Project Syndicate

How to Mobilize Private Capital for Climate Action

Oct 26, 2018 | **HÅVARD HALLAND, JUSTIN YIFU LIN**

BEIJING – The conclusion of the United Nations Intergovernmental Panel on Climate Change's most recent report is stark: climate action is far more urgent than previously believed, and it must include a wide range of initiatives, from improved regulation to continued technological innovation. But without massive amounts of long-term "patient" capital – which only institutional investors can muster – it will be impossible to transform energy systems fast enough to mitigate the risk of ecological, economic, and social disaster.

Technically, institutional investors – such as pension funds, sovereign wealth funds, and insurance companies – hold sufficient financial firepower to address climate change, and some are seeking to align their portfolios with the UN Sustainable Development Goals (SDGs). In OECD countries alone, institutional investors control an estimated $92 trillion in assets. Annual official development assistance by multilateral finance institutions (MFIs) and governments amounts to just 0.16% of that – about $145 billion.

But, as commercial actors, institutional investors' primary objective is to maximize financial returns. Even as some purge their portfolios of carbon-intensive companies, they generally consider investing in new clean-energy infrastructure projects to be too risky, particularly in emerging markets.

To finance the SDGs, including clean-energy infrastructure, MFIs have committed to mobilizing capital from private investors. This mobilization takes place largely through so-called blended finance, whereby MFIs and other public finance institutions use their own capital to crowd in private financing. But institutional investors have been largely absent from multilateral blended-finance initiatives, which have, in turn, failed to achieve a scale relevant to climate change.

So what will it take to mobilize the needed capital from institutional investors? A recent paper by researchers at Stanford and Maastricht universities suggests focusing on three recent developments in the global financial sector.

First, a growing number of institutional investors are reducing their dependence on financial intermediaries. Institutional investors have traditionally outsourced their investments to investment management firms, whose performance is generally assessed

on a quarterly basis. Yet the investment horizon for infrastructure, including clean-energy infrastructure, is often more than 20 years.
From the perspective of blended finance, traditional financial intermediaries, with their short-term biases, constitute a bottleneck between institutional investors and MFIs. The elimination of such intermediaries could thus provide new opportunities for direct cooperation between institutional investors and MFIs, as it enables the former to focus more on investment in long-term assets.

Second, many institutional investors are establishing collaborative platforms to enable cost-sharing on deal sourcing, due diligence, and other stages of the investment process. Each of these platforms represents a very large amount of long-term capital. But, with few exceptions, they do not include MFIs.

Third, there are new types of local strategic investors that can be highly effective at mobilizing private capital, including from institutional backers. Over the last decade, at least 20 countries have established state-sponsored strategic investment funds to co-invest in infrastructure projects with private-sector partners. Other countries have established green banks, whose domestic focus reflects the fact that 90% of private climate-finance investments are made within the capital's country of origin.

The strategic investment funds that have successfully mobilized private capital are structured much like private investment organizations. They emphasize the independence and integrity of the investment decision-making process; and their boards and board committees have a high share of independent directors selected for their financial and business expertise. Some funds, such as India's National Investment and Infrastructure Fund, are owned mainly by private and institutional investors, with the government in a minority position.

Managed by finance professionals recruited from the private sector, these strategic funds invest primarily in equity, and take an active role in structuring and arranging new deals. Because they are linked to local government and business networks, they are in a strong position to mitigate local risk.

MFIs, by contrast, tend to emphasize country representation on their boards, leaving these boards with less financial-sector expertise in the relevant sectors. At the management and staff level, the private-sector branches of MFIs frequently have expertise in a wide range of areas. Despite this, MFI boards – unlike their private counterparts – generally do not establish a broad investment policy or delegate decisions on individual infrastructure projects to an independent investment committee; instead, they themselves make the decisions on capital allocation.

Given MFIs' bureaucratic structures and frequently cumbersome procedures, institutional investors tend to be skeptical about them. Institutional investors often consider the projects MFIs pitch to be too small, too risky, or not profitable enough, and they worry that, if something goes wrong, MFIs' bureaucracies will not permit them to address it swiftly.

Whereas MFIs have expanded their offers of risk mitigation for investors, they overwhelmingly remain providers of debt. Crucially, they invest very little in infrastructure equity. This is a significant distinction, because whereas equity investors frequently take an active role in structuring and arranging new infrastructure projects, providers of debt and risk mitigation generally engage once a project is fully documented and confirmed as “bankable.”

To achieve their goal of mobilizing private-sector capital, MFIs need to engage on institutional investors’ collaborative platforms, and address these investors’ concerns. This means helping them to assess and mitigate risk in new regions and sectors where green infrastructure is needed, if appropriate in cooperation with local strategic investment funds and green banks.

By developing the capacity to assess and bear risk on commercial terms, traditionally risk-averse MFIs could engage more productively with institutional investors. And by building up the capacity to undertake equity investment in clean-energy infrastructure, MFIs could increase their capacity to engage with institutional investors at relevant stages of the infrastructure-investment cycle.

Simply put, in order to mobilize institutional capital effectively, MFIs will need to start functioning more like private investment organizations, even as they fulfill a policy-defined mandate. This is a tall order; the OECD has suggested that efficient private capital mobilization may require a culture change within MFIs. But, if we are to curb climate change and achieve the SDGs, it could be the only way for MFIs to mobilize institutional investor capital at any relevant scale.

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