24 members with equal representation from developing countries and developed countries. See: http://www.greenclimate.fund

GCF Monitor

The GCF monitor reviews the progress of the GCF's efforts to respond to the challenge of climate change. Each edition analyses and briefly describes a unique topic selected because of its high importance at the recent Board meeting or other relevant event. The GCF Monitor is produced by the FS-UNEP Collaboration Centre of the Frankfurt School of Finance and Management.

Introduction

The global transition towards a low-carbon and climate resilient economy will require significant resources to combat climate change in the order of trillions of dollars, incl. a crucial shift in the way public and private actors make decisions. Year-over-year trillions of dollars (23 tr. in 2019, +40% growth compared to 2010) flowing in the real economy (World Bank, 2021). While only a fifth of this magnitude is needed to be consistent for a 1.5°C pathway (IPCC, 2018), currently only 800 billion US dollars are flowing to climate-consistent investments, two-thirds of it from private source (UNFCCC 2021). Consequently, the huge need for climate-consistent projects and programmes, planned and underway, cannot be funded from public sources alone. Therefore, the role of the private sector is crucial for the transformation of the global economy and the financial system.

While existing private sector initiatives recognise the importance of tackling climate change, not all private sector potentials are exhausted yet, and face investment barriers and risks. Public players, such as the GCF, play a key role in stimulating and scaling private climate friendly investments by requiring or incentivizing businesses to reduce emissions and strengthening resilience.

The GCF is considered as the flagship fund for private sector engagement. Therefore, addressing barriers to mobilize private finance – especially for adaptation – that prevent investments from materialising represents a key challenge for the GCF. In accordance with the Governing Instrument, the Private Sector Facility (PSF) is an integral part to finance private sector activities at national, regional and international levels. The importance of private sector finance is also defined in the up-dated strategic plan. For the period 2020-2023, it states "to more systematically and fully realize the potential of the GCF to mobilize resources at scale, and support to mobilize resources at scale, and support activities to increase the impact of investments, while encouraging a wider alignment of financial flows with countries' climate plans and strategies." Therefore, PSF has the mandate to promote the participation of private sector actors in developing countries, consistent with a country-driven approach. Although there is enormous interest amongst the private sector across the world in partnering with the GCF, so far only a limited number of private sector actors have achieved GCF accreditation as Accredited Entities (AEs), and only a few private sector proposals are approved by the GCF board. In response to the above mandate, the PSF is developing a private sector strategy with the overall purpose of ensuring a more proactive engagement of private sector entities (GCF/B.23/12/Add.01).

GCF's private sector partners

The GCF aims to directly and indirectly finance climate actions and will promote the participation of private sector actors in developing countries. Although not precised within the GCF, *direct finance* refers to transactions between the GCF and a partner, relating to financing the GCF supported project or activity. *Indirect finance* counts the remainder of the private financing for a project – so called co-finance. Co-Finance are financial resources required to implement a funded activity for which a Funding Proposal has been submitted, additionally to GCF finance (GCF Policy on Co-Financing, 2019).

The GCF engages on various levels with private sector partners (Stoll et al., 2021). With respect to direct and indirect finance, AEs are the main GCF partner. In coordination with National

Designated Authorities (NDAs), AEs propose project ideas, submit funding proposals, and manage/monitor approved projects. AEs can be private or public, non-governmental, sub-national, national, regional or international, as long as they meet the GCF accreditation requirements. To demonstrate their eligibility for accessing and managing GCF funding, these institutions go through a process of "accreditation", designed to assess their financial and project management, experience and safeguarding capacity for projects and programme management. A closer look at the AEs reveals that all private sector AEs are from the broader financial sector such as banks and investment funds. Based on their existing business model, they inherit a huge potential as most of the private financial sector AEs are endowed with those fiduciary standards and can leverage different financial instruments, incl. equity or guarantees. Given the nature of non-financial sector actors, they are generally less endowed with such fiduciary standards.

