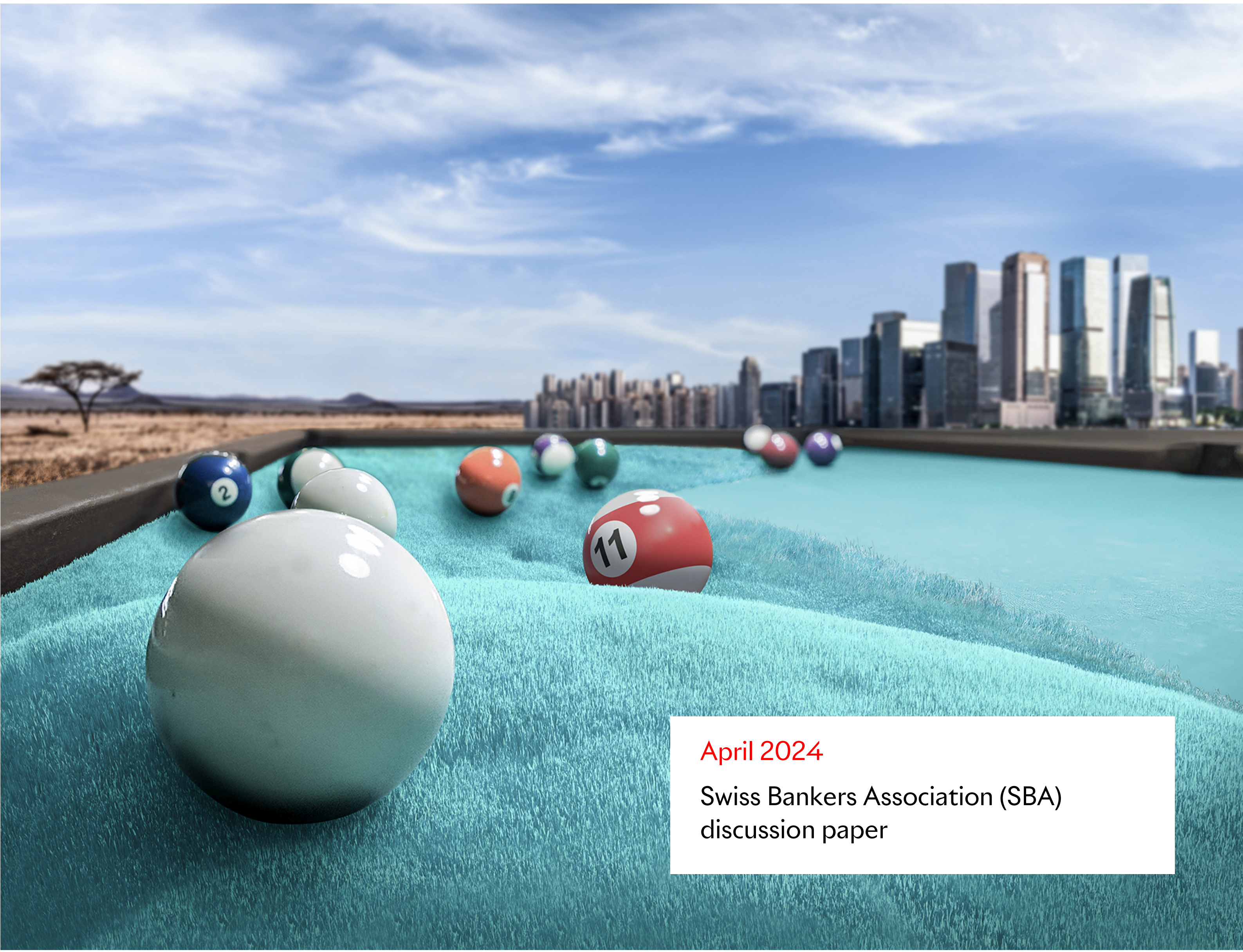
Swiss Banking

Climate Finance

Mobilising private capital via blended finance



April 2024

Swiss Bankers Association (SBA) discussion paper

SBA DISCUSSION PAPER

Climate finance – mobilising private capital via blended finance

Main points in brief

- The Glasgow Financial Alliance for Net Zero (GFANZ) has calculated that around USD 3.2 trillion a year in investment is needed to halt global warming. It is an undisputed fact that financing on that scale is impossible to achieve without mobilising private capital.
- The funds required to close the financing gap are available in the private financial sector, but private investors' willingness to provide them depends on the investability of individual projects. It is necessary to ensure that the invested capital generates a return commensurate with the risk involved.
- Much of the investment required takes the form of infrastructure finance in emerging market and developing economies (EMDEs, typically the G77[1] and China). At present, however, this is in most cases not investable for private investors.
- There are strategies that address this challenge, one of which is the funding structures referred to as "blended finance" which employ public capital to reduce risks and thus make projects investable for private investors. In an ideal scenario, this can mobilise many times as much private capital. The impact of the investment, and a risk-appropriate return (investability) are equally relevant.
- The volume of blended finance investments made to date is far too small to mobilise anything like the sums needed, since they are mostly limited to individual projects and are therefore not scalable. This means they can only have a limited impact in terms of slowing or preventing climate change.
- Structures that facilitate scaling and replication at every stage in the funding cycle (from investors to projects and back again) therefore need to be created, ideally in the form of project and financing platforms. This will require the existing structures to be aligned appropriately via financial institutions such as development banks.
- The Swiss financial centre already has the framework in place to achieve its aspiration to be a leading hub for sustainable finance. To ensure this remains the case going forward, however, and to remove any future obstacles, that framework needs to be carefully reviewed and adjusted where necessary.
- This discussion paper does not examine individual products or specific regulatory proposals in detail; instead, it highlights the need for private capital, the potential of blended finance, and the obstacles in its path. A systematic approach is required, initially comprising further detailed discussions between all the stakeholders involved.

