CAN
CLIMATE ACTION NETWORK
Europe

Climate change adaptation and the role of the private sector

Creating effective tools for private sector engagement

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Contents

Adaptation acronyms

CSR	Corporate Social Responsibility
CTCN	Climate Technology Centre and Network
DFIs	Development Finance Institutions
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GIIF	Global Index Insurance Facility
IATI	International Aid Transparency Initiative
IFC	International Finance Corporation
IMF	International Monetary Fund
IPCC	Intergovernmental Panel on Climate Change
LICs	Low Income Countries
LMICs	Lower-Middle Income Countries
MDBs	Multilateral Development Banks
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OECD DAC	OECD Development Assistance Committee
PPPs	Public-Private Partnerships
SMEs	Small and Medium Size Enterprises
UN	United Nations
UNFCCC	United Nations Framework Convention on Climate Change
WB	World Bank

Executive summary

Financial support to developing countries is crucially important to enable their transformation to low-carbon development pathways as well as to allow them to adapt their societies to a changing climate and deal with the unavoidable impacts. Promises were made by developed countries at the UN climate summit in Copenhagen end of 2009 to mobilise new and additional financial support to increase to 100 billion US dollars per year by 2020. While most of this amount is expected to be met through public finance, most commentary within developed countries argues that private sources will make up the bulk of these funds.

This focus on the private sector in the adaptation debate is wholly relevant.

- The private sector accounts for 85% of all investments worldwide.
- 90% of people in developing countries depend on private sector generated income.
- The private sector represents close to 75% of global climate finance flows.

However, given the diversity of the private sector and of the adaptation challenges facing developing countries, its not be taken for granted that the private sector will succeed in tackling all kind of adaptation challenges. In the past, support to the private sector has often failed to alleviate poverty and livelihood threats in many of the poorest parts of the world.

Private investment activity to date has been unevenly distributed amongst countries and economic sectors, and often it appears not to match developing countries' most pressing adaptation needs. It rarely meets the needs the most vulnerable and poor communities and Least Developing Countries (LDCs).

These patterns of private sector behaviour have important implications, not least that the discussion on private finance needs to sharpen. It must dissect different kinds of financial flows - from portfolio equity, to direct investment, to commercial bank lending, to bond finance. Each of these implies a different quality of finance for the recipient, with implications for how it might support adaptation efforts.

The gaps in delivery of private finance also pose a major challenge for public finance, which must not only leverage new resources specifically for adaptation but also redirect investments to countries and sectors that currently miss out.

The goal of this report is to provide an overview of existing possibilities and proposals of the role of the private sector in adaptation. It seeks further to do a critical analysis of when, where and how the private sector can contribute to meet adaptation needs of developing countries.

The report concludes that there is a role for the private sector in climate adaptation, but it may not be best placed to meet the needs of the most vulnerable and poorest communities hence there may be a few specific areas and sectors where it could focus.

Main findings of the analysis of private sector adaptation

- Many of the instruments in use, or proposed, that will increase the contribution of the private sector to adaptation are in the early stages of development (e.g. adaptation market mechanism). Others build on the experience of the private sector in development. Yet little is known about the specific contribution of each to meeting the adaptation needs of countries with varying levels of development, nor the needs of vulnerable communities within developing countries.
- Although crucial to reducing vulnerability, some of the indirect instruments discussed in this report (e.g. internalising adaptation costs or encouraging technology transfer and development) seem more appropriate, at least in their current form, for countries with large public resources.

- More research is required, based on a bottom-up approach from specific needs to specific tools and instruments. It is important to explore how different tools relate to and complement one another in order to make intelligent policy decisions near term.
- It is essential to develop a common methodology to record and track private finance, including adaptation finance. Without such a system, it will not be possible to ensure an equitable distribution of the scarce climate finance available. Nor will it be possible to hold developed countries to account for their commitments and historic responsibility in climate change.
- Safeguards of public organisations that support the role of the private sector in adaptation need to be strengthened. Public organisations must in addition improve implementation oversight to ensure projects comply with such safeguards.

Introduction

Over the past few years, the global debate on climate finance has increasingly focussed on the potential of the private sector to contribute to and/or leverage climate finance. At the outset, discussion on the role of the private sector in climate finance was focused on mitigation to reduce the level of greenhouse gases emissions. Today the role of the private sector is increasingly relevant as regards the global adaptation debate.

The private sector currently represents close to 75% of global climate finance flows. Private capital is essential to scale up climate finance in light of restricted public resources.[1] However, the term 'private sector' includes a highly diverse group of actors and activities operating at international, national and local levels. This makes analysis of the contribution of the private sector to adaptation especially challenging.

Adaptation to climate change comprises all actions aimed at reducing the vulnerability of human and natural systems to the current and future effects of climate change, including climate variability. Meeting the adaptation needs of developing countries may come with a large price tag. Although estimates vary depending on the methodology, baseline scenarios and projections, they all suggest that developing countries adaptation needs (see table 1) are comparable to current aid flows (US$ 134 billion in 2011, according to the OECD).[2]

Table 1: Selected annual adaptation needs

Annual finance needs (US$)	Year and scenario	Source[3]
27-66 billion	Costs by 2030, model based on PCC's SRES A1B and B1 scenarios	UNFCCC (2007)
54-198 billion, plus additional US$ 65-300 billion for ecosystem protection	Costs by 2030, based on UNFCCC (2007) but accounting for some methodological concerns	Parry et al (2009)
75-100 billion	Costs between 2010 and2050 of adapting to a 2°C warming	World Bank (2010)

Adaptation actions or measures are also very diverse, but they can be divided into two broad categories: technical and social measures.[4] The first category includes measures that primarily target the physical infrastructure of developing countries. Examples include reforestation of coastal areas, research to develop drought-resistant crops, developing early warning systems, and building flood barriers and irrigation systems.

