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Climate Report

Building Blocks of Mainstreaming:

A framework for integrating climate
change across financial institutions

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Executive Summary

Following the landmark events of 2015, international development and climate agendas have become increasingly linked. The Sustainable Development Goals have identified climate action as a central piece of advancing long-term development objectives. For the first time, the Paris Accord has led to both public and private financial institutions being called by the international community to take climate change into consideration as the world focuses on achieving the ambitious goal of ‘zero-net’ emissions by the end of the century. This implies an integration or ‘mainstreaming’ of climate-related issues by development finance institutions (DFIs), as well as the broader financial community.

This report identifies the principal areas and issues to be addressed by financial institutions in the process of mainstreaming climate change and supporting the low-carbon, climate resilient (LCCR) economy. It is based principally on a desk review and the experience of public development finance institutions and in depth case studies that I4CE has conducted. This report’s focus on DFIs as they have in some cases well over a decade of experience on addressing climate-related issues in their policies and analysis of individual projects. Much of this experience has a strong potential value to support private financial sector actors in mainstreaming climate change across their activities.

Financial Institutions Increasingly Called to Mainstream Climate Change

The 2015 Paris Agreement has firmly placed national action for all countries globally at the heart of both international and domestic climate action. The wide-reaching transformations for developed, emerging and developing economies embodied by the aspirational 1.5°C climate change goal will require both a significant redirection of existing financial flows and an increase in overall investment. Scaling-up financial flows to trillions of dollars per year is necessary to achieve the ‘well below 2°C’ long-term objective. It will also demand a shift from focusing on a ‘siloed’ vision of climate finance, to supporting all activities aligned with a LCCR transformation across the economy. This evolution solidifies the linkage between promoting economic and social development in all countries worldwide, and promoting a reduction in greenhouse gas emissions and an increasing resiliency to future climate change.

A number of questions – political, financial and technical – will need to be answered regarding how the new international commitments will be achieved in practice. It appears necessary that climate change mitigation – and the transition to a low-carbon, climate resilient economy be linked to broader national policy frameworks and the financial value chain. To do so, climate-related issues need to be addressed in discussions on financial instruments, direct and indirect support mechanism, as well as the broader policy framework impacting the risk-return profiles of individual investments.

Climate, Financial Institutions and Mainstreaming: roles and rationales

The last five years have seen a significant expansion of the rationale for financial institutions to take climate change and other sustainability concerns, into consideration. Previously, the integration of climate-related issues has been perceived as a mandate on behalf of public interest. However, it has increasingly been highlighted that climate change poses both significant risks – and opportunities – for nearly all non-financial and financial economic actors. Based on calls to take physical, policy and legal risks into consideration, both public and private financial institutions are now exploring how to reduce their exposure to climate-related risks. In some cases, they are going as far as to evaluate their contribution to the LCCR transition of the economy. Differences between ‘Common-interest’ and ‘Private-interest’ rationales for mainstreaming can influence the strategy adopted by a given financial institution depending on its focus on reducing its exposure to risks, or to maximizing the ‘transition impact’ of its activities in line with national LCCR strategies. This, in turn, can influence the mainstreaming process as presented in **Table 1**. Differences in approaches can have an impact on: overarching objectives, the time horizon taken into consideration, the information needed on underlying investments and assets, as well as how this information is integrated into economic analysis (welfare-based cost benefit) and financial analysis.

Building blocks of mainstreaming: lessons from DFIs

Public financial institutions – whether domestic development banks or international development finance institutions (DFIs) – are in a position to be key actors in aligning development and the low-carbon transition challenge. These institutions channel financial resources and often provide capacity support to recipients to support the achievement of international and national development mandates and objectives. In practice DFIs can contribute to climate action in developing countries by taking on three main responsibilities: i) facilitate access to capital, ii) assist in the development of national development strategies coherent with a low-carbon and resilient transition, and iii) work with national banking and financial industries to foster their involvement and leverage additional financing. Over the last decade, DFIs have taken significant steps to mainstream climate change which offer examples and lessons for all financial institutions.

Taken to its fullest extent, mainstreaming of climate change or the transition to a LCCR development model implies both formal and informal integration into all activities of a given DFI. Thus, climate change becomes a ‘prism’ through which all finance activities – as well as development plans, country and regional strategies, and institutional policies – is understood and analyzed.

As seen in **Figure 1**, the financing and investment decision making can be divided schematically into two overlapping parts: the ‘Upstream Governance & Policy’ level and a ‘Downstream Structuring & Appraisal’ Level. Dividing investment decision-making processes into these two broad

areas allows a better understanding of how the investment framework set at the upstream policy level, influences how activities and projects are selected and analyzed at the downstream level.