[1] The Group of 77 is the largest intergovernmental organisation of developing countries in the United Nations, which provides the means for the countries of the South to articulate and promote their collective economic interests and enhance their joint negotiating capacity on all major international economic issues within the United Nations system, and promote South-South cooperation for development. (See https://www.g77.org/doc/index.html#establish.)

This discussion paper situates the topic of mobilising private capital through blended finance within a global context, from a Swiss perspective. The remarks below focus on the scale of what is required and the associated challenges, and are based on estimates and information from the Glasgow Financial Alliance for Net Zero (GFANZ) and statistics from the OECD. In particular, they emphasise the role of blended finance as a financing structure and a conduit between sources of funding and investment projects. The opportunities for the Swiss financial centre to cover an appropriate share of what is required are also examined.

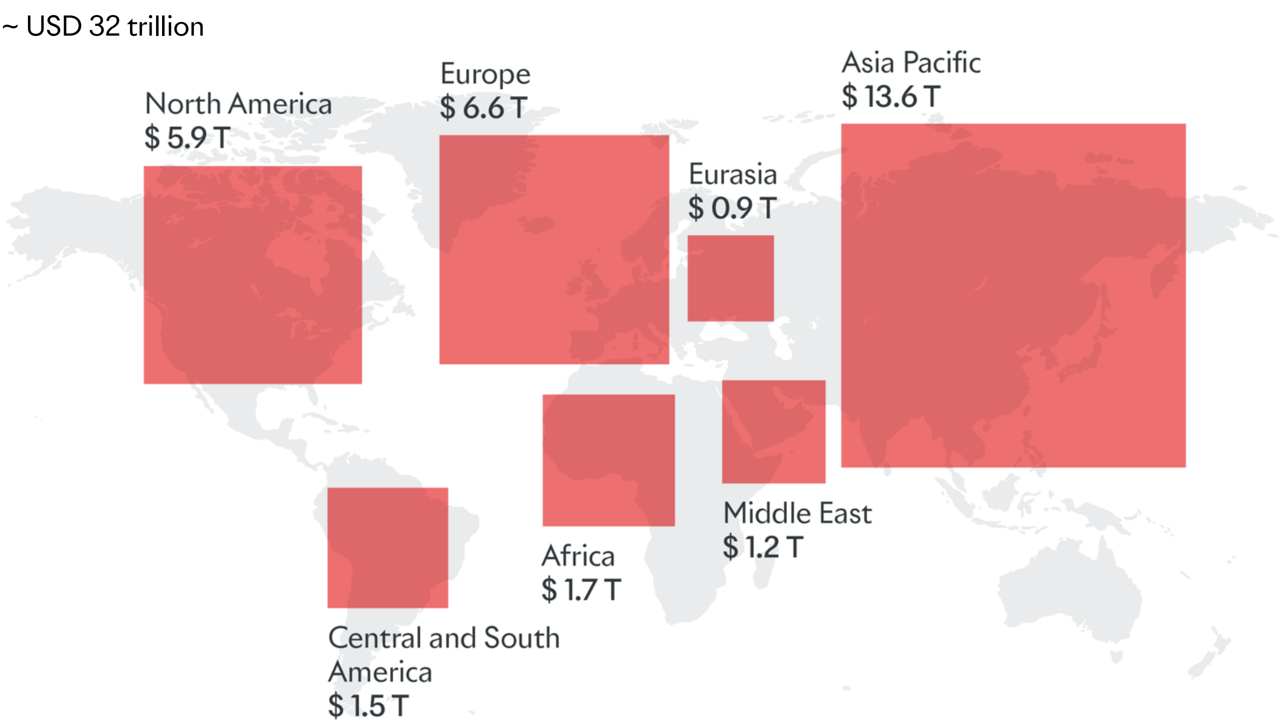
The context and relevance of climate finance for climate change

Climate change is a global challenge. Meeting the goals of the Paris Agreement and thus mitigating climate change requires the use of financial resources. A term often used in this context is "climate finance", meaning the use of local, national or supranational financing from public and private sources in support of measures to mitigate, and adapt to the negative impact of, climate change.