Social measures include actions that focus on decreasing the vulnerability and building the resilience of communities to climate change. Examples of social measures include increasing access to social protection systems in developing countries, improving access to health services, introducing new agricultural and land management techniques, and raising awareness about the importance of protecting ecosystems.

Adaptation and the private sector: a brief review of existing studies

The focus on the private sector in the adaptation debate should not be a surprise. The private sector accounts for approximately 86% of all investments worldwide. Up to 90% of the population in developing countries depend on the income generated by it.[5]And as already mentioned, the private sector represents close to 75% of global climate finance flows.[6]

In addition, most literature on climate finance and the private sector is also explicitly or implicitly underpinned by the idea that a stronger private sector is linked to economic growth or, at the very least, economic and social development.[7]

One of the first adaptation and private sector topics to be researched was the role of insurance in protecting developing countries and vulnerable communities.[8] Subsequently, following the debate generated around the Green Climate Fund and the private sector facility, a number of reports emerged that, modelled on the support given by Development Finance Institutions (DFIs) to private sector development in developing countries, explored financial instruments for use to mobilise climate finance, including adaptation.[9]

A number of parallel lines of research have also attracted significant attention in the past couple of years. One of them looked at the possibility of creating an adaptation market mechanism, based on the idea and similar principles of the carbon market.[10]Another important body of literature focuses on the policies and measures that can lead the private sector to internalise adaption costs in their business models and adopt measures to reduce their vulnerability, and by extension, that of their workers and neighbouring communities.[11]

At the same time, a number of challenges when using the private sector to channel and mobilise adaption funds have also been explored. There are severe limitations in respect to definitions, approaches and tools to account for and track private sector flows.[12] The lack of data has serious implications for the coordination of support to developing countries.

Without clear information, it is difficult to ensure resources are equitably distributed among developing countries and sectors. Research has also identified important methodological inconsistencies that could lead to the overestimation of the potential of the private sector to mobilise and contribute to meet the adaptation needs of developing countries.[13]

There are also limitations for the private sector to cover the adaptation and mitigation needs of developing countries. A number of reports have pointed to important differences in private sector development between different countries, which could lead to uneven and inequitable distribution of adaptation finance channelled or mobilised through the private sector.[14]

The private sector is especially weak in the poorest countries, when compared to many middle-income countries.[15] This limits the opportunities to mobilise finance from local companies. At the same time, investment opportunities for foreign companies also decrease with the level of income as a result of worsening business conditions and the increased informality of the economy.[16]

The concern is that, unless efforts are made to steer private finance in an equitable manner, it would mostly benefit a handful of developing countries, but bypass the poorest ones, where the needs are greatest. Based on the experience of multilateral development banks (MDBs) in development and the private sector, concerns have also been raised about the possibility that the private sector would mostly benefit multinational companies from major economies, instead of developing countries' local companies.[17]

Adaptation and the private sector: addressing just one part of the puzzle

This report is about adaptation and the private sector. It does not aim to answer the question of whether or not the private sector can help developing countries to adapt to climate change. Given the diversity of the private sector and of the adaptation challenges faced in developing countries a much more nuanced analysis is required.

This report aims to identify when and where the private sector can contribute to meet the adaptation needs of developing countries. The report also sheds light on the direction that research is taking and identifies gaps in current research efforts.

Section 1 draws a comprehensive picture of the different ways in which the private sector can contribute to adaptation efforts in developing countries. Section 2 looks at the limitations of the private sector, especially when addressing the needs of the most vulnerable. The two sections together clarify what we can expect the private sector to achieve and what is beyond its potential.

Subsequent sections look beyond the role of the private sector in adaptation and focus on the overall framework or conditions that need to be in place to make the private sector work for adaptation. Section 3 focuses on tracking private finance flows and Section 4 on the use and role of standards in steering and ensuring the private sector contributes to meeting the adaption needs of developing countries.

Adaptation finance and the private sector

Given the increase in the number of publications on the topic under discussion, it is important to map current research efforts in order to identify current research opportunities and gaps. From a donor or government perspective (i.e. how public investors can increase the contribution of the private sector to meet the adaptation needs of developing countries) mechanisms and tools can be divided into two different groups:

- **Direct instruments** use public funds to incentivise private sector investments in adaptation-related projects directly (see diagram 1 below). They entail the use of public funds to increase private sector participation in adaptation projects. An example of a direct instrument is a loan provided by a DFI, for example the IFC, to an adaptation project involving the private sector in a developing country. Providing guarantees to private sector projects is another example.
- **Indirect tools** use public funds to create mechanisms designed to either raise additional adaptation finance or increase private sector investments in adaptation (see diagram 2 below). No direct support to the private companies implementing adaptation actions is provided. Some examples of indirect instruments include: enacting legislation that affects the behaviour of private companies; or creating a bond market to raise finance for projects or governments in developing countries.

