Green Finance Institute

What next for mobilising capital in service of a just transition in the Global South?

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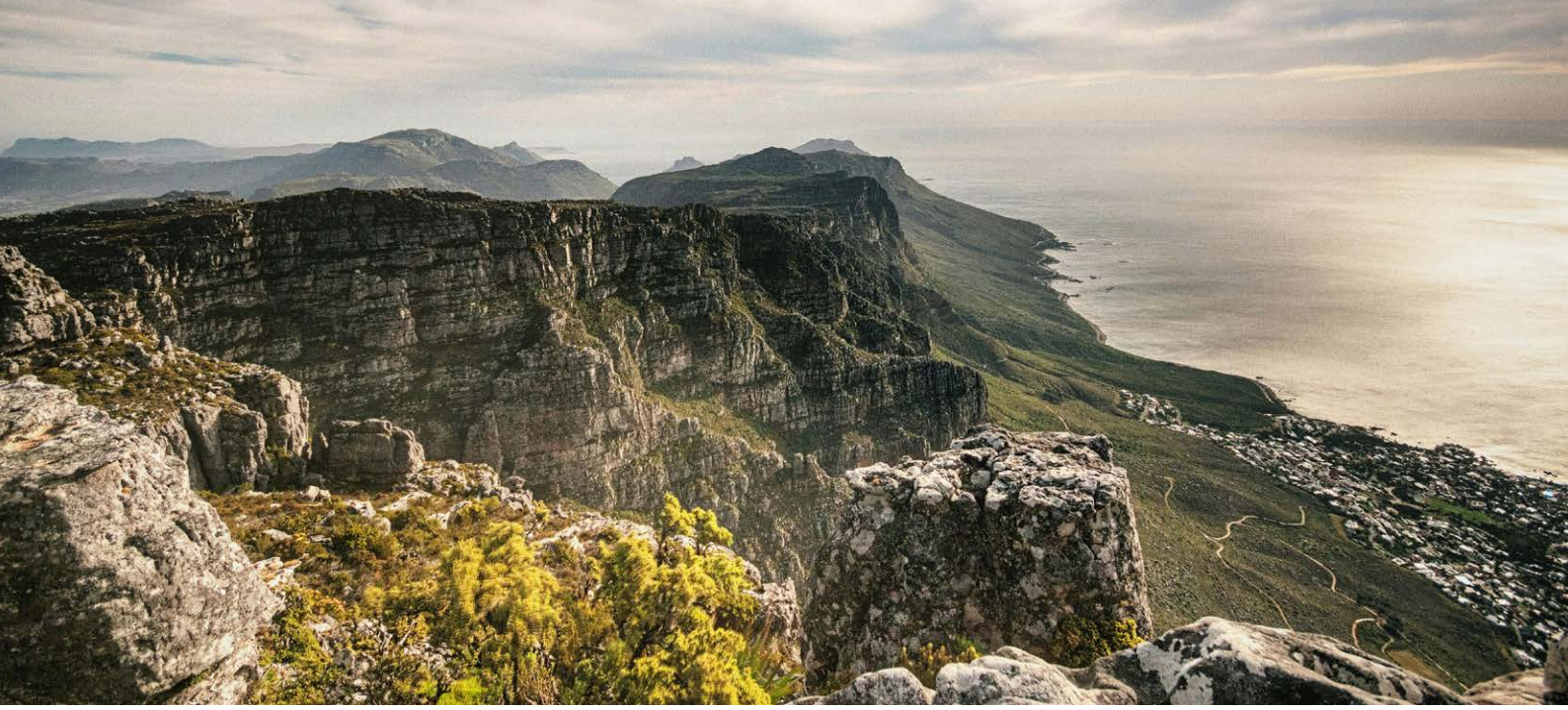
It is now well recognised that, with public balance sheets increasingly stretched, private capital has a significant role to play in financing the net zero transition. Both in donor and recipient finance ministries, there is precious little fiscal head room; for example, South Africa's consolidated budget deficit rose to 4.9% of GDP in 2023/24[1]. Yet at COP28, it was noted with "deep regret"[2] that the long-term climate finance goal of US$100 billion per year agreed at the Paris COP in 2015 had not been met. According to The Organisation for Economic Co-operation and Development (OECD), of the US$89.6 billion climate finance mobilised by developed countries in 2021, only 16% of this was private finance (US$14.4B in 2021)[3]. As of 2023, global private climate finance deployed stood at US$625 billion[4], 49% of total climate finance, demonstrating growth but not at the pace and scale required.