The "private sector" is not limited to financial actors, such as banks, funds and insurance companies. It embraces a wide range and diverse set of actors with different – and sometimes competing – goals and roles within a country's economy. They can be broadly divided and differentiated by majorly demand side or supply side activities:

- Actors creating demand for finance: Actors on a spectrum ranging from individuals and households, (M)SMEs to large corps producing goods and services.
- Actors supplying and/or channelling finance: They include a diverse set of institutions that provide financing, either as debt, equity, or mezzanine, determined by the risk/return profile and investment horizon, among other characteristics.

With respect to private financial actors, these can be distinguished between, private parties with both development impact and financial return objectives (i.e. impact investors and social enterprises) and private actors with commercial financiers. The latter includes, local and foreign companies, commercial banks and local and foreign companies, commercial banks, local and foreign institutional investors, as well as retail investors (OECD, 2020). While the former more often aim for financial risky investment in adaptation and mitigation actions that involve early-stage technologies or business models that are not commercially viable, the latter aim to leverage a large quantity of co-investment with lower risk but with lower reward expectations. The former has the potential to achieve higher impact returns but likely requires more GCF funds (to reduce risks) to be attractive. Thus, there is also a need to identify and distinguish private finance sector partners within the private sector strategy, i.e. to adjust communication, but also the terms and conditions for engaging them.

Therefore, important cornerstones in the GCF's private sector strategy to bridge private and public sources, need to define, *who* and *how* the GCF shall and can effectively promote private sector-led growth in the overall project portfolio. The identification of different private sector partners - both for actors creating and supplying the demand for finance - represents the basis to design differentiated engagement strategies.

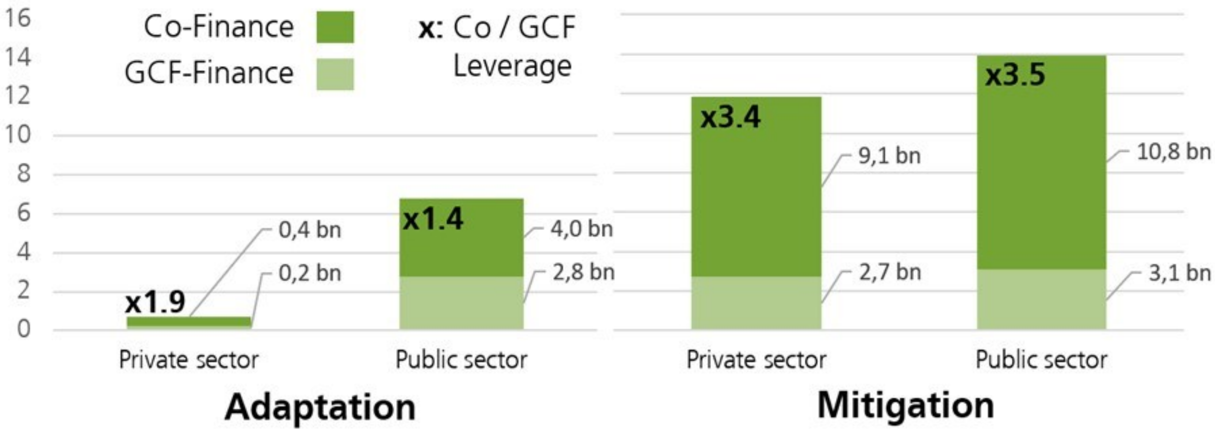
Private sector portfolio analysis

Analysing the GCF's private sector engagements through examining the portfolio appears challenging. Within the GCF the PSF is responsible for private sector proposals; the division of mitigation and adaptation oversees public sector proposals. Although private finance on the operational level is defined as "all financial resources that are provided for the implementation of a funded activity from entities that are more than 50 per cent owned and/or controlled by private shareholders", the categorisation between public and private proposals is not transparent. The subsequent analysis differentiates between private sector (left bars, n=35) and public sector (right bars, n=143) projects in Figure 1, across GCF and co-finance type (public and private) and theme (mitigation and adaptation). Overall, private sector finance has a large bias towards mitigation result areas. However, private sector AEs, so far, typically submit individual projects which aim less for systematic changes, that has been frequently criticised during proposal assessments.