Diagram 1: Direct instruments

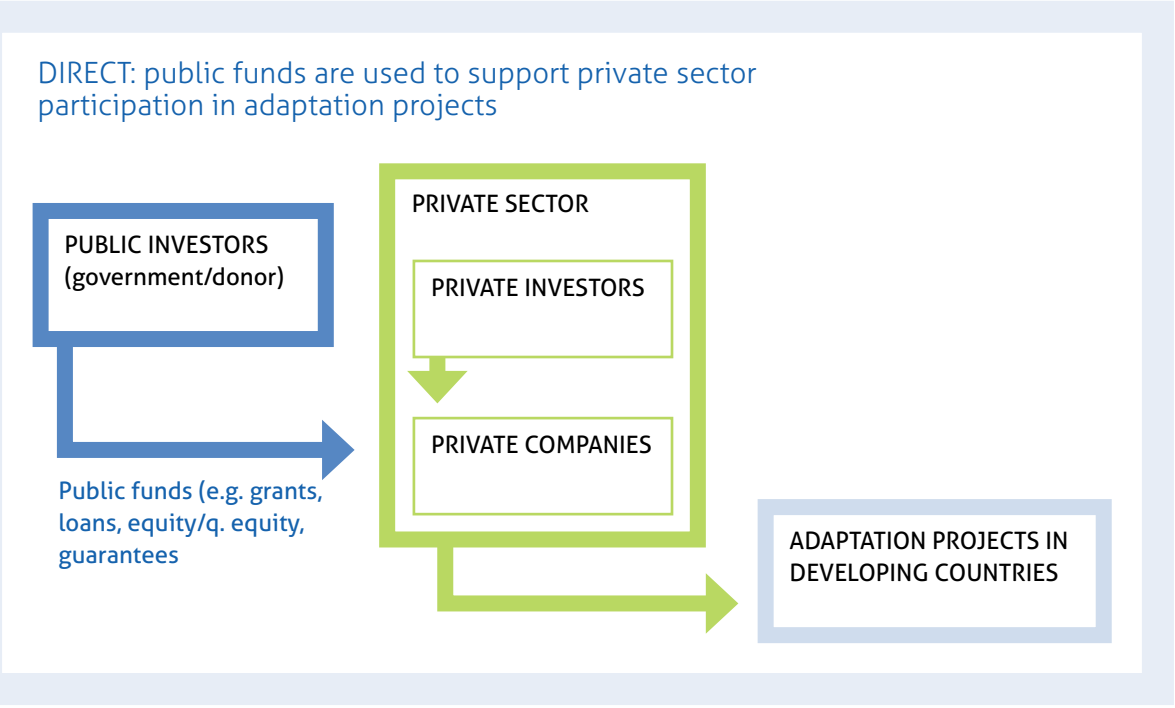
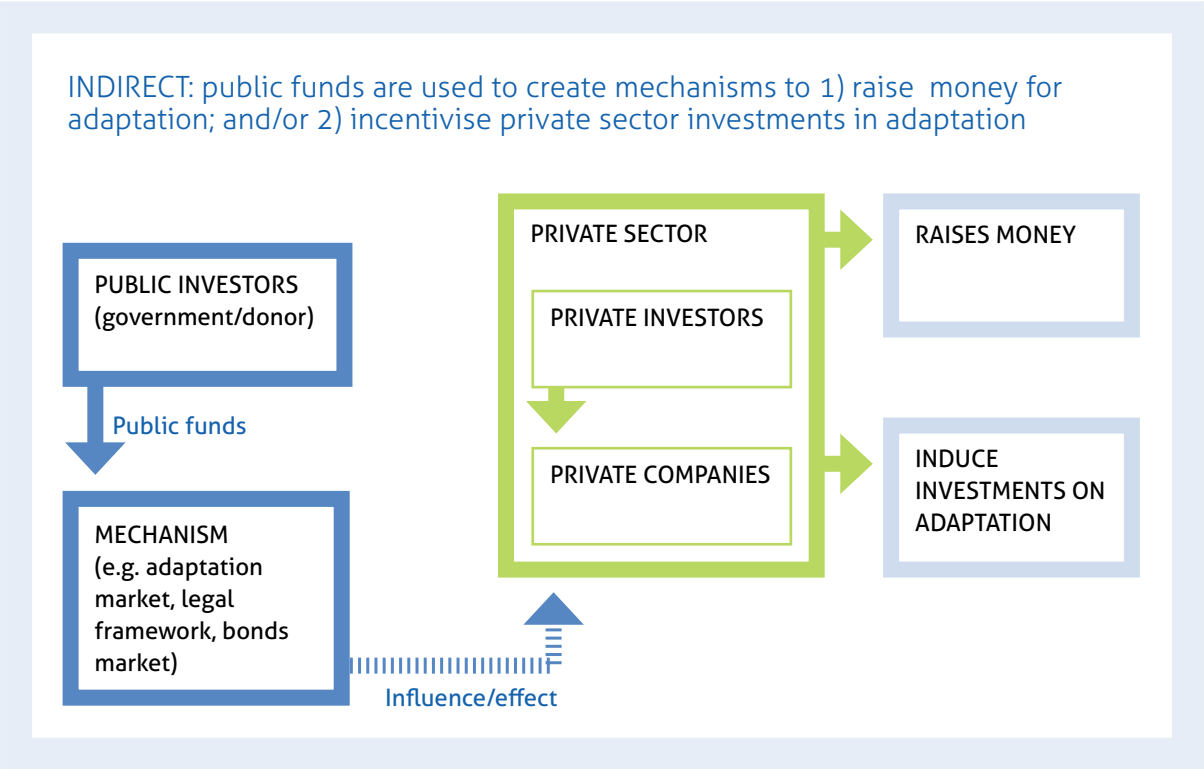


Diagram 2: Indirect instruments



Direct instruments

Direct instruments seek to incentivise or facilitate private sector investments in adaptation projects. The discussion about direct tools has mostly revolved around the different financial instruments that can be used to incentivise this behaviour. In the experience of development finance institutions (DFIs), including multilateral development banks (MDBs), working with the private sector has usually served as the starting point and model for discussion. Most common financial instruments are introduced in Table 2.