At present, finance flows into climate protection are below the demand for climate finance, and are not growing fast enough. The Standing Committee on Finance of the United Nations Framework Convention on Climate Change (UNFCCC) estimates that the transition to an emissions-free and resilient economy by 2050 will require USD 1.6 to 3.7 trillion annually. Similarly, a GFANZ analysis indicates that to achieve net zero by 2050, USD 32 trillion will be needed by 2030 alone, or USD 3.2 trillion a year from 2021 to 2030.[2] Figure 1 shows the geographic breakdown of the estimated investments required.

Figure 1

Geographic breakdown of the climate finance requirement from 2021–2030 according to GFANZ



Source: GFANZ

[2] https://www.gfanzero.com/netzerofinancing (November 2021)

Challenges and opportunities for investments in climate finance

If we look at where the biggest challenges in climate finance are to be found, information from the Center for Global Development (CGD) indicates that almost two thirds of global greenhouse gas emissions have their origin in EMDEs. At the same time, many of those countries are especially vulnerable to climate risks, in particular small island states exposed to rising sea levels.[3] Over the coming years, these economies will need substantial financial resources in order to reduce their emissions and adapt to the impact of climate change.

This is compounded by the fact that many EMDEs are still highly indebted following the COVID-19 pandemic and, as interest rates climb around the world, they face rising government borrowing costs, high levels of debt in USD terms, and depreciation of their currencies. This makes it especially difficult to meet the urgent need for climate finance from public funds.

GFANZ estimates that private actors could supply 70% of the financing required by EMDEs,[4] which also translates into opportunities for private investors. Private sector financial institutions thus have a key role to play in funding the transition to net zero, both by directly offering net zero investments – supporting and enabling decarbonisation projects – and by acting as financial intermediaries, guiding the finance flows of their clients.

However, there are also numerous hurdles and restrictions facing private climate finance in EMDEs. One in particular is political uncertainty. Others include technological risks that drive up capital costs, as well as limited availability of data.[5] The result is unattractive risk/return profiles and, consequently, a lack of attractiveness for private investors.

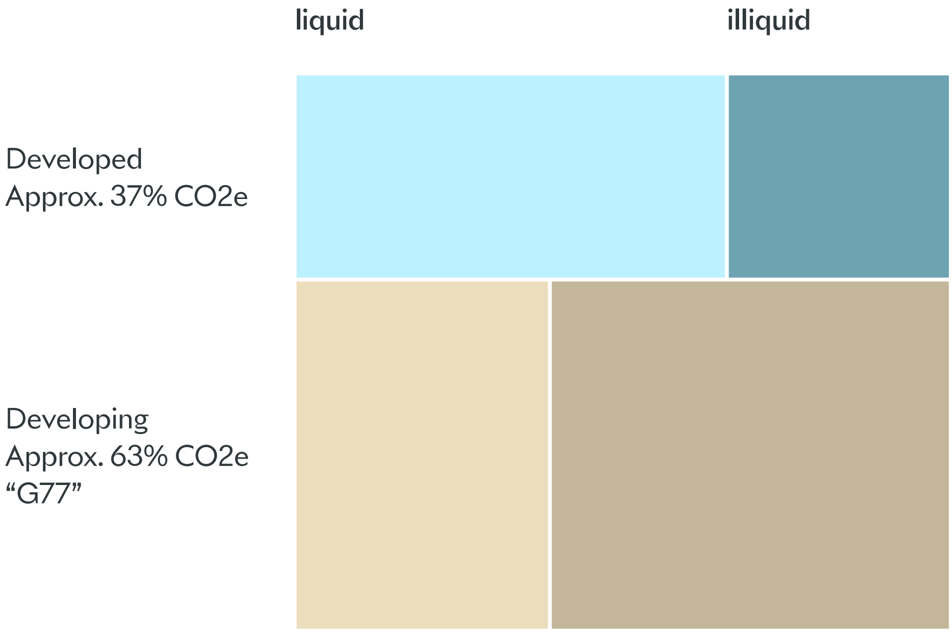
In most emerging economies, the perceived and actual risks exceed the fiduciary limits of mainstream investors. The country risk especially is, in most cases, higher than fiduciary obligations permit. Few EMDEs are rated as "investment grade",[6] and the private sector regards investments in them as too risky because most bonds are far outside investors' risk limits, which normally exclude anything with less than a "BBB" or "BB" rating. It is a similar story with equity investments.

The diagram in figure 2 illustrates the challenge of climate finance. Currently, asset and wealth management's core investments are in liquid assets from developed economies (shown in light blue). The transactions are largely standardised. Typical admixtures in the portfolios of investors with a higher risk capacity include illiquid investments in developed economies (dark blue) and liquid investments in less developed economies (light brown). From a climate perspective, however, illiquid investments in less developed economies (dark brown) are particularly in demand, because that is where the need for finance to reduce emissions is greatest.

[3] https://www.ipcc.ch/site/assets/uploads/2018/02/WGIIAR5-Chap29_FINAL.pdf (2014)
[4] https://www.gfanzero.com/netzerofinancing (November 2021)
[5] Without data, it is impossible to tell where investments are made, and how targets can be set, achieved and measured.
[6] Rating for bonds where the default risk is deemed to be low. Investment-grade bonds are those with ratings of at least BBB (Standard and Poor's) or Baa (Moody's). Often, corporate and institutional investors such as pension funds have rules that only permit "investment grade" investments.