The issue of timing is important as the earlier climate change is mainstreamed into the process, the more it has the capacity to make substantive or systemic changes to projects to better take into consideration climate change concerns. Beyond the availability of tools, tracking and

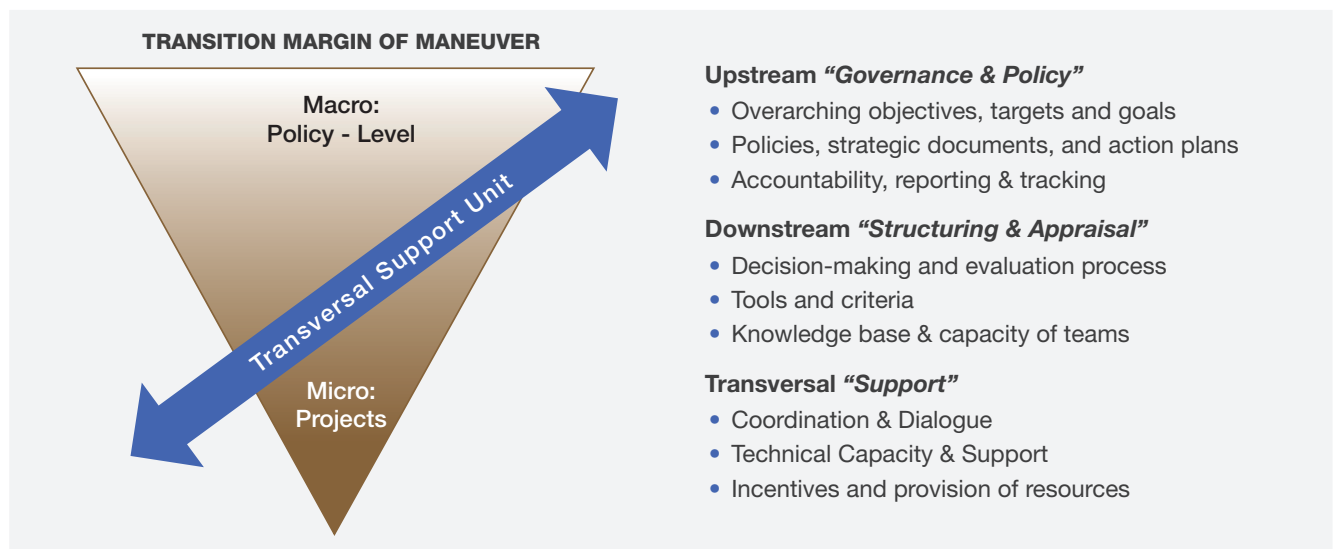
accountability frameworks, there are multiple needs for ‘transversal support’ across these two levels of planning and decision-making. Some DFIs have put into place transversal support units to facilitate the uptake of climate-related issues, to improve coordination and dialogue, to provide technical capacity and support to recipients, as well as in some instances to assist in the provision of incentives and additional resources such as the channeling of concessional funding coming from international climate funds.

TABLE 1: IMPACTS OF DIFFERENCES IN MAINSTREAMING RATIONALES

	Common-Interest Rationale	Private-Interest Rationale
Objectives	<ul style="list-style-type: none"> Contribute to national and international mitigation or adaptation objectives Fulfill related political commitments (financial flows, capacity building, etc.) 	<ul style="list-style-type: none"> Reduce exposure of future cash flows to climate-related risks Identify and capitalize on climate-related opportunities
Time Horizon	<ul style="list-style-type: none"> Investment and interventions meet short term (annual) internal objectives and contribute to medium- to long-term societal objectives (10 to 50 years) 	<ul style="list-style-type: none"> Within time horizon material for investors: from short term to long-term (often no more than 5 – 7 years)
Information needed to assess individual investments	<ul style="list-style-type: none"> Identification of sectors, value chains, technologies, processes and projects that contribute to a country’s LCCR pathways Identification of actions that will improve local resiliency 	<ul style="list-style-type: none"> Vulnerability to physical risks (country, regional or other aggregated approaches) Exposure of project types (sector, tech.) to potential climate policy risks (regulations, carbon pricing)
Economic and Financial Analysis	<ul style="list-style-type: none"> Inclusion of emission data in economic analysis to assess welfare impacts Integration of a social cost of carbon into economic analysis Discount rates used in economic (welfare) and financial analysis should not ‘crush’ the future value of climate action 	<ul style="list-style-type: none"> Inclusion of quantified physical and climate risks in financial analysis Integration of a “real” or “shadow” price of carbon in financial analysis

Source: Authors

FIGURE 1: DECISION-MAKING PROCESS AND THE IMPACT WOF CLIMATE-RELATED INFORMATION



Source: Authors after (Cochran 2012; RICARDO-AEA 2013)

Why can this be challenging in practice?