Table 2: Main types of financial instruments

Type	Definition	Examples
Grants	A transfer "made in cash, goods or services for which no repayment is required." [18] It constitutes a direct subsidy to private companies.	• Technical assistance • Grants/subsidies • Grants elements in loans
Debt	"Transfers for which repayment is required."[19]	• Loans • Credit lines (loan to an intermediary for on-lending) • Syndicated loans
Equity	Investments that involve the ownership of shares in a company. Can me made either directly or through and investment fund.	• Public equity • Private equity
Quasi-equity	Instruments with equity or debt features that have a lower repayment priority in case of liquidation that debt, but higher than equity.	• Debt-based: – Subordinated or junior loans – Mezzanine loans • Equity-based: – Preferred stocks – Convertible bonds
De-risking	Instruments intended to reduce the risk profile of the private sector investment with the idea of facilitating finance.	• Loan guarantees • Investment guarantees (political and macroeconomic insurance)

Source: elaborated by the author based on Pereira, J (2013)

Although there is not enough space in this report to examine all these instruments in detail, it is worth exploring some of the features and conclusions of recent research. Existing research has mostly focused on these financial instruments from a financial perspective, without much consideration about making the link to specific projects or needs on the ground.[20]

Some research has tried to go one step further and look at whether these financial instruments are adequate to support all countries and communities affected by climate change.[21] It has been found that many of these instruments are inadequate to support domestic companies and are more likely to benefit projects implemented by foreign multinational companies.

This has led to concerns about the contribution of the project to developing countries' sustainable development as well as their ability to reach poor and rural communities. For similar reasons and based on data from DFIs, it has also been found that support to the private sector is much more likely to flow to upper-middle income countries instead of low-income and lower-middle income countries, where the needs are greater.[22]

However, these studies have also been conducted from a top-down approach, instead of building on the experience of developing countries and local communities. There is, therefore, an important knowledge gap when it comes to case studies looking at real examples of how different financial instruments can be used to meet specific adaptation needs. This gap is only slowly being filled by new research.[23]

One notable exception to the lack of examples and data is the field of parametric insurance (insurance triggered by an event of a pre-defined intensity, instead of losses), where a more consistent and advanced research agenda, including private insurance companies, has been in place for many years.[24] Moreover, a number of pilot projects have been or are underway in several countries, including Malawi, India, Mongolia and the Philippines.[25]

Indirect instruments

Indirect instruments are based on the implementation of mechanisms that influence or affect the behaviour of private companies. In general these mechanisms are created with one of the two following goals in mind: raising additional adaptation finance; or increasing private sector investments in adaptation. Indirect tools are summarised in Table 3.

Table 3: Selected indirect instruments

Type	Definition	Examples
Market mechanisms	Key feature of market mechanisms (or market-based instruments) is that a price signal is used to promote the production of a certain service or good, or to reduce it (in this case promote adaptation measures). They also can also be used to raise money for adaptation.	Adaptation credit mechanism Carbon market (mitigation)
Bonds	Fixed income financial instruments used to raise money, in this case, for adaptation.	Catastrophe bonds (e.g. Mexico) World Bank Green Bonds
Internalising adaptations costs	Private investment on adaptation can be increased by encouraging business likely to be affected by climate change to adopt measures to reduce their vulnerability.	Awareness raising Advice and information Accurate climate modelling Legislation
Technology development and transfer	Supporting research and pilot projects can help to lower the risk and deployment costs of adaptation techniques. Also includes dissemination of the technology.	Research Pilot projects

Source: elaborated by the author

A number of authors have proposed creating market mechanisms, modelled in a similar way as the carbon market, in order to incentivise private sector investments in adaptation and raise additional finance. Research is still in its early stages and different models have been proposed to turn adaptation actions into a tradable credit.[26] However, much more work is required before a pilot system can be implemented.

In addition, creating an adaptation market mechanism faces a number of problems, compared to mitigation. For example, the impact of future climate change is uncertain, unlike the level of emissions, and therefore quantifying benefits can be extremely difficult.[27] Moreover, valuing the whole range of different adaptation measures, including environmental services (e.g. reforesting a coast), is extremely challenging from a technical point of view.

On top of this, the effectiveness of the existing carbon market in reducing emissions and generating additional finance has been contested.[28]

Alternatively, climate bonds could be created – like any type of bond – in order to raise finance from private investors. Sovereign **catastrophe bonds** can be issued by developing country governments to raise funds. They function as normal debt issued by countries with the particularity that repayment of the principal (the amount used to calculate the interest) is forgiven if an event of a predefined magnitude hits the country.

The main obstacle in the deployment of sovereign catastrophe bonds is that they are debt issues with a higher interest rate than normal, to compensate for the extra risk. As a consequence, they might not be possible or interesting for countries with poor credit ratings or that are heavily indebted to issue bonds.

Similarly, the costs can also be very expensive for small countries, such as small island states, where the impact of such an event is likely to affect most of the country. One option to overcome this problem is to create facilities or institutions that pool together the risks of several countries and have good credit rating, thereby allowing developing countries to issue bonds with a lower interest rate than in the open market.

It is also possible to use bonds to raise finance for specific adaptation projects. For example, the World Bank issues Green Bonds to raise money for mitigation and adaptation projects. Since 2008, the World Bank has issued USD 3.5 billion in Green Bonds.[29] When issuing Green Bonds, the World Bank benefits from its AAA credit rating (the highest granted by credit rating agencies) to obtain finance at a low interest rate.

