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Green Finance Institute

What next for risk-sharing?

There is widespread acceptance that public finance cannot bear the largest burden when it comes to financing the infrastructure we need for net zero. This is principally for socio-economic reasons. Additional government borrowing, already at over 100% of GDP in the UK, may lead to interest rate rises and higher taxes, ultimately hitting the least well off the hardest. There is also likely insufficient demand for the amount of sovereign debt that would need to be issued to meet the projected investment required for net zero, which ultimately, must be met by private capital, with public capital and development capital deployed mainly as enablers.

At face value, this would seem straightforward. Many, if not most, financial institutions and asset owners are committed to net zero. So the capital is already committed in principle. Similarly, there has been a plethora of regulations designed to 'green' the financial system, and a suite of financial products such as green bonds and green loans through which capital can be deployed. The problem with this picture is that while these interventions offer the means to hold borrowers to account, there is a sense that this finance is not always "additional".

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LLOYDS BANK

J.P.Morgan

All of these tools are necessary but not sufficient. BloombergNEF has found that around 4:1 of investment in low carbon versus fossil energy supply will be required by the end of the decade – it is currently at 1:1. The quantum of capital allocation via these green products is modest. The Climate Bonds Initiative puts green bonds and associated fixed-income products at 5% of global market share. It is important therefore to retain focus on the bigger prize - that what is needed is vast amounts of 'vanilla' capital going into new green projects and technologies. This requires a mobilisation strategy, which is neither a purely regulatory nor product driven strategy.

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Blended finance is 'the wrapper' under which most mobilisation strategies fall – this is usually characterised as the deployment of public capital to offer 'business as usual' returns to financial institutions. The landscape is however more complicated than that. There are numerous ways to close the gap between private risk/return appetite and project developer/issuer need and public capital is only one.

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Data from Convergence suggest that despite high-profile commitments and associated rhetoric, private capital for climate through blended finance is actually in decline – from $7.13 billion between 2017-2019 to $5.87 billion between 2020-2022. If blended finance is to move from the realm of a much-discussed but ultimately niche product suite to actually accelerating the transition to a net zero economy at scale, a mindset shift is needed. This, in turn, needs to be underpinned by thinking holistically about whole-sector transition, not just individual, sub-scale deals. This means looking first at investment need, and then working backwards to aggregate a mix of risk-sharing solutions that will ultimately mobilise capital at scale. The point is not to prove that one blended finance approach can work, the point is to address sector demand. There are a range of tools that can support this approach from three different parts of the system – public, private and demand-side. All of these must combine to deliver a successful mobilisation strategy and realise sector transitions. This approach must be leveraged in the deployment of new climate finance mobilised at COP28. In the first four days alone, there was over $57bn mobilised.[1] This finance, and any further commitments post-COP28, can maximise impact through this approach.

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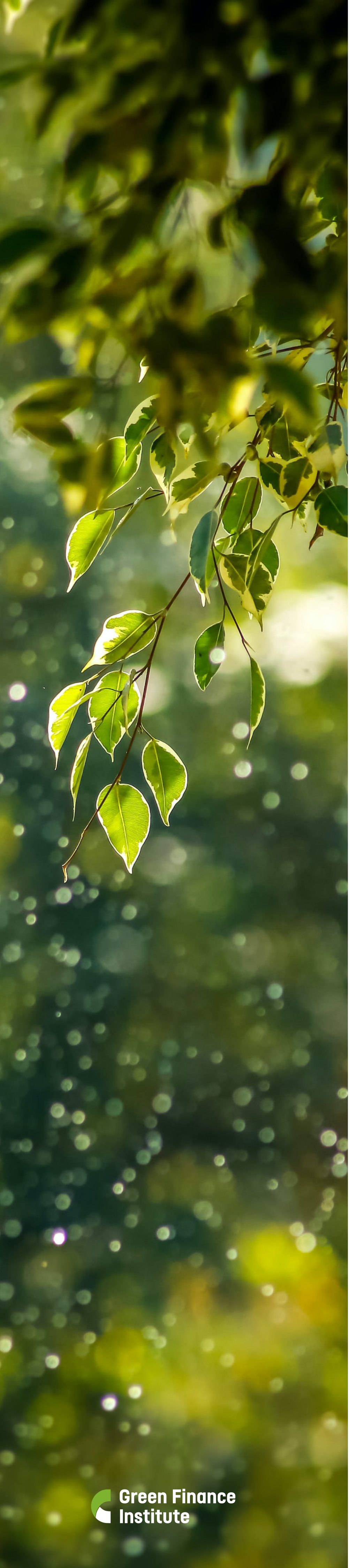
1. https://www.cop28.com/en/news/2023/12/CP28-mobilizes-over-57-billion-in-first-four-days#:~:text=-Climate%20Finance%3A%20Over%20%2430%20billion,Health%3A%20%242.7%20billion



1) Public Finance as an enabler

Public finance cannot bear the whole burden of financing net zero. But it can still be deployed as an enabler of private capital. It can also be deployed as investment, generating potential returns for taxpayers or at least return of principal. This includes the deployment of multilateral development bank (MDB) capital whose ultimate source is the public purse.