Figure 2

Climate finance requirement and investability



Source: Center for Global Development, SBA diagram

Overall, though, such investments are made in an unfamiliar environment and the proportion of illiquid investments is much higher. According to the CGD, around 63% of CO_2 emissions have their origins in the G77 countries and China. In addition to the usual technological and financial market risks, greater consideration needs to be given in such cases to political, regulatory and administrative risks, as already mentioned. There are also obstacles with regard to the return on investment (ROI): these include demand uncertainty, amortisation periods, price uncertainty and production volumes, to name but a few.

Currently, only a fraction of the estimated USD 1.6 to 3.7 trillion in funding required is available. According to the OECD, just USD 51 billion of private funding was mobilised in 2020, a third of which (around USD 17 billion) can be ascribed to climate protection.[7] It is clear that the existing frameworks and financing structures are not adequate to meet the financing requirements in EMDEs. They need to be adapted in order to bring the investability and availability of opportunities for private investors up to the necessary level.

For the reasons set out above, government money and the financial markets alone cannot fund the fight against global warming and its consequences. A range of instruments, approaches and financing sources are available to meet these challenges, which aim to improve access to climate finance and promote investments in climate protection measures: they include green bonds, sustainability-linked bonds, debt-for-nature swaps, blended finance, voluntary carbon markets, private philanthropy and special drawing rights from the International Monetary Fund (IMF). One especially promising instrument is the combination of public and private capital, which can reduce investment risks and so mobilise private

[7] https://www.tossd.org/docs/Infographic_Mobilised_Private_Finance_TOSSD.pdf (June 2022)

investments. Multilateral development banks and international financial institutions are especially suited to this partnership. They create financing structures and act as a hub connecting private to public funding.

The Network for Greening the Financial System (NGFS) has examined this issue and published a report entitled “Scaling Up Blended Finance for Climate Mitigation and Adaptation in Emerging Market and Developing Economies”[8]). Unlike that report, this discussion paper specifically addresses the situation in Switzerland.

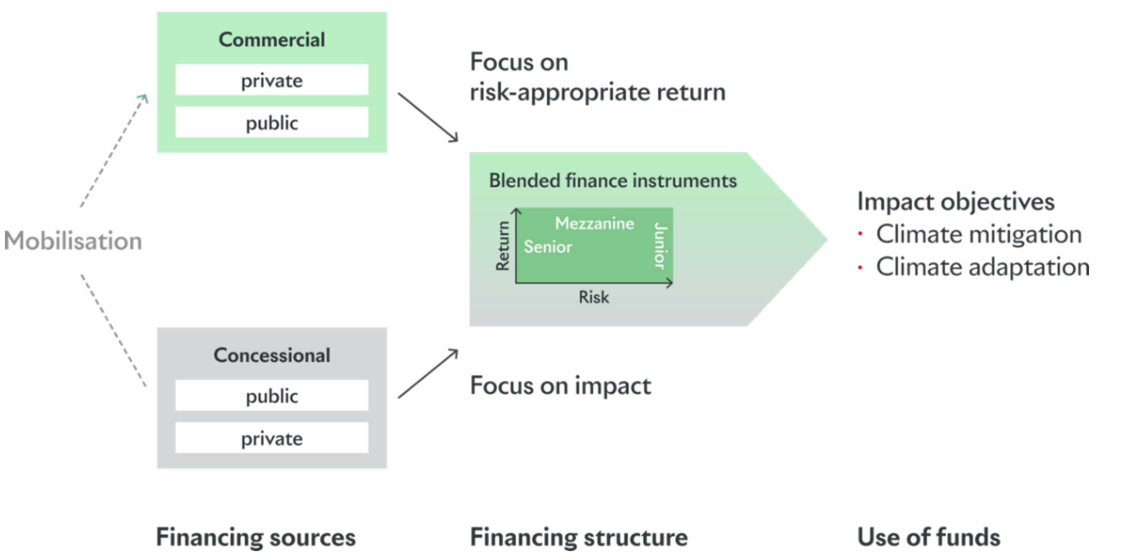
Financing mechanisms to mobilise private capital via blended finance

Blended finance plays a special role in mobilized private capital.[9] It involves the strategic use of public development funding to activate private capital flows, especially by enabling private investors to achieve an appropriate return on their investments, with positive effects for both them and the projects they support. Blended finance offers a number of approaches and tools to achieve this.[10]

By agreeing to be first to bear losses on climate-related financial instruments, concessional sources of financing (often public or philanthropic funding) can improve the expected risk-adjusted return for commercial (mostly private) investors, and so lower the investability hurdle (see also figure 3). When designing such instruments, care should be taken to avoid misdirected incentives created by guarantees (moral hazard), by implementing appropriate governance. Such incentives occur when profits are privatised and losses socialised. Another challenge is potential over-subsidisation: how much risk should be assumed by concessional sources of financing, or what return should be guaranteed in order to mobilise private capital without subsidising the return earned by commercial investors.