In spite of this, one general criticism with the use of bonds is that they are mostly limited to activities that can generate a stream of revenue so that interest can be repaid. Also, the additionality of many bonds is questionable. In the case of sovereign bonds, there is a reputational risk for the investors, as the revenues are not usually earmarked for climate projects, but contribute to the general budget.[30]

Another concern is whether bonds can attract investors other than responsible investors and thus contribute to a more general (additional) greening of the private sector.

There is a different range of tools to incentivise companies to internalise the costs of adaptation and trigger investments to reduce their vulnerability. However, most of them have a common goal: to raise the awareness of private companies about the actual risk posed by climate change. This requires producing reliable data including robust uncertainty estimates, but also providing guidance and support to the private sector in understanding, assessing and planning actions to reduce their vulnerability against climate change.

Specific tools implemented by governments include supporting research, providing guidance and support, promoting dialogues and linkages between research centres and government experts and building knowledge networks between the private sector and academia.[31]

In spite of this, there are a number of inherent challenges that help to explain why studies show that most companies are well aware of the risks posed by climate change adaptation, but only a few of them assess the risks and implement actions to tackle them.[32] The challenges include the uncertainty about the impact of climate change, the existence of global businesses and the difficulty or reluctance of managers to plan 20-30 years ahead.

In general, instruments to incentivise the internalisation of adaptation costs require significant government support and investment. Without external support many developing countries would not be able to implement these kind of measures. This could undermine the future competiveness of local companies both in the global and domestic markets, for example, by making companies more vulnerable.

Tools related to the development and transfer of adaptation technologies seek to lower the risk and deployment costs of adaptation techniques as well as to disseminate them. They are closely related to the tools to internalise the costs of adaptation in that they require a significant level of involvement by public actors. As a consequence, they also face similar problems to those described above. Nonetheless, some international organisations have started to do some work – mostly dissemination – in developing countries.[33]

The Climate Technology Centre and Network (CTCN) is an example of a more ambitious initiative, although its formal operations are yet to start. The CTCN was established by the 16th session of the COP in 2010 with the specific objective of encouraging the development and transfer of mitigation and adaptation technologies by establishing networks with academia, governments, and other stakeholders.[34]

Notwithstanding these projects, there is much to be in done in terms of exploring opportunities for the research and testing of new technologies in developing countries.

Bankable projects: an insight into the private sector

Understanding how these instruments work requires exploring in more depth the motivations of the private sector. The private sector is inherently profit-seeking and makes investments when the expected cash flows generated by the project can compensate the risk involved in the undertaking. Lenders would usually be willing to finance projects meeting these conditions and hence make projects 'bankable'.

Adaptation activities can thus be divided into two categories:

- **Bankable projects:** those defined above.
- **Non-bankable projects:** projects which do not generate a cash return or where it is too small compared to the risks. When the social return is high enough, governments or donors might be willing to step in in order to make them bankable. Non-bankable projects can be made bankable through any of the instruments discussed above.

Some non-bankable can become bankable after an initial stage requiring public support. For example, projects involving a technology developed with public support might no longer need public support once it has been demonstrated. The same can also be applied to innovative products requiring pilot projects such as parametric insurance.

Enabling environment as a pre-condition

Underpinning most of the measures discussed above there is a crucial question. In order to thrive and make sustainable investments, the private sector requires the existence of an appropriate policy framework and an enabling environment. Without such pre-conditions, none of the measures discussed above are likely to yield significant results.

An appropriate and enabling policy framework requires both legislation (e.g. about company structure, ownership legal requirements, exchange markets, etc.) as well as institutions (e.g. registries, oversight authorities, etc.), the rule of law and economic planning by the government. To date, little research has been made on this topic in relation to climate change in developing countries.

In general, there is little agreement about what would be an ideal policy framework beyond the need for clear and enforceable regulations, the rule of law and a few other basic aspects. The debate becomes very political and ideological as soon as it moves into issues such as the role of the government and the degree of liberalisation in the economy.

This debate is beyond the scope of this report, but developed economies have traditionally promoted a liberal economic model, often through the World Bank and the IMF.[35] However, many experts have argued that developed and emerging countries have often relied on industrial and protectionist policies in the past.[36]

It is important not to underestimate the interests at stake in this debate. After all, major multinational companies, those more likely to benefit from liberalised economic systems, have significant economic and political clout. Ultimately, it can be argued that there is no ideal policy framework, but a range of different options that need to be tailored to each country and its particular circumstances. This reinforces the idea that using a country-specific approach is essential to address the challenges of adaptation.

Prioritising the needs of the most vulnerable

In most cases it is the poorest countries and the poorest communities that are the most vulnerable to the impacts of climate change. It is therefore pertinent to assess whether the private sector can help these countries and communities to adapt. A number of reports have looked into this issue and have found many limitations.

Uneven spread of private investment across the developing world

Current overall investment flows from domestic and international sources are mostly concentrated in emerging and developed countries, followed by a limited number of middle-income countries. High-income countries receive approximately 60% of all inflows of foreign direct investment (FDI), followed by upper-middle income countries (32%), whereas lower-middle income and low-income countries receive 7% and 1% respectively.[37]

Global climate finance flows show a similar trend. Recent estimates indicate that approximately 47% of global climate finance goes to projects in developing countries, although it seems that most of it goes to China, India and Brazil.[38] This suggests most developing countries face an important funding gap.