> 75% of climate finance was facilitated through market-rate debt instruments with an average cost of capital between 10% and 12%.

To compound this challenge, when climate finance is deployed in countries that most need it, the cost of capital remains high relative to countries in the Global North. In the Climate Policy Initiative's 2023 report on South Africa's climate finance landscape[5], "75% of climate finance was facilitated through market-rate debt instruments with an average cost of capital between 10% and 12%". This reflects the fundamental risk aversion many lenders and investors have to emerging markets, which range from political to currency to liquidity and corporate governance risk, which – without action – will be increasingly compounded by increased physical risks from climate change.



However, it is not only a quantity of finance challenge, but also a quality of finance challenge. This challenge is central to the transition, one that will be disruptive but must be equitable. The International Labour Organisation estimates[6] that 80 million jobs will be lost and 100 million created in the transition to a net-zero economy – but the location and quality of these roles is a critical factor.

We are already seeing this, in 2022, with the decommissioning of the Komati power station in Mpumalanga, South Africa[7] and more recently, the closure of the Port Talbot blast furnaces[8] in Wales in the UK.

Jobs are being lost or relocated and communities bear the consequences of these outcomes. When looking to finance the transition, these factors must be taken into account.

Furthermore, the notion of a just transition does not resonate with all countries in the Global South, with many focused on security, development and social resilience. The Institute for Human Rights and Business has identified four essential elements[9] of a just transition that highlight the need to present risks and opportunities to potentially affected groups, including workers, communities, indigenous peoples, and consumers and give them agency in transition planning and decision making.

In all, this means that whilst recipient countries need capital for the transition, it needs to be both low cost and also to support wider public policy requirements. Quite often this is framed by the market as an insistence on local content requirements that add friction cost to transactions. But these requirements are also about the ongoing legitimacy of the transition itself and so are essential if we are to deliver at the scale and pace required.

This briefing note sets out a view on how to scale finance for a just transition in emerging markets and developing nations, building from a closed-door discussion held during London Climate Action Week (LCAW) with leading finance practitioners and experts from South Africa, India and the UK.