Figure 3

The blended finance mechanism



Source: ResponsAbility, SBA adapted presentation

[8] https://www.ngfs.net/en/scaling-blended-finance-climate-mitigation-and-adaptation-emerging-market-and-developing-economies
[9] The private capital to be mobilised can be found across the entire range of potential private sources: not just institutional or private investors, but also companies via the capital market. In Switzerland, asset and wealth management is at the forefront.
[10] See e.g.: Blended Finance: A Brief Overview (2019), p. 9 ff.

Swiss financial institutions are playing a pioneering role in blended finance, with examples including BlueOrchard and ResponsAbility, both of which have some 20 years' experience in this field. However, they have recently been taken over by asset managers based in the UK in transactions that were made for strategic reasons (know-how, network, reputation, human capital) and not on the basis of assets under management (both in the low single-digit billions).

The developed economies, including Switzerland, could count their contribution of public funds towards the commitment of USD 100 billion annually (target) for EMDEs which they entered into as part of the UN Climate Change Conference. In 2020, Switzerland mobilised some CHF 659 million from public and private sources combined, with CHF 390 million being in the form of public funding and the remaining CHF 269 million private.[11]

Given the limited amount of public funding available, a high degree of leverage for private capital needs to be targeted. Today, the commitments made by development banks to EMDEs are complemented by, on average, 36% from private sources.[12] This corresponds to a leverage factor of just over 0.5 (approx. 1/3 from private sources and 2/3 from public). To achieve the financing targets, the medium-term target needs to be between 5 and 10.

International institutions are very aware of this issue, and are therefore attempting to bring about scaling and standardisation through themed approaches. A good example of this is the UN Capital Development Fund Blue Peace Financing Initiative.[13]

Role of various actors and drivers in mobilising private funds

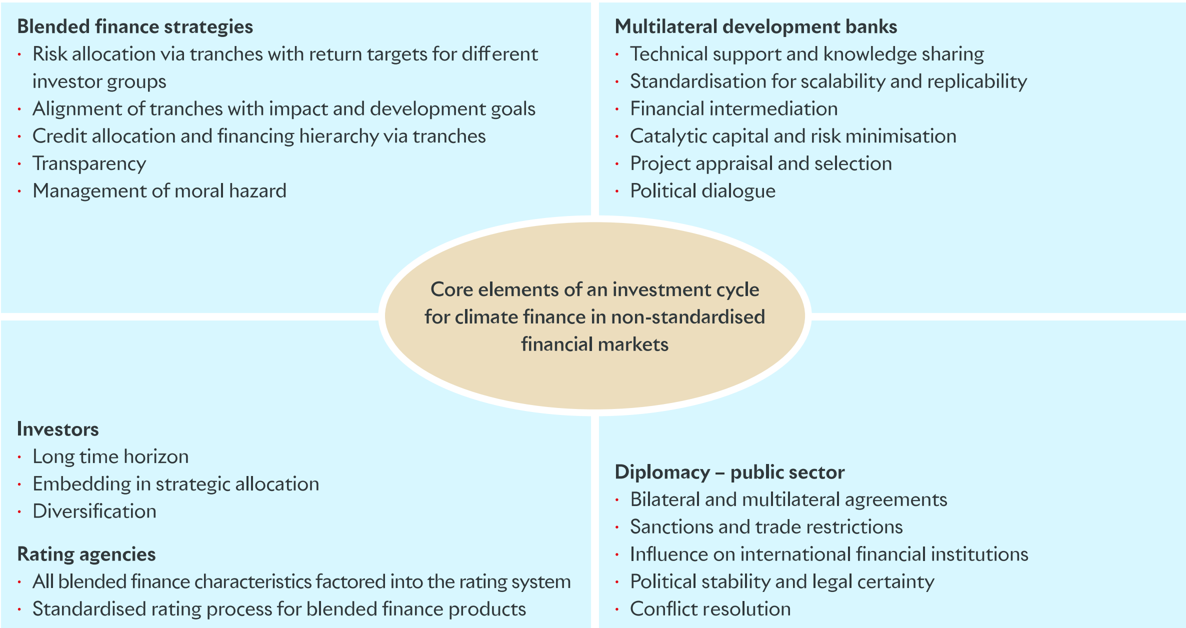
When it comes to mobilising private capital to close existing gaps, the focus for investors is clearly on investability. It is often forgotten how easy it is to invest in traditional investments in standardised markets. Information is available, trading systems are tailored to it, and investors can do almost everything themselves thanks to fully automated, straight-through processing.

This paper now considers four key areas that can be viewed separately, but only tackle investability – and thus mobilisation – when they are combined.

[11] Switzerland's 8th National Communication and 5th Biennial Report (2022)
[12] According to an OECD report on blended finance: https://www.oecd-ilibrary.org/docserver/fb282f7e-en.pdf?expires=1673515009&id=id&accname=guest&checksum=D4C227CBA71B45603E1945387723A4DE
[13] https://www.uncdf.org/blue-peace-financing-initiative

Figure 4

Core elements of the investment cycle



Source: SBA

Blended finance strategies

In blended finance strategies and financial instruments based on them, tranches play a central part in structuring and channelling the capital and risk flows between the various parties involved. Tranches are segments within the overall capital structure of a blended finance instrument, each of which has its own features and objectives. Their role includes risk allocation, return targets, impact and development goals, credit allocation and the financing hierarchy, to name only the most important.