Despite their development mandate, DFIs' support to the private sector is also concentrated in a small number of economies. Very few projects implemented by the International Finance Corporation (IFC) benefit low-income countries (8.3% of total investments).[39] In the case of the EIB, the figure is only 3.8%, but it includes support to both public and private actors.[40]

Similarly, only 25% of all companies supported by the EIB and IFC are based (fiscally) in low-income countries, while 49% of them are based in OECD countries or jurisdictions commonly considered as tax havens.[41] This is usually attributed to the weakness of the private sector in many developed countries and the frequent correlation between poor governance, the lack of an investment-friendly policy environment and widespread poverty.

This evidence suggests that support to the private sector in the context of development shows an important bias towards higher income countries. Ensuring a more equitable distribution of support for private sector adaptation activities would require important corrective measures.

Reaching SMEs in developing countries

In order to maximize the developmental impact of private sector adaptation activities and ensure they are sustainable in the long term, it is essential to focus on domestic companies, as opposed to foreign companies.[42] In particular, it is essential to support small and medium enterprises (SMEs), including those in the informal economy because they "account for over 60% of GDP and over 70% of total employment in low-income countries, while they contribute over 95% of total employment and about 70% of GDP in middle-income countries."[43]

Most of the economic output and employment is generated by businesses operating in the informal economy, which represent 80% of the businesses in developing countries.[44]

However, research looking into projects funded directly by the main DFIs shows that support tends to benefit companies from developed and emerging economies, independently of the country where the project is implemented.[45] Credit lines provided by DFIs and implemented by local financial intermediaries provide an avenue to channel international funding to SMEs and private households.

An evaluation conducted by the World Bank's Independent Evaluation Group found that only 52% of all the operations involving credit lines had a satisfactory performance.[46] The use of financial intermediaries by DFIs and MDBs has also been criticised for the weaknesses of monitoring mechanisms and the lack of transparency about the projects supported by the intermediaries.[47]

Private sector money flows to some sectors but not others

The private sector appears to be uninterested in sectors that are relevant from an adaptation perspective. For example, private sector investments in developing countries have concentrated on energy and transport, whereas little attention has been paid to water infrastructure.[48] Furthermore, private investments in some of these sectors, such as water infrastructure and energy distribution present some difficulties in terms of pricing. Attempts to privatise these services in developing countries have mixed or even disastrous consequences.[49]

Similarly, investments in the agricultural sector usually focus on cash crops and large industrial production instead of small-scale farming.[50] This suggests that they are unlikely to contribute to increase food security and reduce the vulnerability of local communities to climate change.

Private sector money often fails to reach the poor and vulnerable

Private sector adaption activities are likely to miss the poorest and most vulnerable communities. The first problem is about penetration. As discussed above, direct support to the private sector and international support to the private sector is unlikely to reach domestic SMEs or important sectors that are important from an adaptation perspective such as smallholder agriculture. The problem is that existing direct instruments as well as international donors are more suited to supporting large companies (see section on direct instruments).

A second set of concerns stems from the for-profit nature of the private sector. The private sector aims to transfer the costs of adaptation to their end consumers. While this can be a reasonable strategy in the case of products intended for exports (e.g. coffee or textiles), it raises some questions when the consumers are the poor and vulnerable communities (e.g. irrigation).

The problem is not whether the private sector should make a profit from providing products and services to the poor and vulnerable, but most importantly, whether poor people and vulnerable communities should pay for their own adaptation.[51] Transferring the end-bill to poor and vulnerable communities contradicts the very principle of common but differentiated responsibility, which should guide climate finance.

Tracking the flow of finance

Knowing how much money is flowing to developing countries, the nature of the activities and who is providing the funding is essential to ensure adaptation flows are coordinated, provide predictable funding, ensure donors are fulfilling their commitments under the principle of common but differentiated responsibility and ensure all vulnerable countries and communities receive their fair share of funding.

Tracking finance flows is one of the foundations of accountability.

An effective tracking system should include the following elements:

- Agreed methodology: common definitions to ensure data is comparable and reliable
- Information disaggregated by origin
- Information disaggregated by destination
- Sufficient information about individual flows, including the sector, nature and objective, so that the functions stated above (coordination, predictability, distribution, etc.) can be effectively performed.
- Public and easily accessible information

The international application of the OECD DAC criteria on the use of the adaptation marker has been discussed as an option, but the OECD DAC only records public flows; the marker is not used consistently by donors. In addition, it only provides an indication of whether adaptation is the primary, secondary or non-target of the project.

We are still at the beginning of the path towards an effective tracking system. The most immediate challenge is the diversity of private flows, which is compounded by a lack of clear and comparable data, the existence of different metrics (the lack of agreement about what should be counted as adaptation finance or not) and the overlap between adaptation and other types of finance/flows.[52]

Issues underpinning successful private sector adaptation

Additionality

Despite being a feature of most climate finance commitments, there is currently no agreement about what additional finance means and how it can be measured. Arguably, additionality has two main components[53]:

- Financial additionality: Would the private investment have happened anyway? Financial additionality is the most common approach to measure additionality.
- Operational and institutional additionality: Have there been improvements in, for example, the environmental or social performance of the investment as a result of the public institutions involvement? Mobilizing additional financial resources is important, but maximising adaptation impacts is at least equally crucial, especially when supported by public institutions. Private finance mobilised with public support should be more closely aligned with the adaptation aims or needs of the supporting donor or government.

Adaptation finance should also be additional to aid flows. Most climate finance projects can and should have a development component, but the same funds should not be counted simultaneously as contributing to both objectives. This is especially important, given the independent international commitments made by many countries to provide a given amount of aid (e.g. the European target of providing 0.7% of the GNI in aid by 2015) as well as additional climate finance.

