DFAT–UniMelb–CRP Climate Roundtable: Finance

THE UNIVERSITY OF MELBOURNE

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Background Briefing Note[1]

1. Introduction and purpose

Global climate finance flows were estimated to be between USD 850–940 billion in 2021, representing a 28%–42% increase from 2019/20 averages.[2] Despite this positive short-term trend, the quantum falls far short of the scale needed to meet the Paris Agreement goals. To be on track with a 1.5°C scenario, at least USD 4.3 trillion of annual climate finance is estimated to be needed by 2030.[3]

The engagement of public institutions will be crucial to grow and redirect public climate finance and reduce fossil fuel subsidies. However, it is clear that the public sector cannot do this alone. While annual public finance must grow by four to nine times by 2030, private climate finance must grow by more than ten times to USD 2.61 to 3.92 trillion per year by 2030.[4] A central question for negotiators and policymakers in upcoming Conferences of the Parties (COPs) is how public institutions can deploy 'carrots' and 'sticks' effectively to scale public and private climate finance, deployed across sectors.

This briefing note provides background to frame the discussion on climate finance convened by the Department of Foreign Affairs and Trade (DFAT) in collaboration with Melbourne Climate Futures and the Climate Reality Project. To stimulate discussion, we have described foundational facts, barriers, and 'carrots' and 'sticks' that the Australian Government may deploy, for the following themes:

- Theme 1: Scaling and making effective climate finance, especially private sector finance
- Theme 2: Design principles for a best-practice Pacific climate fund.
- Theme 3: Scaling nature-positive financing, without compromising other core Official Development Assistance (ODA) objectives.

2. Discussion theme 1: Private and innovative climate financing

2.1 Background

The task of scaling climate finance takes place against a background of compounding poly-crises, including food and energy crises, increasing macroeconomic pressures across international markets, and high sovereign indebtedness and reduced fiscal space for low- and middle-income countries (LMICs). Catalysing climate finance requires engagement with these interacting crises and how they are expressed in particular regions. For example, high debt vulnerability poses a risk for many countries also facing climate vulnerability, exchange rate vulnerability, and food insecurity.

Regions face varied starting positions, with different needs and barriers to mobilising private finance. The overall quantum, distribution, and main sectoral recipients of climate finance for key Indo-Pacific neighbours are provided below:

- **Pacific:** USD 1.3 billion of climate finance in 2019/2020, predominantly from public sources (93%). Adaptation finance represented 55% of the total, while mitigation finance accounted for 45%. The main recipient sectors were water and wastewater systems, land use, and renewable energy.
- **Southeast Asia**: USD 24.4 billion of climate finance in 2019/2020, with a balanced mix of public (52%) and private (48%) sources. Mitigation finance represented 91% of the total, while adaptation finance accounted for 9%. The main recipient sectors were renewable energy, low-carbon transport, and energy efficiency.
- **South Asia**: USD 21.4 billion of climate finance in 2019/2020, mostly from public sources (77%). Mitigation finance represented 80% of the total, while adaptation finance accounted for 20%. The main recipient sectors were renewable energy, low-

carbon transport, and water and wastewater systems.[5]

Climate finance to date has fallen short of estimated need in all regions, and increased growth is required across both adaptation and mitigation, and from both private and public finance sources.[6] However, based on the existing patterns of climate finance, Indo-Pacific neighbours are expected to have the following priority needs:

- **Pacific:** Continued growth and redistribution of public finance, for both mitigation and adaptation (see 3.1 for limitations on private finance in the Pacific).
- **Southeast Asia:** Scaled private and public finance, primarily for adaptation.
- **South Asia:** Scaled private finance, primarily for adaptation.