The correct tranche structure is key to reconciling the interests of the various shareholders. Attention also needs to be paid to avoiding negative incentive structures and, in particular, moral hazard: the danger of a party taking on excessive risk because it does not have to bear the full consequences of doing so. This situation can occur when a party is protected or insured against potential losses in a manner such that it acts in ways it would not if exposed to the risk in full. It is especially important to structure and manage projects carefully, to balance the twin goals of financial return and development policy impact.

The role of multilateral development banks

Multilateral development banks (MDBs) play a key role in blended finance by facilitating and catalysing private-sector investments in development projects. Their involvement makes a vital contribution to mobilising public funding and directing it towards sustainable and effective initiatives. MDBs' key functions include risk mitigation via the use of appropriate instruments as well as technical support and knowledge sharing, financial intermediation, political dialogue and, especially, assessing and selecting projects. Scalability and replicability are essential to mobilising the financing cycle to the necessary degree. MDBs can therefore open the door to investors.

The role of diplomacy

In international finance, diplomacy can have a substantial impact on the all-important financial counterparty risk. It can help to reduce the risks of financial transactions by creating a legal framework, promoting stability, resolving conflicts and influencing international agreements and sanctions. It plays a central role in shaping the global financial landscape and can directly affect the reliability of contracting parties in international finance. This is why diplomacy can be crucial to enabling projects to overcome the investability hurdle.

Investors and rating agencies

Investors need to keep a close eye on their return targets but also be constantly aware that they are dealing with illiquid investments in developing countries. Every one of these investments is associated with substantial risks of loss, essentially has a long time horizon, and involves illiquid individual holdings, even though the structuring of blended finance provides short-term tradability in a normalised environment. This means that they are primarily suited to investors with a long time horizon and high risk tolerance who invest systematically in asset classes – including climate finance – and build up a strategic exposure over an extended period. Diversification plays a key role. Their selections are mostly based on their own analysis and specially chosen instruments, perhaps complemented by the evaluations of rating agencies, which can therefore play a role in standardising blended finance.

Figures for blended finance

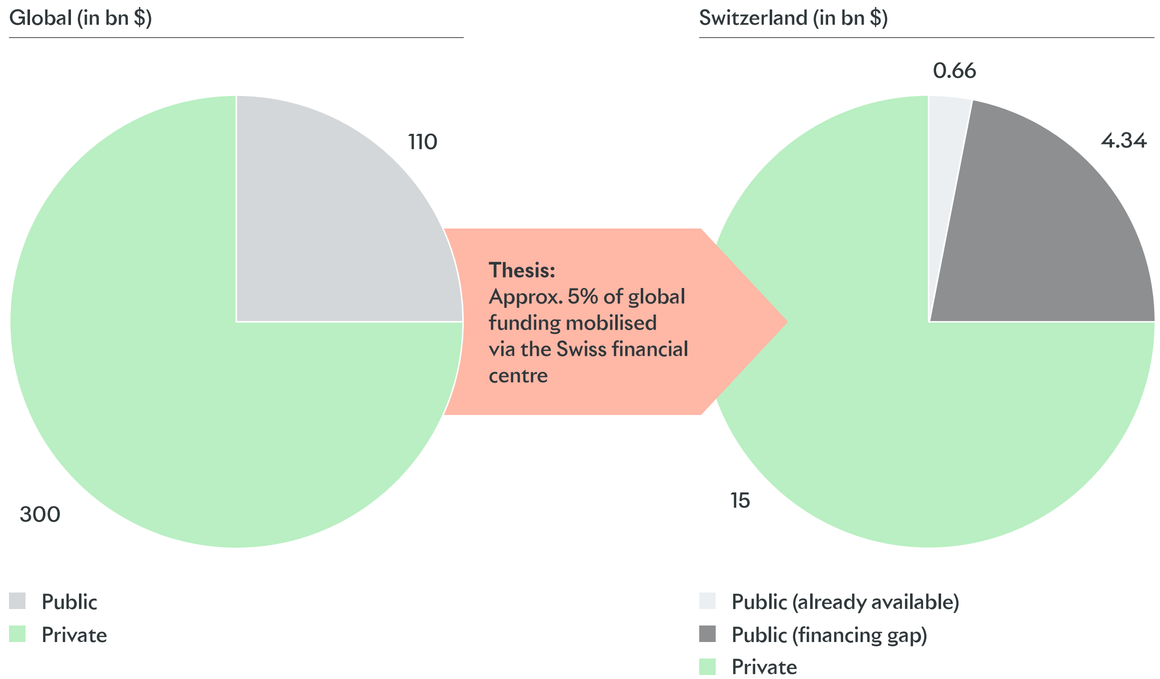
Blended finance currently makes up only a small part of public financing for climate-friendly investments. According to the OECD, it accounts for between 38% and 46% of mobilised funds. This is not unique to climate investments, however, but is in line with the general trend in mobilised private finance.[14]

GFANZ estimates that greater use of blended finance approaches combined with increased leverage could mobilise USD 110 billion in public funding annually between 2021 and 2030 to support private investments of USD 300 billion,[15] giving a total of USD 410 billion per year. This corresponds to a leverage factor of roughly three.