The GCF promotes with its PSF the provision of de-risking investments to private equity funds and financial institutions to mobilize co-finance. The co-finance leverage describes the use of GCF funding to trigger complementary funding. Figure 1 illustrates almost a similar co-finance leverage between private sector and public sector by theme. On average each dollar of GCF investment in mitigation leveraged 3.4x (3.5x) dollars in private (public) mitigation finance. Notably, the co-finance leverage is largely in favour of mitigation, compared to the low co-finance performance for adaptation projects (private x1.4 and public x1.9). In those cases, a further investigation is needed to identify driver of the co-finance leverage ratio by actors and applied technology, such as opportunities for generating return, financing instruments, terms, and conditions of the co-finance. However, it is clearly shown, that in this calculation, the thematic result areas (mitigation and adaptation) represent a higher weight to co-finance mobilisation, than the actors (private and public). The much lower co-finance ratios for adaptation projects with a high share of GCF grant support reflects basically the broadly known investment barriers for the private sector, such as missing business cases in adaptation activities.

While co-finance leverage is an important mean, it still needs to be effective to achieve the mandate of the GCF. Reductions and avoidance of greenhouse gas (GHG) emissions, increased resilience by counting direct and indirect beneficiaries are the two most common indicators. Calculating and comparing public (n=70) with private (n=33) sector projects GHG emission reductions, public projects appears much more cost effective. When considering total project volume, including co-finance, the public sector projects achieve on average emission reduction of 0.28 tCO_2 per invested dollar – twice the amount of private sector emission reductions with 0.14 tCO_2 per invested dollar. This numbers must be considered with care as ex-ante estimations may still vary as they are calculated based on assumptions.

Figure 1: Total Funding Amount by theme (nominal) and type



Note: Co / GCF leverage in bold (i.e. x3.4). Total number of projects: n=178; private sector projects: n=35; public sector projects: n=142. Standard error in whiskers. Light green bar: GCF finance, Dark green bar: Co-finance. Funding amounts for cross-cutting projects are dissolved and aggregated to mitigation and adaptation result areas. In absolute terms, the 35 private sector projects are cumulative 12.5billion (mitigation: 11.8 billion / adaptation 0.7 billion), compared to a cumulative total of 20,7 billion (mitigation: 13.9 billion / adaptation 6.8billion) for 143 public sector projects. The private and public classification of the projects is based on official information provided by the GCF.

Summarizing the analysis, two effects can be isolated: Firstly, while the co-finance leverage of private sector projects is similar as for public sector projects (this holds for mitigation and adaptation result areas), in absolute terms, private sector projects (are much larger than public sector projects. Thus, there is a large potential to fulfil the GCFs objectives by paving the way towards the trillions of private sector funding flowing in the real economy. Secondly, however, although larger in absolute terms, the lower performance of avoided or reduced emissions per invested dollar of private sector projects, provides an indication, that pure private sector projects are noticeably inferior compared to public sector projects in terms of impact, at least ex-ante project implementation.

Recommendations

The role of the private sector is important in the mobilisation of climate finance and fundamental in the transformation of the global economic and financial system. The sole provision of an operational level definition, which characterizes a project as private, are insufficient to be able to broadly mobilize the enormous market potential and to collaborate with real economy players. Deliberate steps are needed for future public sector projects to align private sector opportunities with national objectives. This ideally starts with the NDAs during the strategic country programming. It would be beneficial to the GCFs overall objectives, if the private sector strategy could clearly distinguish between different private sector groups, their respective roles, and interests, namely: pure financial sector actors, and real economy players – and their subgroups.

In addition, the lack of information to differentiate between private sector projects aiming for development impact, incl. financial return objectives and private projects with commercial financial objectives, incl. varying risk-return profiles, hinders to clearly identify private sector actors. Therefore, more clarity is required on what qualifies as a "private sector proposal", incl. formulated development impact, especially in adaptation result areas. Finally, more details and clarity on impact and performance measurements are needed to track progress in achieving the mandate of the GCF.

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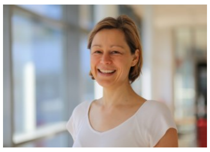

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The GCF Monitor provides an independent analysis by the FS-UNEP Centre for Climate & Sustainable Energy Finance of the Frankfurt School of Finance & Management. It is published with financial support of the German Federal Ministry of Economic Cooperation and Development (BMZ).