There are several options for public capital deployment but for each, it is important to recognise the importance of understanding the nature of risk. These include financial risk, but also market risk (particularly demand and revenue dynamics) and technology risk – notably in the case of 'first of a kind risk' where technology pathways are currently uncertain. For public sector actors, it is vital to build the capability to understand these interlocking risks in order to develop appropriate solutions to address them – this can ensure both effective mobilisation of private capital but also value for money for taxpayers.

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There are several options for public capital deployment in the context of blended finance:

Debt

Most blended finance debt interventions take the form of a guarantee. A guarantee such as that offered by His Majesty's Treasury or a government backed entity such as a development bank or fund, can be up to 100% of principal and interest of debt financing, or 100% of one element of a broader package of debt finance. An ongoing fee from the lender is payable to the guarantor for the duration of the debt issuance. This allows any issuer to substitute the guarantor for the purposes of credit rating or regulatory capital treatment. In the event of insolvency of the borrower or debt-issuer, the guarantor will be liable for and remit payment to investors.

Guarantees work either by extending the credit rating of the guarantor to the borrower or by other mechanisms, such as first loss provisions or contingent loans that improve the credit rating. As such many types of guarantees fall under this category of 'credit enhancement'. An exapmle[2] of this is the African Development Fund and African Development Bank's provision of partial credit guarantees to support ADF countries and state-owned enterprises. The GFI has pioneered its own credit enhancement product – the GF2 which supports capital mobilisation from local institutional asset owners into domestic climate smart infrastructure. By transforming the credit rating of such projects, local pension funds can invest and access higher returns, instead of mostly buying local sovereign debt. The GFI is now exploring rolling out this product in South African municipalities.

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This approach to risk sharing through providing guarantees ultimately widens the pool of eligible investors, reduces financing costs for the borrower and can help build scale – as, where the size of the guarantee is less than the total size of the debt, this can crowd-in further finance at market rates. This makes it both a prudent and efficient use of public capital.

Equity

As companies scale and seek equity investment, there are multiple opportunities for public capital deployment to help crowd-in private investment. This is principally about building a bigger pool of equity for growth companies to access by tapping large pools of private capital, particularly for example in defined contribution pension funds as is the case in the UK. Commitments have now been made from asset owners to invest 5% in UK of assets in unlisted companies but it will still be important to generate the right risk/return profiles for these schemes and their members. Options for this deployment include co-investment for public or development capital alongside the private sector on equal terms, which helps broaden the scale of the pot as well as creating opportunities to generate a return for His Majesty's Government which can be returned or recycled according to need. When appropriate, public capital can also be deployed in the form of mezzanine debt that converts to equity in the event loan payments are not met.

Equity needs are also sector specific. The GFI has looked in detail at the investment thesis for the Electric Vehicle (EV) battery supply chain and has identified an equity gap of £20-100m, after early-stage proof-of concept but before commercialisation (this will vary in other sectors). The GFI has designed a Battery Investment Fund[3] which has been road-tested with investors and a pipeline of recipient companies. It would create an SPV made up of public and institutional equity, which would then on-lend or invest in companies in the EV battery supply chain, depending on financing need. This will deliver the scale-up capital required and instead of 100% loss of capital under grants, allow for the recycling or return of public capital.

2. https://www.iisd.org/credit-enhancement-instruments/institution/african-development-bank/
3. For more information see https://www.greenfinanceinstitute.com/wp-content/uploads/2022/05/Powering-The-Drive-To-Net-Zero-Report.pdf

2) Demand – companies seeking finance.

To bring the demand side closer to the needs of private investors, there are things that businesses and developers can undertake to increase their access to capital and lower financing costs.