2.2 Barriers

Barriers to climate finance are highly context specific and are best understood by appraising specific regions. A detailed analysis of the Indo-Pacific is out of scope here but would be valuable. A few, general observations across emerging economies are provided:

- **Capital costs and size**: High up-front costs for mitigation and adaptation projects, long project time horizons, and generally higher cost of capital combine to deter prospective investors.[7]
- **Subsidies**: Scarce public funding is directed to fossil fuel subsidies, distorting the playing field against prospective renewable energy projects that may otherwise have market advantage.
- **Systemic risk:** Many underlying investor risks are structural and take time to reform, relating to exchange rate fluctuation, demand volatility, and macroeconomic and policy stability.[8]

2.3 Potential solutions

The core issue for discussion is how best to connect these specific financing needs with the correct mechanisms and financiers, while overcoming barriers. In general, different financial, policy, and regulatory levers will need to be deployed in combination, depending on regional requirements. Below is a non-exhaustive list of interventions to scale private finance recommended by the literature:

- **Domestic policy and regulation**: Reduce investment risk and build investor confidence through long-term planning and regulation.[9] This may include climate transition regulation such as legally binding national emission reduction targets, sectoral policies, and phase-out plans for high emission technologies;[10] and incentives for solutions that are scalable or in hard-to-abate sectors, emulating the policy successes utilised in the renewable energy sector.
- **Risk distribution:** Reduce the investment risk of target markets, including through targeted public defrayment of risk, such as blended finance or guarantees;[11] green securitisation of assets; and scaling of carbon markets.[12]
- **Measurement and transparency**: Promote the harmonisation of climate finance definitions, measurement approaches, and ESG disclosure, working with regulators and non-state actor leaders such as the Task Force on Climate-related Financial Disclosures (TCFD) and the Glasgow Financial Alliance for Net Zero (GFANZ).[13]
- **Development Finance Institutions (DFI) reform**: Unlock the capacity of DFIs to catalyse public and private climate finance by supporting reform of their business models, incentive structures, and mandates.[14]

The following section lists the most promising innovative financial instruments to support climate outcomes, particularly in LMICs. However, these instruments have struggled to scale. Solutions that are well understood, but require political support to be highly viable, have also been included below:

- **Climate-conditional debt relief:** Generate fiscal space for developing countries to drive climate initiatives, including through facilitation of conditional grants, debt-for-climate swaps, trilateral debt swaps, debt restructuring, or climate resilient debt clauses.[15]
- **Fossil fuel subsidy phase out:** Liberate public finances and level the playing field for renewable energy investments by phasing out fossil fuel subsidies.
- **Innovative conditional lending instruments:** Scale innovative financial instruments that extend financing conditional on climate-related actions or outcomes, including green or sustainability sovereign bonds (“use of proceeds-designated”), and sustainability-linked bonds (“performance-based”).[16]
- **Concessional finance:** Encourage donors to follow the leadership of the Australian Government and boost the proportion of climate finance deployed through concessional finance and grants. Concessional finance and grants currently constitute 16% and less than 5% of overall global climate finance, respectively.[17]
- **Collaborative finance models**: Develop strategic engagement models between traditional creditors or states with financial hubs and LMIC partner states, building on the evolving lessons from Just Energy Transition Partnerships (JETPs). This may include deeper collaboration beyond the provision of finance, such as by providing support across a whole investment chain and project lifecycle.[18]
- **Technical assistance and capacity building**: Address structural barriers to scaling private sector finance through long-term technical assistance and capacity building efforts. This could include support to develop capital markets, manage foreign exchange risk, grow green bond markets, and facilitate just transitions through reskilling and upskilling programs.

3. Discussion theme 2: Pacific fund

3.1 Background

Pacific Island Countries (PICs) are distinct as a class of recipients of climate finance. In contrast to most LMICs, the Pacific receives climate finance primarily from public sources (93%) and through grants.[19] Private sector investment is minimal, driven by the fact that PICs mostly have limited fiscal space, are high-risk markets for investment, have small domestic debt markets, and have minimal access to international debt markets. Moreover, they are both highly climate vulnerable and have little responsibility for climate change and are therefore priority recipients of international support.

A dedicated Pacific fund would have to navigate a crowded public climate finance ecosystem. The Pacific is currently served by several specific public financing facilities, including the Pacific Resilience Facility and the Australian Climate Finance Facility, and has been relatively successful at accessing other public climate finance through the Green Climate Fund (GCF), Global Environmental Facility, and multilateral development banks.[20] Three fundamental questions for a new fund would be:

- How could a new fund be additive, rather than duplicative of existing efforts?
- How can a new fund operate more effectively than existing funds?
- How would it be capitalised?