Leverage

Calculating how much private adaptation finance can be mobilised with a given intervention (e.g. a soft loan or market mechanisms) is crucial for the predictability of future flows. There is no agreed methodology to estimate leverage ratios. Different DFIs and climate funds use different approaches, which can lead to significant confusion.[54] In addition, higher leverage ratios do not necessarily indicate that projects are more effective in terms of achieving better results.

In fact, research has found evidence suggesting the opposite might be true.[55] Although the exact level depends on the instrument that is being used and the project characteristics, high leverage ratios often mean that the contribution of the public institution is heavily diluted compared to other sources of finance. This often goes hand in hand with a lower influence over the project.

High leverage ratios also mean that a large share of the cost is coming from other sources and could contradict the idea of additionality,[56] especially when, as discussed below, funds provided by other public institutions are often included in the calculations.

Overall, this suggests that leverage ratios offer limited added value to assess the efficiency and effectiveness of climate finance. Similarly, using leverage ratios to compare projects has important limitations in the absence of proper context information.

Accounting for money coming from other public sources

It is common in private projects for DFIs or climate funds to claim they have leveraged money provided by other public investors. For example, leverage ratios frequently include money provided by other public institutions, such as other multilateral banks or recipient governments.[57] While in some cases these funds might have actually been leveraged, many DFIs and governments have earmarked budgets meaning funds would have been spent on climate projects anyway.

Governments usually have detailed budgets, while DFIs often earmark or commit mid-term finance to some sectors, regions or countries.[58] It is thus not clear that funds provided by public investors can be counted as leveraged finance. In addition, public actors involved in a project often claim to have leveraged one another's money, which could lead to double counting and inflating overall leveraging estimates.

Attribution

Many projects involving the private sector include different public actors and, quite often, multinational companies. This leads to important problems when it comes to attributing the project to a specific country of origin. Public actors can involve not only bilateral or multilateral donors and development finance institutions, but also recipient governments.

Multinational companies usually have complex international structures including subsidiaries in several different countries. Attribution can be even more challenging when funds are channelled through a financial intermediary (for example, a local bank or an investment fund based on a third country).

Effective safeguards and private sector standards

This section deals with different guidelines that affect and regulate the environmental, social or ethical performance of the private sector.

Effective safeguards

In this report, the term 'safeguards' refers to the guidelines adopted by public organisations providing public support or encouraging private sector adaptation activities (e.g. DFIs, MDBs or climate funds). Safeguards perform a number of essential functions. In addition to being the foundations of monitoring, evaluation and accountability systems, they also help to prevent harm; make funding decisions by allowing comparing the performance of different projects; and steer funding in a given direction (ensuring projects meet specific targets).

In this section we pay particular attention to whether existing safeguards address adaptation concerns.

Existing safeguards are insufficient

Existing safeguards do not seem to be sufficient to ensure the private sector projects maximise their adaptation and climate performance in general.[59] To date, no DFI, MDB or climate fund has developed a comprehensive set of climate safeguards. Existing MDBs or other DFIs have a number of safeguards in place, but they do not comprehensively address climate concerns, though this can be explained by the broader development mandate of these institutions.

As a result, MDBs and other DFIs, such as the EIB and the IFC, continue to support fossil fuel-based energy projects, including large coal power plants.[60] Existing safeguards sometimes also fail to ensure private sector businesses are conducted in line with best ethical and social practices, for example, by preventing the use of tax havens, which could undermine developing countries' revenues.[61]

Climate funds have not usually developed their own safeguards and rely on those of the implementing agencies (often MDBs). This can be problematic because, in addition to being insufficient as mentioned above, climate funds receive data and evaluations performed following different methodologies and safeguards. This can make it difficult to ensure the comparability and consistency of different projects.

Implementation of safeguards

Beyond the adequacy of existing safeguards, a number of lessons can also be drawn from their implementation. Evaluations looking at the implementation of safeguards by the World Bank, the IFC and the EBRD found that they are not always adequately upheld through monitoring and evaluation systems.[62]

These evaluations also show that the implementation of standards is especially challenging when support to the private sector is channelled through financial intermediaries. When it comes to sub-project monitoring, DFIs, for example, rely on the information provided by the intermediary itself. This information is not usually disclosed to the public and in the limited case when information is made available, it is with the consent of the intermediary.[63]

MDBs and other DFIs often argue that revealing information about sub-projects (e.g. the companies participated by an investment fund) could undermine the competitiveness of the intermediary. However, non-disclosure can lead to insufficient transparency regarding the operation of the private sector and can obstruct the public scrutiny of adaptation projects supported with public funds.

Private sector standards

The term 'private sector standards' refers to the guidelines adopted by private companies to reduce the vulnerability (adaptation) of their business models to the impacts of climate change.

The promotion and adoption of adaptation standards by private companies is closely linked with the discussion about how to encourage businesses to internalise adaptation costs (see section 1). When companies identify, assess and adopt measures to reduce their vulnerability to climate change they usually develop internal guidelines (standards) to ensure adequate measures are implemented throughout their value chain. As mentioned above, the measures proposed to achieve this objective require significant government support and investment. This could be a problem for under-resourced developing countries.

