

Project Syndicate

Disrupting Multilateral Climate Finance

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BEIJING – A recent report by the United Nations Intergovernmental Panel on Climate Change warns that to avoid the direst consequences of global warming, societies must make social and economic changes on a scale with “no documented historic precedent.” As we have noted previously, only institutional investors – like pension funds, sovereign wealth funds, and insurance companies – hold enough financial firepower to address climate change.

However, to minimize risk, institutional investors generally prefer to allocate their capital to operational infrastructure that is already generating stable revenue, rather than to new projects. For the same reason, their investments are focused in advanced economies, which in recent decades have received more than 70% of private-sector investment in infrastructure. Climate change requires institutional investors to move beyond these boundaries. But they need help to mitigate the associated risks, which is why we believe the world needs a new global climate finance facility (GCFF), exclusively targeted at mobilizing institutional investor capital, and designed to address the shortcomings of current multilateral initiatives.

Aside from several promising enterprises, governments and multilateral finance institutions are struggling to mobilize private capital at a scale relevant to climate change. Crucially, institutional investors have been largely absent from such initiatives, for several reasons. First, MFIs and institutional investors have different priorities. The activities of MFIs are based on member countries’ policy goals and client countries’ needs, and do not always reflect investor demand. By contrast, institutional investors, as commercial actors beholden to pensioners and other stakeholders, will not invest in projects that are deemed too risky or unlikely to yield adequate financial returns. To attract their interest, MFIs’ terms must be competitive with those offered by the private asset-management companies used by institutional investors. Moreover, many institutional investors are unfamiliar with infrastructure investment in general, let alone in emerging markets. Consequently, MFIs must also build capacity to address these investors’ concerns about engaging in unfamiliar sectors and regions.

Second, there is a disconnect between promoting private investment in low-income and fragile countries, and mobilizing private capital for climate action in middle-income

countries, where carbon emissions are far higher. Whereas green investments in the first group of countries may appeal mainly to a small set of specialized private investors and “impact investors,” larger sums of private capital, including from institutional investors, could be mobilized in the second group. At the moment, however, MFIs’ policies do not distinguish sufficiently between these two contexts, which require entirely different strategies, resources, and institutional structures.

Third, MFIs need to raise their presence on institutional investors’ collaborative platforms, take on more risk, strengthen partnerships with local strategic investment funds, and adjust their governance structures to conform with the corporate governance principles to which private investors are accustomed. According to a recent G20 report, MFIs should also strengthen their capacity to mobilize equity investment.

Finally, with few exceptions, existing multilateral initiatives – such as the Green Climate Fund and the Clean Technology Fund – mobilize private capital at the project level, rather than at the portfolio level. But, because most institutional investors manage large amounts of capital with small investment teams, they typically do not have the capacity to invest directly in individual projects; they need a vehicle or fund to channel their investments.

In light of these challenges, investor control is the key to mobilizing private capital for green infrastructure. Private investors are extremely hesitant to relinquish control to public entities, owing to fears that public bodies can be swayed by political influence and may not invest on commercial terms. To assuage these concerns, MFIs must emphasize the independence of the investment allocation process. One interesting model is India’s National Investment and Infrastructure Fund (NIIF), a \$6 billion government-sponsored investment fund that has been highly successful at mobilizing institutional investors’ capital.

The Indian government holds a fixed 49% minority share in the NIIF itself, and in the company that manages it, with private and institutional investors controlling the majority stake. The NIIF operates like a standard commercial investment fund, and the government has only two representatives on the six-member board. The fund’s investment committee, which makes all investment decisions, is made up entirely of investment professionals, who (like the NIIF’s staff) are recruited mainly from the private sector. These curbs on public-sector control are designed to free the NIIF from possible political influence, thereby reassuring investors that the fund operates on fully commercial terms within its policy-defined mandate.

According to a recent paper by researchers at Stanford University and Maastricht University, to mobilize institutional investor capital for financing the fight against climate change, MFIs must start functioning in a similar way. But large institutions change slowly, and the urgency of climate action requires disruptive changes, rather than incremental reforms. That is why a new GCFF, targeted at mobilizing capital from institutional investors and modeled on the NIIF structure, may be an important part of the answer.

To be sure, while MFIs would be minority investors in the proposed GCFF, they would still play a key role in helping private investors assess risks in new contexts. MFIs would also need to share these risks and supply technical support based on their expertise across a broad range of sectors and regions. Critically, to reassure MFIs that their AAA credit rating and preferred-creditor status would not be threatened, the GCFF's budget would need to be “ring-fenced” from other financing initiatives. But these challenges can be managed.

In general, MFIs inhabit a different world from the institutional investors whose capital they seek to mobilize. To attract enough private capital to advance climate-change solutions, MFIs must start to treat large institutional investors as their partners and clients. A new GCFF, with the right resources and high-level support, would help drive the required change.

HÅVARD HALLAND

Håvard Halland is a visiting scholar at the Stanford Global Projects Center (GPC) at Stanford University.

JUSTIN YIFU LIN

Justin Yifu Lin, a former chief economist of the World Bank, is Dean of the Institute of New Structural Economics and the Institute of South-South Cooperation and Development, and Honorary Dean of the National School of Development, Peking University. His recent books include *Going Beyond Aid: Development Cooperation for Structural Transformation* and *Beating the Odds: Jump-starting Developing Countries*.

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