3.2 Key barriers

Operation of a new fund should start with a deep understanding of existing barriers to finance for PICs. These include:

- **Direct-access challenges**: Multilateral funds, such as the GCF, have been slower to provide national entities project certification and disbursement than most bilateral funds. This is largely driven by slow accreditation for direct access for national entities, at 2–5 years on average.[21] Delayed accreditation is attributable to onerous accreditation processes and limited country-specific Public Financial Management (PFM) capacity.
- **Unsupported projects:** Accessing climate finance from multilateral funds such as GCF has been most successful when partnering with multilateral organisations, such as DFIs or UN agencies. However, PIC priorities may be neglected when they diverge from those of the partner, or where preferred projects fall below the climate fund's target disbursement size.
- **Project design challenges**: Funding may be delayed due to difficulty designing projects that satisfy funds' accreditation criteria. This is driven by factors within fund control, such as the complexity of project approval criteria, and endogenous challenges, including the complexity of adaptation projects in locations with procurement challenges and high financing costs.[22]
- **Execution limits**: State capacity to implement projects may be limited, due to finite capacity of the suitably skilled workforce.
- **Macroeconomic and fiscal barriers**: As described above, in 3.1.

3.3 Potential solutions

3.3.1. Additive efforts and effectiveness

The cumulative result of existing barriers is that access to funding from climate funds is inconsistent with the speed and scale of climate adaptation required by PICs. The following solutions have been proposed in the literature to reform existing climate funds and would be relevant to a new venture:

- **Scope of funding**: Ensure that the fund's priorities, including target sectors and investment size, are driven by expressed community need and gaps in existing climate fund provisions.[23]
- **Risk mandate**: Accept a greater scope of risk. This may include rebalancing risk to shareholders or deploying more novel financial instruments.[24]
- **Mixed access modalities**: Provide PICs with mixed modalities of access. While direct access is frequently preferred by PICs, it may come with a burden on state capacity and resources that may be mitigated through international partnership access models.[25]
- **Streamlined direct access**: If accreditation is required for direct access to the climate fund, streamline accreditation processes to reduce the burden on the PFM capacity of states.[26]
- **PFM capacity building:** Support PFM capacity building, including by strengthening PIC reforms to integrate climate finance considerations into government planning and budgeting.[27]
- **Implementation improvements**: Prioritise programmatic investments, with longer funding windows and financing focused on drivers of vulnerability rather than impacts.[28]

3.3.2. Capitalisation

Capitalisation will depend upon the political preferences of donors. A prospective fund may be capitalised through conventional means, such as general budgetary commitments from traditional creditors, or through novel funding streams. These could include direct hypothecation from domestic climate revenues of donor states, such as from carbon tariffs or fossil fuel windfall taxes, or through non-state actor (NSA) 'liability funding', where suitably incentivised NSAs with culpability for climate change voluntarily capitalise the fund as a form of climate reparations. Commitments could also be tied to discussions on the New Collective Quantified Goal on climate finance, due to take place at COP29.

Discussion theme 3: Nature-positive financing

4.1 Background

Nature-positive and biodiversity financing is growing in salience. A deepening body of research and the adoption of the Global Biodiversity Framework at the UN Biodiversity Conference (COP15) strengthen the scientific and political urgency to align finance flows with conservation and restoration of biodiversity and nature. Private actors are increasingly seeking opportunities to participate, however, they currently contribute only 17% of total investments in nature-based solutions (NbS).[29] Overall, a large biodiversity finance gap remains, of USD 700 billion per year.[30]

Scaling nature finance, while pursuing climate objectives and without additional public finance commitments or detracting from existing ODA flows, will likely require identification of opportunities that are *both* nature and climate-positive. In upcoming climate COPs, actors must therefore be precise about where these issues intersect and which outcomes they are prioritising. For example, financing for NbS may be preferred where projects can enhance carbon sinks, aid in adaptation, and preserve biodiversity, in contrast to some biodiversity conservation or sustainable fishery interventions that have less climate relevance.

