The case for a functional definition of climate finance

Submission to the Standing Committee on Finance by the International Institute for Environment and Development

Introduction

In 2009 at COP15 in Copenhagen, developed countries promised to channel $100 billion a year by 2020 to historically low emitting and climate vulnerable countries. This approach to climate justice is underpinned by the approach of using the common but differentiated responsibilities principle established under the UNFCCC framework combined with the polluter pays principle which recognizes that countries who have done least to cause climate change but being most affected by its impacts need financial support from richer nations that have prospered through carbon intensive development. Indeed, given the interconnected and global nature of climate change, a whole of society response is necessary.

Despite the necessity for climate finance to right the wrongs of the past and address climate change impacts, trust towards providers of provide climate finance is low as providers have not kept their promises to deliver climate finance at the expected quantity and quality. The $100 billion goal from COP15 has not been reached and the little climate finance that has been disbursed to countries in need has been overcounted. Research from Oxfam estimates for instance, an overreporting of overall climate finance by 264%[1].

One reason behind overreporting are differences in reporting from DAC countries which can significantly overstate climate change relevance of activities. Some donors just count spend against the Input Sector Codes that are considered allowable under climate spend while others count any programme affected by weather (water sector, agricultural sector). Others count everything that has been marked with a Rio Marker[2].

To ensure accuracy in reporting and hold providers accountable to their Paris Agreement goals, it is vital to develop a shared definition of climate finance. Definitions prove particularly challenging for adaptation over mitigation given the high variation in adaptation interventions which require different responses specific to contexts and local needs.

Within this backdrop of climate finance, we set out in the following recommendations on what climate finance should do, what its definition should consider and its additionality.

[1] Carty T, Kowalzig J B (2020). Climate finance shadow report 2020. Oxfam, London. https://www.oxfam.org/en/research/climate-finance-shadow-report-2020

[2] OECD (2021) Results of the survey on the coefficients applied to Rio Marker data when reporting to the UNFCCC and biodiversity. https://one.oecd.org/document/DCD/DAC/STAT(2020)41/REV2/en/pdf

I. What does climate finance need to do?

Climate finance needs to deliver the Paris Agreement

In developing the third pillar of Paris Agreement (PA)[3] – the means of implementation – Article 2.1c 'making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development' is critical. Climate finance should enable the other two PA goals for limiting temperatures to 2/1.5°C (Article 2.1a) and increasing the ability to adapt to climate change (Article 2.1b).

In order to achieve the goals of the PA, all financing, and not only climate finance, should be PA-aligned as per Article 2.1c. So it was significant when the members of the OECD Development Assistance Committee announced in their 2021 Declaration their commitment that all ODA should align with Paris Agreement.[4] At COP26 The Glasgow Financial Alliance for Net Zero, a coalition of financial firms committed over USD130 trillion to also align with PA goals and disclose climate risk.[5]

Climate finance needs to do no harm and support social and ecological integrity

A necessary, though not sufficient condition for climate finance needs to be that a minimum standard of social and ecological integrity should be met for eligibility. The interventions funded through climate finance, as with other forms of public financing, should not negatively impact upon societies or ecology.

Climate finance needs to support low-carbon climate-resilient development

Fundamentally, climate finance should support low-carbon climate-resilient development pathways in developing countries.

On the quantity of climate finance to transform development- the USD 100 billion from public finance alone are not sufficient to aid in this transition. Additional financial support from Paris Aligned ODA and private sector will have to contribute towards low carbon climate resilient development.

The quality of the climate finance provided is also critical. Developing countries will need providers to provide climate finance that is accessible and risk tolerant or even risk seeking and offer few- strings- attached financial support. Risk tolerant capital can promote early innovation and incubation as well as de-risk investments for developing countries to

[3] Paris Agreement https://unfccc.int/sites/default/files/english_paris_agreement.pdf
[4] OECD (2021). OECD DAC Declaration on a new approach to align development co-operation with the goals of the Paris Agreement on Climate Change. dac-declaration-climate-change-cop26.pdf (oecd.org)
[5] GFANZ (2021). Amount of finance committed to achieving 1.5°C now at scale needed to deliver the transition. GFANZ. https://www.gfanzero.com/press/amount-of-finance-committed-to-achieving-1-5c-now-at-scale-needed-to-deliver-the-transition/

leverage additional funds from bigger investors. Grants, for instance, are risk tolerant instruments that providers should use more commonly, particularly for adaptation interventions. Highly concessional loans also have a role in climate finance, particularly in mitigation interventions for kick starting new and innovative investments that can expect a return in the long run. Commercial loans from the private sector could also be considered for traditional mitigation interventions as part of "Paris aligned private investment".