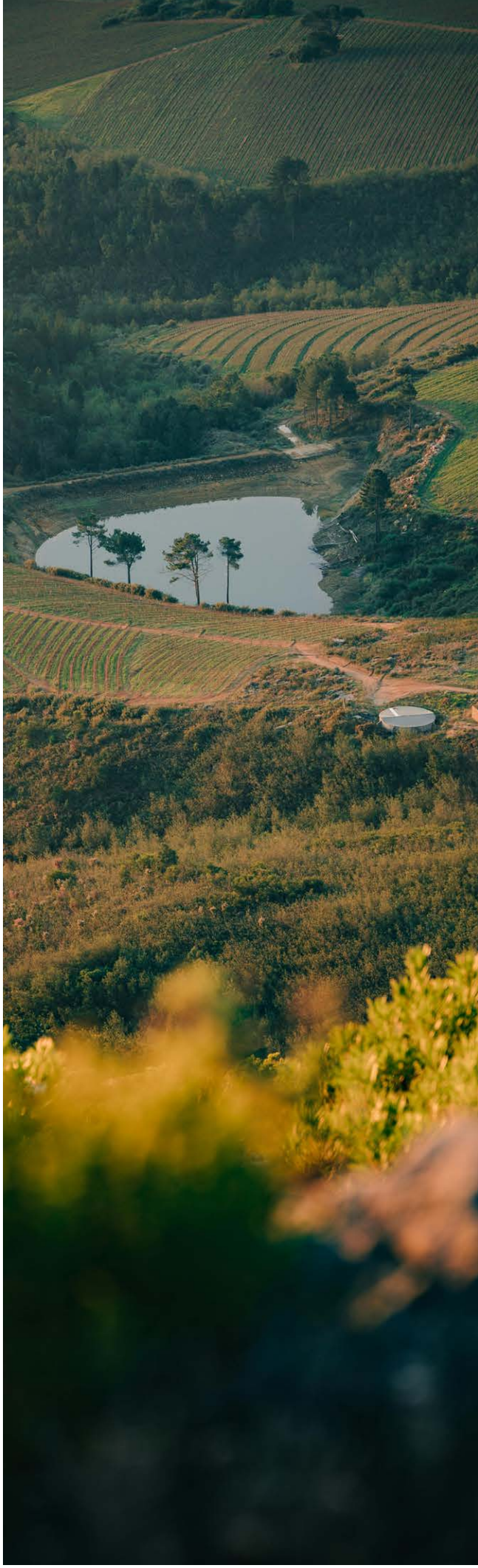
From barriers to solutions

Building a better understanding of how emerging markets and developing nations can increase the flow of private capital to a broad set of projects, covering all elements of the transition, including adaptation and resilience, makes good economic and financial sense at a local level. This is because it ensures that communities, businesses and assets can withstand the more frequent and intense weather extremes that are now upon us, enabling them to achieve societal functionality more quickly than at present. It also makes sense at a global level because it unlocks new market opportunities that contribute to collective global resilience.

This is not just an economic or financial issue – it is a security and social justice issue: the latest UN analysis on global climate impacts underlines the need for urgent action, with 2023 marking the hottest year on record amid rising sea levels and increasingly extreme weather. While economic losses from natural and climate-related disasters are estimated to cost more than US$ 330 billion per year[10], this figure is just the tip of the iceberg of the real uncounted costs on people's lives.

There are two key themes that have emerged across the public and private sector to drive the best outcomes:

- Risk-sharing capital structures that can simultaneously crowd-in private finance and reduce the cost of capital.
- Creating the right institutional architecture that fills the execution gap between global supply and local demand.



Risk-sharing structures

The efficient use of public capital to crowd-in private finance should be a key aim of governments and development finance institutions everywhere. Grant funding has its place but should be limited to those circumstances where cashflows are impossible to generate.

Public capital must be deployed with caution, both to avoid potential inflationary impacts and to maximise private co-investment. By taking a first-loss or guarantee position, public capital reduces financing costs and enhances credit ratings. As mentioned above, diverse risks, including political, credit, currency and construction risk, prevent institutional investors, banks and equity providers from investing in emerging markets.. Whilst there are several products available that cover these risks, such as Multilateral Investment Guarantee Agency's (MIGA's)[11] these are yet to be deployed at the scale required. Default rates are roughly 2% higher on infrastructure projects in emerging economies compared to those in developed countries, but recovery rates are similar at around 75% [12]. This further demonstrates the need to clear hurdle rates at the outset of projects - and public capital can be deployed to do that, leveraging in private investors and then being recycled once the projects are operational.

Furthermore, governments have a toolbox of options alongside capital deployment that they can leverage. Creating a long term and stable policy environment is also key to providing confidence to private finance. For instance, ensuring a consistent application of planning law or the creation of enterprise zones are ways to increase investor confidence.

The Just Energy Transition Partnerships (JET-Ps) have not proven to be the catch-all solution to the challenge they were once hoped to be. The benefits of this solution, to a very complex challenge were overstated and subsequently over-criticised; this binary thinking is not helpful. The JET-Ps should be seen as a first step and one of the successes they have had is in breaking new ground and providing valuable insights to the next iteration – we need to keep learning. Aligning new institutions and innovations like country platforms will be key to success, as will ensuring this alignment is prioritised over the modus operandi of financial institutions to deploy capital quickly.

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A just transition requires a bottom-up approach that ensures capital from development finance institutions is both country and demand driven and that where necessary “project one”, entirely publicly financed, leads to “project ten” that is privately financed. Furthermore, these projects are a portfolio of everything that is required and so will include those projects that might not have a market-level commercial return but are delivering a tailored just transition in-country. This will necessarily mean that within the multilateral development bank landscape there needs to be a recognition that some investments may be environmentally and/or socially transformational and have lower returns, but this is counterbalanced by taking a portfolio approach to both returns on investment and impact.