4.2 Key barriers

Cross-cutting macroeconomic, regulatory and political barriers to climate finance described in 2.2 are equally applicable to nature finance. Nature finance also faces additional, specific barriers:

- **Unspecified targets**: Unlike the Paris Agreement's temperature goal, nature and biodiversity limits cannot be reduced to a single metric. This can result in fragmented prioritisation of efforts, such as the (largely unquantified) four goals and 26 targets agreed at COP15.
- **Valuing nature**: The benefits provided by nature and biodiversity (and NbS projects) are difficult to quantify. Attempts to 'value' ecosystem services are limited by a lack of standardised metrics and contested valuation methodologies.
- **Distributed benefits and costs:** The benefits provided by ecosystem services are frequently common or public goods, that cannot be captured by a single actor. This reduces the possible market opportunity for private actors, deterring investment.
- **Development needs**: Biodiversity loss in LMICs is frequently a byproduct of economic activity, such as agriculture, forestry, and fishing. Financing nature requires sensitivity to ensure that sustainable development needs are protected, when reforming these activities.
- **Uncertainties and risks:** NbS projects involve complex ecological, political, and social risks, beyond the control of investors, which can elevate capital costs and deter investors.
- **Lack of policy and regulatory support:** Policy and regulatory environments frequently do not incentivise or support nature-positive investments. An estimated USD 500 billion per year is provided in public economic support activities potentially harmful to biodiversity.[31]
- **Insufficient scalability**: Many NbS projects are relatively small and localised, which can make them less attractive to large investors.

4.3 Potential solutions

There are no simple solutions to scaling nature finance, without significant public investment. The field remains more nascent than climate finance. Regardless, there are potential zones of opportunity:

- **Fiscal space**: Support countries to grow fiscal space, such as through conditional debt relief, conditional lending instruments, and technical assistance and capacity building (see 2.3).
- **Public finance decision-making**: Mainstream biodiversity into public finance strategies, including assessing portfolio and sector impacts and dependencies on nature.[32] Leading actors such as DFAT can leverage their donor relationship to catalyse reform within DFIs, or can provide technical assistance to Indo-Pacific neighbours.
- **Nature multipliers**: Redirect existing ODA towards projects and sectors that have green 'fiscal multipliers' that achieve both nature-positive and development-positive outcomes.[33]
- **Subsidy reform**: Support policymakers in Indo-Pacific neighbouring countries to reform and eliminate public subsidies that are harmful for biodiversity.[34]
- **Disclosures**: Support efforts to report on financing impacts on nature, leveraging reporting standards such as the Taskforce on Nature-related Financial Disclosures framework.[35]
- **Research**: Fund ongoing research to deepen the evidence base quantifying the private and public benefits of nature-positive investment.

Conclusion

Climate finance needs are vast. But the opportunities and need to act are greater. This background briefing note is not intended to be an exhaustive account of the challenges and opportunities facing climate and nature finance, but has sought to provide common conceptual and factual terrain to support the Roundtable discussions.

[1] Authored by Dr Janine Felson, Dr Arjuna Dibley and Mr Nanak Narulla of Melbourne Climate Futures.

[2] Climate Policy Initiative. (2022). *Global Landscape of Climate Finance: A Decade of Data*, p. 10. https://www.climatepolicyinitiative.org/wp-content/uploads/2022/10/Global-Landscape-of-Climate-Finance-A-Decade-of-Data.pdf

[3] Ibid; Note that one McKinsey study forecast an upper estimate of USD 9.2 trillion required per year to reach net zero by 2050, but received heavy criticism. See, e.g., Burkart, K. (2022, February 17). No McKinsey, it will not cost $9 trillion per year to solve climate change. *Climate & Capital Media*. https://www.climateandcapitalmedia.com/no-mckinsey-it-will-not-cost-9-trillion-per-year-to-solve-climate-change/

[4] Boehm, S. et al. (2022). *State of Climate Action 2022*. Systems Change Lab, p. 8. https://files.wri.org/d8/s3fs-public/2022-10/state-of-climate-action-2022.pdf?VersionId=sfihZTSIzbzenOLt565PlXldO2L5jTLg

[5] Climate Policy Initiative, *Global Landscape of Climate Finance*.