Investment Readiness

This activity usually falls under the auspices of technical assistance to support issuers and sponsors with project preparation to make them more bankable. This is about turning vision into technical procurement plans, alongside a financial advisory capability that structures projects in a way that makes them easy to access for would-be investors. It is about creating both scale and certainty in a way that projects are presented and potentially bundled and scaled. The GFI has advised on the creation of multiple investment readiness funds[4], particularly in the nature space. These funds support landowners and farmers with advice and technical assistance on how they can transition to sustainable land management and monetise the value of their assets by creating credits in carbon, biodiversity and resilience. Where landowners are effectively SMEs, these investment readiness funds advise on bundling and slotting, either through aggregating their land with that of other farmers or up and down their own supply chain to unlock value for investors.

Revenue certainty

Market risk is a key consideration for an investor looking at net zero opportunities, particularly in strategically important but commercially unproven technologies. There are opportunities to create certainty when it comes to revenue by developing new business models and revenue structures.

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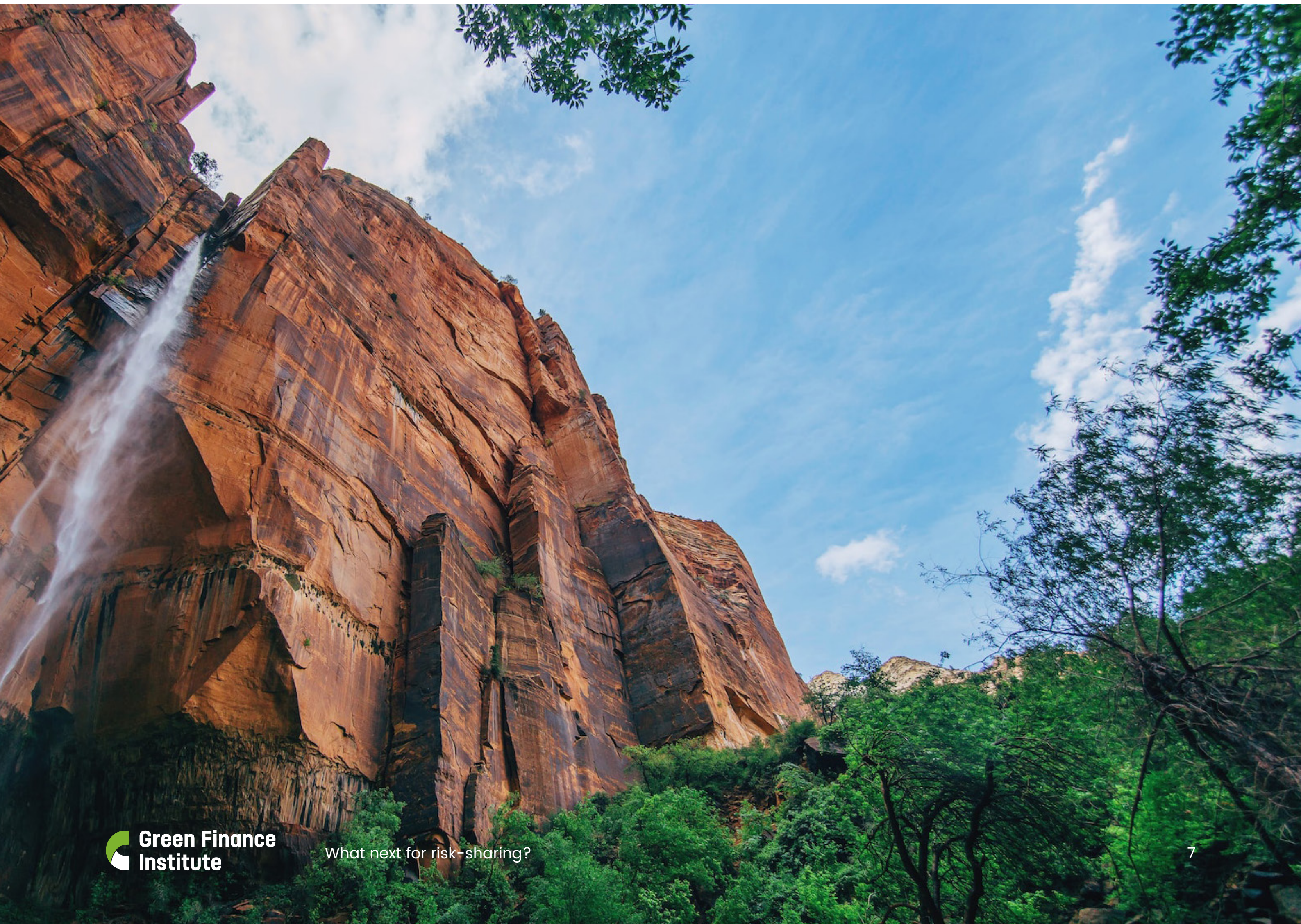
Offtake agreements provide some certainty since they create a guaranteed buyer for the product/service in question. This could take the form of a power purchase agreement for renewable energy or a pool of airline customers who enter a contract to purchase sustainable aviation fuel from an as yet unbuilt manufacturing plant. Offtake agreements can be further enhanced with guarantees (as above) in the event the offtaker becomes insolvent before transacting on the agreed purchase.