Insurance products, particularly index based or parametric solutions, also have a role to play. With parametric insurance, the pay-out is linked to a loss-causing event occurring, not the actual loss sustained as in traditional insurance. These products will therefore pay out if income loss is incurred due to cloud cover over a solar field or drought leading to crop loss[13]. Where first-of-a-kind technology is being deployed, which by definition lacks historical performance data, insurance can pick up the risk of technology performance and its impact on economic outcomes[14]. This can unlock the capital required and speed up time to market.

Bringing more projects into the financeable universe of private capital is where the just transition can be realised. Private sector actors can integrate justice elements into their project design and thereby internalise this process and incorporate it into the package of projects being financed. Separating out those projects that might not have a market-level commercial return but are delivering social benefits or securing local jobs exacerbates the challenge and so public development finance should mandate these elements being included in the portfolio. It will increase the cost of financing at the outset, but overcoming these challenges should be the focus of public capital and in the long run this investment will pay-off – for instance, in nations with low broadband connectivity, connecting schools to the internet has the potential to grow GDP by 20%[15]. In a similar vein, retraining and reskilling programmes (such as those offered by the United Nations Institute for Training and Research)[16] in emerging economies may not result in a return on investment immediately, but manifest in economic terms over time.

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The challenge is the route to scale. Innovative transactions like JETPs and MIGAs referenced above, must be a catalyst to attracting private capital at scale.

Institutional landscape

In any transaction, money moves between counterparties and with respect to developing markets and global investors, there is an execution gap that needs to be filled to get capital to flow. For example, to move beyond one off transactions, with high friction costs and low throughput from private investors to scalable sector transitions, we need to align multiple stakeholders and counterparties. This includes, for example, ensuring that project developers have adequate technical assistance. There is also a need for both financial sector policy and sectoral policy designed to provide a clear enabling environment. Finally, where policy isn't enough, development finance may be required alongside demand side guarantees.

All elements in the value chain need to be aligned before capital can flow. Doing so is ultimately what completes blended finance deals. The challenge is that there are so many counterparties in the chain.

The situation is compounded on the demand side. Governments may have political objectives that point towards the just transition, but they don't have the means to transpose these into a scalable pipeline of investible opportunities. Either they work with stakeholders to create one-off transactions that deliver both capital and impact, or investors cherry pick projects – generally the ones with fewer or no just transition challenges, leaving the difficult or less commercial projects and sectors to public capital.

The solution is to recognise that aggregation and working at scale is not the challenge - but the solution. Only at scale can you align sector policy with development finance and demand side support to create investment pathways that private capital can access. Only at scale can you 'bake in' just transition requirements across the entire transition to avoid cherry picking, whilst bearing down on friction costs.

To deliver this scale we need to both reform existing institutions and create a new sort of counterparty.

On the former – existing institutions require their institutional mandates to be reformed to give effect to the risk sharing arrangements that will mobilise sufficient capital and foster the development of new products and services. Existing institutions – such as the World Bank, Green Climate Fund (GCF), Brazilian Development Bank etc. – are at different scales of engagement, which are all intended to deliver some of the challenges outlined above. However, in order to solve these challenges, they need expanded mandates and ambition to do finance differently; in essence, to take on the appropriate level of risk required to address the systemic risk we are collectively facing. For example, reaching 1.5°C-aligned of "finance flows" would intellectually require that every institution should have their mandates adjusted to consider the set of risks, shift the transition-related processes they bring up, and filter this through their systems. This will allow existing organisations to transition from compliance with standards, to the true mobilisation of resources.

On the latter, an organisation with private sector skills and a public sector mandate can develop financeable sectoral transition plans at scale. Instead of an institutional investor working to align multiple public sector stakeholders and development finance providers, a new institution can do this. What is presented to the investor is a strong pipeline, with clear enabling policy and where necessary concessionary finance provided either by a third party with an aligned mandate (such as a green bank or fund) or the institution itself. Similarly, a third-party can also 'bake in' just transition requirements from the beginning, across an entire sector not just a one-off transaction. By bringing private capital into the process earlier, it would facilitate brokering scalable approaches that deliver adequate risk-return profiles for private capital, and public policy outcomes for governments and their citizens.

We are currently relying on a highly fragmented landscape of actors to deliver this, leading to sub-scale, high-cost finance. To solve it is to recognise we need new kinds of institutions that can align stakeholders and build scale.

Endnotes

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