Grant instruments should be prioritised for Least Developed Countries (LDCs) and Small Island Developing States (SIDs) while a combination of grants and highly concessional loans should be considered for countries with high sovereign debt.

Climate finance needs to be accessible by those who need it most

Currently too little reaches the LDCs and SIDS, who receive around 25% and 2%[6] respectively while only 10% reaches the local level.[7]

The processes to access climate finance from the global funds have been challenging – and in part due to the requirement to show climate additionality and the requirement for demonstrating track record – which undermines the purpose of climate finance through both very low risk tolerance and limited understanding of what it will take to shift the entire development pathways of countries and shift all finance flows to be Paris Aligned.

The processes to access bilateral climate finance – which are much greater levels of funding – are less transparent and tend to relate to where countries have political, trade and historical connections rather than which recipient countries are most climate vulnerable.

II. A function definition of climate finance

The Five 'I's or criteria for climate finance

In reviewing historical examples of how climate finance has been used and defined across different contexts[8,9,10,11], we suggest the following 5 criteria are considered for finance to be counted as climate finance ('the five 'I's'):

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[6] OECD (2021), Climate Finance Provided and Mobilised by Developed Countries: Aggregate trends updated with 2019 data, Climate Finance and the USD 100 Billion Goal, OECD Publishing, Paris, https://doi.org/10.1787/03590fb7-en.
[7] Soanes, M., Shakya, C., Barrett, S., Steinbach, D., Nisi, N., Smith, B., Murdoch, J. (2021). Follow the money: tracking Least Developed Countries' adaptation finance to the local level. IIED, London https://pubs.iied.org/20326iied
[8] Climate Investment Funds (2018). Evaluation of the climate investment funds' programmatic approach. https://www.climateinvestmentfunds.org/sites/cif_enc/files/knowledge-documents/evaluation_of_the_cif_progammatic_appproach_final_report_and_management_response.pdf
[9] UK International Climate Finance (2018). Extent to which ICF intervention is likely to lead to transformational change.https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/813600/KPI-15-extent-ICF-intervention-lead-transformational-change.pdf
[10] Soanes, M., Shakya, C., Barrett, S., Steinbach, D., Nisi, N., Smith, B., Murdoch, J. (2021). Follow the money: tracking Least Developed Countries' adaptation finance to the local level. IIED, London
[11] Patel, S, Shakya, C and Rai, N (2020) Climate finance for hydropower: Incentivising the low-carbon transition. IIED,London.

- **Innovate** – financing should be more risk taking and support innovative first-of-a-kind projects that demonstrate new approaches to climate change and support experimenting in approaches to create suitable interventions within different contexts.
- **Incubate** – financing should support ideas in their infancy before they are scaled up.
- **Influence** – financing should support the leveraging of greater financial flows to scale up and replicate climate interventions by demonstrating the business case, building confidence of investors and de-risking investments across other finance flows
- **Incentivise** – financing should create incentives that create new understandings and different ways of working for changing default behaviours and institutional practices
- **Institutionalise capabilities** – financing should strengthen the agility, flexibility, and responsiveness of institutions to be empowered in their response to the uncertainties of climate change. It should as well as strength capabilities to plan robustly and responsively for a range of futures.

All adaptation and mitigation finance should strive to meet the five 'I's of climate finance. Their validity could also be tested in discussions around financing for Loss and Damage[12] as this stream also develops. We emphasise the necessity of climate finance to transform business as usual approaches by addressing structural and institutional barriers. We also suggest additional considerations for what should count for adaptation and mitigation financing.

Defining adaptation and mitigation finance

Adaptation interventions have mainly been limited to responses on current climate variability. However, through IIED's analysis of transformational adaptation interventions across individuals representing the entire landscape of actors[13] , adaptation requires at least two of the following:

- Responding to current climate variability
- Tackling the underlying drivers of vulnerability such as structural inequality and lack of institutional climate capabilities
- Planning flexible and robust responses for the possible range of uncertain climatic conditions in the future
- Restoring and protecting ecosystems to increase resilience of landscapes and livelihoods

In mitigation, interventions should finance a shift away from business-as-usual models of carbon intensive investments in the energy and transportation sector towards financing low