An additional avenue to encourage businesses to adopt ambitious adaptation standards is through corporate social responsibility strategies (CSR). It has been argued that it can be difficult to include some aspects of private sector adaption in CSR strategies because, unlike emissions reduction, the effects of adaptation measures are mostly local or restricted to the company itself and might not interest the same number of investors or consumers.[64] However, there are many measures related to workers, facilities and local communities that could very easily fit within many companies' CSR strategies.[65]

In addition, another way in which the costs of adaptation could be internalised is by including climate vulnerability criteria in the risk evaluations performed by rating agencies. This would provide a very strong incentive for private companies to adopt and adaptation strategies. However, this idea presents a number of challenges, primarily the difficulty in making accurate predictions and cost estimates.

Conclusions and recommendations

There is a role for the private sector in climate adaptation, but we still have to understand and find out how to develop its full potential. As this report has discussed, different types of tools and instruments, with differing strengths and weakness are being proposed. In many cases a strong body of evidence is still missing for an objective evaluation of their potential in meeting the adaptation needs of developed and developing countries.

Many of the instruments used or proposed to increase the contribution of the private sector to adaptation are in the early stages of development (e.g. adaptation market mechanisms) while others build on the experience of the private sector in development, but little is known about their specific contribution to meeting the adaptation needs of countries with different levels of development, as well as the specific needs of vulnerable communities within developing countries.

The different stages of development of a number of initiatives also call for better policy planning and the elaboration of a more ambitious international research and deployment agenda.

Although crucial to reduce vulnerability, some of the indirect instruments discussed in this report (e.g. internalising adaptation costs of encouraging technology transfer and development) seem more appropriate, at least in their current form, for countries with large public resources. This is not the case of most developing countries, which would require significant external support in order in order to keep pace with developed countries and prevent widening of the adaptation gap.

In general, more research based on a bottom-up approach – starting from the specific needs and moving up to specific tools and instruments – is required. It is also important to start exploring how different tools relate to and complement one another in order to make the right policy decision in the near future.

A number of broader or framework issues also need to be addressed as soon as possible. It is crucial to develop a common methodology to record and track private finance, including adaptation finance. Without such a system, it is not possible to guarantee an equitable distribution of the scarce climate finance available, nor hold developed countries to account for their commitments and historic responsibility in climate change.

The safeguards of public organisations supporting the role of the private sector in adaptation need to be strengthened. In addition, public organisations need to improve implementation in order to ensure projects comply with safeguards. This is particularly important in the case of climate funds. Without effective safeguards in place it is difficult to steer private finance, maximise its contribution to the fight against climate change and ensure accountability.

Core recommendations

Given the urgent need to support developing countries' adaptation efforts, it is essential to begin to fill the knowledge, evidence and policy gaps as soon as possible. In order to kick-start progress, CAN Europe recommends that the international community take on-board four core recommendations:

1. **Increase and focus international research efforts on the private sector and adaptation.**

a. Fund research using a bottom-up approach. Current research relies to a great extent on existing tools and examples. Given the problems of existing tools when reaching poor and vulnerable communities and SMEs, it is important to explore the interface between vulnerable communities and the private sector on the ground in order to develop new approaches.

b. Examine how the private sector can take on projects for the public good (usually non-bankable), including through PPP, other risk-sharing facilities or by creating new classes of assets that can be monetised and help make public-good projects bankable;
c. Explore how different tools relate to and complement one another in order to develop comprehensive strategies to address global adaptation needs and, in particular, those of developing countries. This is especially important in the case of instruments usually implemented with government support (technology development and transfer) so that developing countries can also benefit from those efforts. Potentially, these efforts could be coordinated through the recently created Climate Technology Centre and Network (CTCN).
d. Set up a working group to examine current proposals to create adaptation market mechanisms and develop a 'vulnerability credit', as well as other innovative options such as potential 'adaptation levies' to raise funds for adaptation following the same principles of the 'development levy' currently implemented in Ireland, but for adaptation services instead of public facilities; or the international air passenger levy for adaptation proposed by the group of the least developed countries.

2. **Ensure developing countries can benefit from global adaptation efforts mobilised or implemented by the private sector in an equitable manner and in line with obligations under the principle of common but differentiated responsibility.**

a. Support the development of an enabling environment that is tailored to the best interests of developing countries. The enabling environment should be developed through a 'country-owned' process, follow democratic principles and work in consultation with stakeholders, including private sector, trade unions and civil society.
b. Create in-country and international mechanisms to explore the needs of developing countries and coordinate support.
c. Ensure that private sector involvement in adaptation projects in developing countries does not result in a transfer of the adaptation costs to poor and vulnerable communities. In order to prevent this, government or donor subsidies should be envisaged.

3. **Develop a single climate finance tracking system with common methodology and database.**

a. Ensure that data is comparable and information is disaggregated by origin and destination; provides sufficient information about individual flows so that they can be coordinated and predicted; and information is public and easily accessible. In this regard, the tracking system could build on the experience and standards developed by the OECD DAC database and the International Aid Transparency Initiative (IATI).
b. Address the divergences in estimating leverage ratios, to prevent two different donors from counting the same amount (double-counting) and ensure a clear and separate accounting of ODA flows.

4. **Promoting best practice to make the contributions effective.**

a. Review and strengthen the safeguards currently in use by donors, MDBs, DFIs and other relevant public organisations so that they exclude support for climate-polluting activities, such as fossil fuel-based technologies and uphold internationally best corporate practices, including preventing the erosion of developing countries tax-base through tax havens. Financial intermediaries should be required to uphold the same environmental, social, taxation and transparency standards in their sub-projects; and
b. Develop a common international private sector agenda including a set of measures, guidelines, best practices and support material to help businesses internalize and adapt to climate change. The possibility of finding ways in which rating agencies could compute climate vulnerability should also be explored as a potential incentive for private companies to adopt adaptation strategies.

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