[6] Ibid.

[7] Ibid, p. 21.

[8] Ibid.

[9] Climate Finance Leadership Initiative. (2021). *Unlocking Private Climate Finance in Emerging Markets Private Sector Considerations for Policymakers.* pp. 45-48. https://assets.bbhub.io/company/sites/55/2021/03/CFLI_Private-Sector-Considerations-for-Policymakers-April-2021.pdf

[10] Climate Policy Initiative, *Global Landscape of Climate Finance*, p. 28.

[11] Ibid, p. 19; Convergence. (2023). *Evaluating the Impact of Blended Finance: Convergence's Case Study Portfolio*. https://www.convergence.finance/resource/evaluating-the-impact-of-blended-finance-convergences-case-study-portfolio/view

[12] Centre for Economic Policy Research. (2022). *Climate and Debt*, pp. 63-70. https://cepr.org/system/files/publication-files/173807-geneva_25_climate_and_debt.pdf

[13] High-Level Expert Group on Scaling Up Sustainable Finance in Low- and Middle-Income Countries. (2023). *Preliminary Findings & Recommendations*. European Commission, p. 9. https://international-partnerships.ec.europa.eu/system/files/2023-06/hleg-preliminary-findings-recommendations_en.pdf

[14] Climate Policy Initiative, *Global Landscape of Climate Finance*, p. 25; HLEG, p. 8; Bridgetown Agenda.

[15] See, e.g., Centre for Economic Policy Research, *Climate and Debt*, pp. 71-85.

[16] See, e.g., Ibid, p. 39.

[17] Ibid, p. 5.

[18] High-Level Expert Group, *Preliminary Findings & Recommendations*.

[19] IMF. (2021). *Mobilizing Private Climate Financing in Emerging Market and Developing Economies*, pp. 10-11. https://www.imf.org/en/Publications/staff-climate-notes/Issues/2022/07/26/Mobilizing-Private-Climate-Financing-in-Emerging-Market-and-Developing-Economies-520585

[20] See, ibid, p. 5.

[21] Ibid, p. 50.

[22] Ibid, p. 18.

[23] United Nations Development Programme. (2021). *Climate Finance Effectiveness in the Pacific*, p. 33. https://www.undp.org/sites/g/files/zskgke326/files/migration/pacific/UNDP-Climate-Finance-Effectiveness-in-the-Pacific-Disussion-Paper.pdf

[24] Ibid, p. 29.

[25] IMF, *Mobilizing Private Climate Financing*, p. 50.

[26] Ibid, p x.

[27] Ibid, pp. ix – x.

[28] United Nations Development Programme, *Climate Finance Effectiveness in the Pacific*, p 21.

[29] United Nations Environment Programme (2022). *State of Finance for Nature. Time to act: Doubling investment by 2025 and eliminating nature-negative finance flows*. Nairobi. https://wedocs.unep.org/20.500.11822/41333

[30] Convention on Biological Diversity. (2022, December 19). COP15 concludes with Kunming Declaration, breakthroughs on biodiversity targets and means of implementation. *CBD*. https://www.cbd.int/article/cop15-cbd-press-release-final-19dec2022

[31] World Bank. (2020). *Mobilizing Private Sector Finance for Nature*, p. 10. https://thedocs.worldbank.org/en/doc/916781601304630850-0120022020/original/FinanceforNature28Sepwebversion.pdf

[32] Convention on Biological Diversity. (2021). *Financial Sector Guide for the Convention on Biological Diversity*, p.14 https://www.cbd.int/doc/c/8e24/f151/326b69024f014a8fb9684a8d/cbd-financial-sector-guide-f-en.pdf

[33] See, e.g., World Bank, *Mobilizing Private Sector Finance for Nature*, pp. 72-73.

[34] Ibid, pp. 76-77; Convention on Biological Diversity, *Financial Sector Guide*, p. 14.

[35] Ibid, p. 15.