[12] Decision 2/CMA.2 paragraph 32 "Urges the scaling-up of action and support, as appropriate, including finance, technology and capacity-building, for developing countries that are particularly vulnerable to the adverse effects of climate change for averting, minimizing and addressing loss and damage associated with the adverse effects of climate change"
[13] Patel, S and Gebreyes, B Y (2020) What is effective climate adaptation? Case studies from the Least Developed Countries. IIED, London https://pubs.iied.org/10209iied and Soanes, M, Shakya, C, Barrett, S, Steinbach, D, Nisi, N, Smith, B, and Murdoch, J (2021) Follow the money: tracking Least Developed Countries' adaptation finance to the local level. IIED, London. https://pubs.iied.org/20326iied

or zero carbon investments that benefit society. This means that interventions should uphold social and ecological integrity, support low emission systems, contribute to resilience, and have transformation potential[14]. One means of accounting mitigation impacts could be to measure gigatons of carbon emissions averted or stored.

III. Co-benefits

Many interventions, particularly landscape, forestry, nature-based solutions and ecosystem-based adaptation investments, achieve both adaptation and mitigation benefits. Accounting for co-benefits for tracking purposes may require that providers and recipients agree to the relative weight between the two objectives and divide the funding streams reported under each, rather than to have a third element labelled 'cross-cutting' or similar.

For retrospective accounting, a 50:50 split could be applied to all projects, pending analysis that could be undertaken and synthesised under the Global Stocktake (GST) to propose the best split for each area of investment and record official amounts. This would provide the clearest way of accounting for the primary objective of finance and prevent overcounting of cross-cutting interventions.

IV. What counts? The question of additionality

Above 0.7% Gross National Income (GNI)

Given that climate finance are relatively small flows, that all Overseas Development Assistance (ODA) is now meant to be Paris Aligned (Article 2.1c) and that politically, as the third pillar of the Paris Agreement, climate finance is expected to be additional to ODA , the simplest way to understand what counts as climate finance is that climate finance should be above the already agreed 0.7% GNI target for ODA[15]. For countries that have not adopted the 0.7% agreement and do not spend 0.7% on ODA, climate finance would be counted as the amount over their declared target ODA spend.

Mobilise the trillions from the private sector but count only the public investment

The private stock of finance is vast compared to the public finance, and many corporates and investors are signing up to Paris Alignment. This can be considered 'Paris Aligned Private Investment.' While the tracking of climate finance should focus on effective mobilisation of these private flows it should not count within commitments made by the public Parties. Paris Aligned Private Investment is important and should still be monitored and tracked as part of the enhanced transparency framework reporting.

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[14] Patel, S, Rai, N, and Shakya, C (2019) How climate finance can help repurpose hydropower https://pubs.iied.org/17737iied

[15] The 0.7% ODA/GNI target – a history https://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/the07odagnitarget-ahistory.htm

Grant equivalent

LDCs and SIDS are receiving over 60-50% of climate finance in the form of loans and other non-grant instruments.[16,17] If climate finance is to meet its purpose, it needs to be risk tolerant in supporting experimentation and reducing risks to ODA, enabling domestic development budgets and private investors to build confidence to invest in new ways of improving wellbeing, growing the regenerative economy and protecting development gains. This requires the recipient of the finance to feel they can test ideas without falling further into debt.

Only counting climate finance in its grant equivalence would also build greater trust in donors reporting. The enhanced transparency framework currently only requires donors to report the grant equivalence of loans on a voluntary basis. This should become mandatory to help ensure clear tracking of climate finance.

Build trust by only counting what has a climate objective

The agreed methods under the DAC Rio Markers and under the MDBs tell an important story – we should only count the elements of a programme that genuinely have a climate objective. That is where consensus has emerged previously and is most likely to build trust. We can also only learn quickly what is an effective climate intervention if we look at the specific elements that have climate as its core objective.

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[16] 70.7% of public climate finance in 2019 was delivered in the form of loans, and similar proportions were delivered in the preceding years. OECD (2021) Climate Finance Provided and Mobilised by Developed Countries: Aggregate Trends Updated with 2019 Data. www.oecd-ilibrary.org/docserver/03590fb7-en.pdf

[17] Carty,T, Kowalzig,J and Zagema, B (2020). Climate finance shadow report 2020. Oxfam, Oxford. https://oxfamilibrary.openrepository.com/bitstream/handle/10546/621066/bp-climate-finance-shadow-report-2020-201020-en.pdf