A number of overarching issues and difficulties can be identified as barriers to the mainstreaming of climate change at all levels. Barriers can be loosely grouped on one hand as political and governance challenges, and on the other hand as technical and informational challenges. Political and governance challenges are related to the importance given to climate issues in the mandate of development finance institutions, how it is prioritized among other issues and the confidence that it remains a high-profile issue over time. Technical and informational challenges relate to the collection, production and inclusion of climate-related information into the decision-making process, which pose a number of challenges beyond availability and costs issues. While a proper balancing of costs vs. information precision and end usefulness for decision-making is key, technical challenges may remain to understand the short- and long-term impact of interventions on climate change and the LCCR transition. Finally, the timing of the integration of climate change into the decision-making process can impact the ability of the financial institution to make substantive or systemic changes in project design.

The Building Blocks of Mainstreaming Climate Change

Based on a literature review and analysis of current practices conducted by I4CE, this report explores the main issues and considerations to take into account for upstream and downstream mainstreaming – as well as the need for transversal support on the topic. Comparing the different roles that DFIs currently play in financing development with the challenges that may be faced in mainstreaming climate change reveals a number of questions and recommendations.

Upstream Governance & Policy Level: Key Considerations

Mainstreaming climate action at the ‘upstream’ governance and policy level is essential to ensure that these issues are included within the broader framework of DFIs’ investment strategies. It implies defining investment priorities (and exclusions) in terms of geography (regions, countries), sectors (balance across, priorities within), processes and technologies (prioritization of certain actions). Upstream decision-making is crucial to defining objectives, criteria and fostering support for low-carbon, climate-resilient projects across institutions. It is also an opportunity to identify and prioritize areas and interventions where the involvement of a DFI could significantly support the transition to a country-appropriate LCCR development model.

Overarching objectives, targets and goals

Definition of overarching climate-related objectives, targets and goals is often seen as the first step to mainstreaming climate change considerations within an institution. Furthermore, how this objective is structured and how eligible projects are defined can have a significant impact on the direct and indirect incentives given to operational teams. The definition of a climate transition

strategy and its disaggregation in sectorial, regional and technological objectives should receive special attention. Key considerations include:

- How are objectives translated in operational incentives: does it emphasize volume or end-project impact?
- Do objectives support direct emission reductions or transformative change?
- How are eligible investments classified and climate-related and transition-related benefits defined in practice?

Policies, strategic documents, and action plans

The structuring of strategic intervention frameworks to support low-carbon climate-resilient development and respect long-term transition objectives is perhaps the most important step to ensure that an institution’s activities support the mainstreaming of climate and the LCCR transition. Once ‘enshrined’ within the frameworks, different processes and tools can be used to i) screen and prioritize technological options and sectors, ii) understand the order of magnitude of impacts, or iii) set thresholds for maximum emissions or other relevant indicators. Furthermore, inclusion creates an opportunity for capacity building and knowledge sharing between operational teams and in-country counterparts to help identify the most efficient means of achieving development objectives in a manner consistent with climate goals. Key considerations include:

- *Are climate and energy issues formally and systematically defined as priority areas?*
- *Is there a dedicated action plan for the whole institution with clear definitions of responsibilities?*
- *What engagement and links with recipient country priorities and strategies to foster a ‘transition’ to a low-carbon, resilient economic model (policy, regulation)?*

Accountability, Reporting & Tracking

Getting climate change on the agenda – and keeping it there – requires that attribution of responsibilities and accountability requirements are formalized within performance indicators and reporting processes of a given institution. Indicators can focus on both institution-wide performance, as well as unit- or individual- level incentives. Key considerations regarding accountability and reporting include:

- *Is climate included in principal institution-wide key performance indicators and part of reporting and accountability priorities?*
- *Is there a mechanism to ensure political follow-up and accountability (i.e. dedicated report)?*

Downstream Identification, Structuring & Appraisal Level: Key Considerations

Moving from strategic orientation documents to concrete actions, interventions and investments is a process that can vary widely between institutions. In general, this consists of a mechanism for translating annual country, region or sector programming into a pipeline of interventions, including project finance, capacity support actions, policy dialogue and policy loans. The inclusion of climate-related criteria

that are clearly visible and applied in the identifications process is essential to ensuring that the end-impacts of a DFI's interventions match the ambition of their objectives.