4. https://www.greenfinanceinstitute.com/gfihive/neirf/ and https://www.greenfinanceinstitute.co.uk/gfihive/firns/

Within this offtaking process, there are floors and ceilings that can be agreed on price, to provide further clarity and certainty to both buyer and seller. The most well-known example of this is the successful deployment of Contracts for Difference in offshore wind in the UK which effectively guarantees a minimum price that the UK government will pay as offtaker from future wind farm and other renewable energy developments. The GFI has been advising the Department for Transport on a similar mechanism to support the production of Sustainable Aviation Fuel in the UK.

Beyond this, there is also the need to develop new revenue models in nascent sectors like carbon removals and nature-based solutions to support adaptation to a changing climate. In the latter, the revenue model is not immediately obvious and will have to be constructed through a certain amount of financial engineering. For example, funding natural flood management solutions is at face value, something only government could do. However, where these solutions are delivered, businesses, utilities and homeowners are likely to benefit from lower insurance premiums. This lowering of premiums is a potential revenue source that could be packaged and passed back to a private investor, mitigating the need for a solely public approach to funding flood resilience. With funding from NEIRF (see above) 'Connecting the Colm' aims to address environmental challenges from the Colm river and its catchment through exploring private green finance for nature-based solutions.



3) Private Sector

Finally, it is not simply the case that private investors should just sit back and wait for appropriate risk-adjusted returns to roll in. There are things they could and should do to create new markets and projects for their high level, net zero commitments to mobilise into.

The first involves developing a better understanding of the perceived risks and collaborating on public-private solutions. This was a core activity of the UK Green Investment Bank that worked with investors to improve understanding and created investible sectors such as waste AD and listed offshore wind. Following this approach, each sectoral coalitions the GFI runs, brings specialist private investors and lenders around the table with policymakers and developers to unpack the barriers to investment and co-design solutions, including through a newly launched 'Private Finance Group' for nature, which not only aims to increase awareness of potential investors of nature-based solutions but also to help shape investment readiness and capacity building activity.

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There may also be the opportunity to create and develop new assets classes like venture philanthropy which offer a more productive outlet for banks' CSR budgets and deliver greater societal benefits through leverage and scale. The GFI has pioneered this approach through our Utilisation Linked Finance for scaling up EV charging infrastructure – a guarantee provided from a philanthropic commitment de-risks bank loans to new developments where demand may be initially low.[5]

Finally, the proper integration of specialist insurance products into the investment value chain is an underutilised approach. It can help de-risk investments yielding many of the same benefits described above.

5. https://www.greenfinanceinstitute.com/utilisation-linked-finance/

Conclusion

Whilst the approaches to blended finance above have been tried, tested and piloted, rarely have they been scaled and they have certainly not mainstreamed. This is because in this nascent market, the approach has been product first, instead of identifying the sectoral need and working backwards. Much like in the case of green products, many of these blended finance approaches have been deployed on an individual basis, but they are not in themselves a mobilisation strategy for sectoral transition.

Every sector is different and each needs a holistic approach to mobilising the sufficient capital at scale needed for net zero. In transport for example, government guarantees are needed to crowd-in private capital to build the supply chain. Enhanced offtake agreements are needed to finance the charging infrastructure so that lenders have a guaranteed revenue source in the current absence of sufficient EV users. And educated specialist investors must seize on these opportunities to bring them into the discussion to inform solutions that will deliver the returns they need for their clients.

The GFI has pioneered this approach in two ways. The first is by thinking entirely by sector – in other words, financing green opportunities is first and foremost recognising the capital need and working backwards from there. The second is recognising that to deliver this approach requires a different institutional approach that involves working with both public policymakers and private capital providers in parallel. That is why the GFI sits in between public and private sector and has developed the skills and tools to work with both. The Institute continues to develop this approach in the UK through the Net Zero Council and the Net Zero Blended Finance Project. To existing sectors in the built environment, transport and nature, the GFI is adding greenhouse gas removals and industrial decarbonisation. Other sectors will follow.

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The GFI is looking to build more coalitions to deliver sectoral transitions in the UK and globally. Sector experts from both policymaking and investment need to come together to design new mobilisation strategies where they can have the greatest impact. Please get in touch if you would like to be involved.