[14] https://www.tossd.org/docs/Infographic_Mobilised_Private_Finance_TOSSD.pdf (June 2022)
[15] https://assets.bbhub.io/company/sites/63/2021/10/NZFRs-Key-Messages.pdf p. 12 (November 2021)

Figure 5

Hypothetical example of figures



Source: GFANZ, Switzerland's 8th National Communication and 5th Biennial Report (2022), SBA calculations and presentation

If we place these estimates in the context of the Swiss financial centre, the picture is as follows: asset and wealth management in Switzerland has assets under management of around CHF 5,000 billion [16] and aspires to be a hub for sustainable finance. That ambition should go hand in hand with a target for volumes. For discussion purposes, it is assumed that around 5% of the global volume of blended finance solutions would be necessary to achieve that leadership position.[17] On the basis of the GFANZ estimates, that equates to around USD 20 billion, with USD 15 billion annually needing to be mobilised from private sources.

Assuming no net new money inflows, that USD 15 billion would correspond to an annual allocation of less than 0.4% or, given an average term of 10 years (not unusual in venture capital, private equity and infrastructure), a target allocation of 4% of the Swiss volume. At this order of magnitude, a positive diversification effect is achieved along with a return contribution to total assets, meaning that the expenditure involved is worthwhile for the investor.

It should be borne in mind that, at this level, climate finance is not an additional security selection within existing investment strategies, but rather an adjustment or complement to them, in other words a question of asset allocation. This appeals to those who invest their assets systematically and for the long term – typically, institutional and professional investors as well as high-net-worth private individuals with a long time horizon.

[16] Swiss Banking Trends 2022
[17] The basis for this assumption is the Swiss asset and wealth management business in the global context.

On the demand side – in other words, the existing investor base of the Swiss financial market – these figures seem entirely realistic. However, "foreign" public capital would also have to be mobilised, since the annual figure of around CHF 390 million[18] would not be enough to reach USD 20 billion, given an estimated leverage factor of three. Figure 5 illustrates the hypothetical figures described here.

This hypothetical estimate is underpinned by practical experience. Venture capital and private equity projects in developed nations are routinely oversubscribed, whereas similar projects in EMDEs cannot be financed without public money. The ongoing efforts by the Swiss authorities must be seen in this context. The Federal Council set out its position in its 2022 report on sustainable finance.[19] Measure 11 in this report aims to promote finance flows with a climate and sustainability impact in EMDEs. The report mentions two direct financial initiatives and one framework initiative:

- The Sustainable Development Goals (SDG) Impact Finance Initiative aims to raise CHF 100 million from public and philanthropic stakeholders by 2030. These funds seek to then mobilise up to CHF 1 billion in private capital to finance the SDGs in developing countries. This corresponds to a target leverage of 10 – a very ambitious figure when set against the GFANZ estimate (which assumes a factor of 3). This initiative could send a signal, but is of little relevance from a climate finance perspective, since it is broadly focused on the SDGs and is also rather modest in terms of volume.
- The second initiative within Measure 11 relates to the Swiss Investment Fund for Emerging Markets (SIFEM). This fund is to actively contribute to the implementation of the goals of the Paris Agreement. All investments must be compatible with the countries' climate goals, and at least 25% of new investments must be fully committed to climate protection. By the end of 2021, SIFEM had achieved a commitment volume of CHF 1.2 billion of which CHF 174 million was accounted for by private finance, giving a leverage factor of 0.17. Here too, it must be concluded that from a climate finance perspective with a focus on mobilising private finance, this measure is falling far short of achieving the necessary and desired effect.
- Measure 11 also states that Switzerland should continue to use its seat in the International Monetary Fund (IMF), multilateral development banks and other institutions such as international climate funds to ensure that multilateral financing contributions are used effectively with regard to the climate and sustainability and can exert a catalytic role to the extent possible. This measure is of central importance and therefore needs to be fleshed out with specific content and mandates.

What does this mean for the political framework in Switzerland?

If Switzerland is to assume a leading role in mobilising private finance, the framework must take account of the entire financing cycle, i.e. including the corresponding allocation to climate finance. This is the only way to close the financing gap that exists today.

The following questions arise at the national level:

- What standardisable and targeted financial instruments are available for blended finance solutions?
- How can investability be achieved for different client segments?
- Where are the potential tax obstacles?
- What legal and political conditions and adjustments are needed in order to use scarce public funds as a lever for blended finance constructs?

[18] Switzerland's 8th National Communication and 5th Biennial Report (2022)
[19] Sustainable finance in Switzerland – Areas for action for a leading sustainable financial centre 2022–2025 (December 2022)

- How can investors outside Switzerland be given access to financial instruments?
- How can the focus of Swiss climate policy be expanded from purely public funds to private investments?
- How can the mandate of the public institutions (SIF, SECO, SDC, FINMA, etc.) be aligned with the goal of mobilising private finance?
- What activities in the field of Swiss diplomacy can enable and instigate development projects that are cross-border, scalable and replicable?