Decision-making and evaluation process

The integration of climate change objectives through capacity-building, information-sharing and standards during the identification, structuring and assessment process can support improved 'climate' or 'transition' impacts on a case by case basis. However, this can require for information to be tailored to the objectives and needs of recipient teams and functions. Key considerations include:

- *Are climate change issues formally & systematically integrated into project identification, screening, structuring and assessment procedures?*
- *Does the appraisal process include an opportunity to identify climate-coherent project alternatives to achieve principal development objectives? Are additional resources available to make them feasible?*

'Tools,' Process and Criteria

The transition to low-carbon, climate-resilient development pathways requires not only increased financial flows to low-carbon projects, but equally a cap – and reduction – of investments in carbon-intensive activities. It therefore necessitates a move from a system of tools and indicators that focuses solely on tracking climate-specific investments, to a system that pursues the optimization and alignment of all activities across financial institutions with LCCR development. The mainstreaming of climate change objectives across all operations is key to both increasing flows going to climate-specific investments, and to aligning development investments with the recipient country's long-term vision to achieve the low-carbon transition. Key considerations include:

- *Have screening, eligibility and knock-out criteria been established and integrated into the upstream phases of project identification?*
- *Are climate-related criteria included in the economic/welfare analysis conducted for the project in a manner that does not overly discount future climate-related benefits?*
- *Are climate-related criteria (shadow carbon price, risk metrics) incorporated into the financial analysis of interventions?*
- *Can existing metrics and analytical tools be adapted to look both at direct climate-related impacts, as well as supporting a long-term low-carbon, resilient transition?*

Knowledge Base & Exchange

In many instances climate change mainstreaming requires 'doing development differently' and finding new – and novel applications of existing – solutions to achieve development objectives that are coherent with climate objectives and countries' long-term decarbonization pathways. This requires that both operational teams and in-country counterparties have the capacity and knowledge to identify and prioritize how to do this in practice. Furthermore, framing climate change as an opportunity in the face of existing or

future constraints – whether by focusing on short-term co-benefits such as energy security or forward-looking physical or transition risks – can help build a business case for action. This may be an ongoing process that requires new processes for information sharing, training and interaction between operational and transversal teams.

- *Do operational teams have the knowledge and familiarity with low-carbon, resilient project typologies, technologies and options to suggest and support their development and implementation?*
- *Are project teams able to use and operationally interpret the tools and criteria?*

Ensuring Climate Mainstreaming Functions Transversally: Key Considerations

The mainstreaming of climate change across a financial institution through the different actions outlined above requires substantial political and technical support. A transversal support unit can assist in getting climate change on the agenda, keeping it there, and then in turn supporting operational teams in developing the required capacity and knowledge – provided that appropriate incentives have been set. The objective of this team can be to provide support on climate change issues and help identify opportunities. To ensure efficient knowledge-sharing, this team may be composed of a network of centralized and decentralized – in country and regional offices – team members across the institution. It appears crucial that a balance is found between playing the role of an 'oversight' body, ensuring that climate-related issues have been addressed, and being a 'trusted' partner supporting operational teams to success in effective mainstreaming.

Coordination & Dialogue

Coordination and dialogue on climate-related topics is a key piece in keeping climate on the agenda, as well as ensuring that country and sectoral teams have the capacity and knowledge to integrate these issues into their daily activities. This may combine both oversight duties and day-to-day engagement with operational teams. Key considerations include:

- *Can the transversal unit support and foster further recognition of climate change across the institution, with follow-up and monitoring at highest level?*
- *Does the unit have an opportunity to support integration of climate objectives into dialogue and programming with borrowing member countries?*

Technical Capacity & Support

A transversal climate unit can support operational teams on the technical questions related to aligning climate and development priorities. This can be done directly, through in-house expert knowledge-sharing and capacity-building, or indirectly through assisting in writing projects' terms of reference and providing operational teams with external technical support. Climate change support can cover a broad number of subjects, such as project options identification, integration of climate change issues into

country modeling and technical support on renewable energy, energy efficiency and other policy frameworks for policy dialogue. Throughout this process, it is essential that the transversal climate team support the framing of climate mainstreaming and demonstrate that projects can achieve climate and development goals in an acceptable fashion. Key considerations include:

- *Is the transversal climate team able to frame the 'Business cases' to demonstrate the value of aligning climate and develop priorities and climate proofing projects to sectoral and operational teams?*
- *Can the unit support the capacity of country / project teams in technical assessment, project identification and pilots?*
- *Is the use of unit's support and consultation formalized within the project identification and appraisal process?*
- *Can the unit initiative and develop projects to demonstrate how alignment of climate and development objectives could be done in practice?*

Incentives and provision of additional resources

The mainstreaming of climate and energy concerns may be seen as an additional constraint on achieving the principal objectives of development finance institutions. To help ensure that a transversal climate team is seen as a resource beyond being an oversight body, incentives and additional resources should be made available to through the unit – at least in the short term until teams are acculturated to this new way of conducting activities. Key considerations include:

- *Are earmarked financial resources made available to cover added costs for project improvements that increase climate/transition impacts (studies, pilot project development, training and capacity building)?*
- *Can the climate change unit channel or link the concessional financing with outcomes supporting transition- or climate-related objectives?*

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