Can institutions such as the International Monetary Fund (IMF) play a key role at the international level through monitoring, capacity-building, risk assessment and climate diagnostic instruments? One challenge in terms of scaling is the differences in local conditions which, though they may seem insignificant, are in fact crucial in practice from an investment perspective. Consideration therefore needs to be given not just to the public-private dimension but also to the international-local dimension.

Climate policy measures and commitments such as the Nationally Determined Contributions (NDCs) under the Paris Agreement must send the right signals to investors. The creation of a strong climate information architecture for data, taxonomies, standardisation and disclosure can help. Examples of this include the International Sustainability Standards Board (ISSB) and the Net-Zero Data Public Utility (NZDPU).

Switzerland is already actively involved in international bodies, alliances and financial institutions with the aim of influencing international climate policy to mobilise private finance, and playing a role in shaping international finance and project platforms that are already under consideration, in order to create the necessary capacities, competition and innovation. However, greater dimensions of financing need to be targeted. The right framework has yet to be created in Switzerland. A conducive and enabling environment at the international and local levels will also be needed.

Development banks have recently been criticised for failing to create sufficient incentives or use the right business models to concentrate on maximising the mobilisation of private capital. Multilateral organisations are currently mobilising less than USD 1 of private capital for every development dollar they invest in their entire portfolio. The governments of developing countries also often lack the political and institutional mechanisms to attract long-term capital and develop bankable project pipelines. As well as promoting the last of these by building up capacity, investing in project preparations and providing technical support, politicians must also link sector strategies and investment plans to sustainability standards and reduction targets in order to enable access to funding via blended finance.

Figure 6

Adjustments required to the framework

Swiss framework		International framework	Foreign local framework
Financial market	**Other**		
Supply standardisable, goal-oriented financial instruments for blended finance solutions Make those financial instruments investable for various client segments Eliminate tax obstacles to those financial instruments Enable access to financial instruments for investors outside Switzerland to broaden the investor base	Shift focus of Swiss climate policy from purely public funding to private investments Align the mandates of the authorities (SIF, SECO, SDC, FINMA, etc) with the goal of mobilising private capital Via Swiss diplomatic activities, enable and instigate development projects that are cross-border, scalable and replicable	Switzerland to exert influence on international climate policy to mobilise private capital via • international bodies • international alliances • seats in financial institutions Help to shape international financial and project platforms that are already being considered to create the necessary capacity, competition and innovation	Create investor-friendly local conditions to limit the public funding required for guarantees: • Investor protection • Politics decoupled from investments • Credible relevant institutions • Relevant financial transparency

Decreasing influence

Source: SBA

A number of factors may play a part in creating investor-friendly local conditions and so limiting the need for public funds to provide guarantees. They include:

- investor protection
- decoupling of politics and investments
- credibility of the relevant institutions
- relevant financial transparency.

A good political framework is the most important multiplier when it comes to mobilising private capital for investments in the infrastructure of EMDEs. Development banks are not just central capital providers but also crucial to strengthening politics on the ground. However, strong political leadership is also needed, along with a reliable legal framework and a transparent politics that helps the private sector do business.

Conclusion

Appropriate pricing of CO_2 would be the best way of billing major emitters for the climate costs they create, and so directing private investments towards lower-emission projects. In practice, however, politicians are reluctant to take this step, especially in industrialised countries.

Financial instruments are therefore needed that appeal to investors with different risk profiles and investment horizons. Such instruments already exist, but are far too insufficiently scaled and aligned towards sequential financing of individual projects. Funding individual new projects using the existing instruments and structures is not enough. The financing requirement is much too high, and the resource requirement for individual projects cannot be justified. Instead, what is needed are financing platforms and, increasingly, separation of projects from their financing.

Global direct investment spending on decarbonisation has to triple between 2021 and 2025 in comparison with 2016–2020 and rise to an average of USD 4.5 trillion per year after 2026 in order to achieve USD 125 trillion in total investment by 2050. GFANZ estimates that private actors worldwide could provide up to 70% of that funding, which – depending on the actions of politicians and the level of public support – offers huge opportunities for private investors. This is because the latter play a key role in direct net-zero investments and in supporting and enabling decarbonisation investments by others (especially companies).

However, private investments require the development of financial markets and growing market maturity in EMDEs, and depend crucially on implementation of the necessary political measures by the public sector in order to achieve net-zero emissions by 2050. Blended finance can play a decisive part in kick-starting the financing cycle.

Nevertheless, if the financing gap is to be substantially reduced, in particular by the use of blended finance, and if the goal is self-financing, this also means that the framework must be aligned with the needs of the financing cycle and thus the expectations of private investors. That applies to the national frameworks in both Switzerland (and other developed nations) and the countries in which investments are to be made. Another factor of great importance is the international financial institutions (World Bank, IMF, MDBs, etc.) acting as an interface. Targeted political measures to improve the framework along with enhanced and more ambitious blended finance are therefore key to reaching the required level of private investment.

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