**FINANCIAL MECHANISMS FOR CLIMATE CHANGE PROGRAMS IN LATIN AMERICA[[1]](#footnote-1)**

**POLICY BRIEF**

***Key Messages:***

* Developing countries receive a large amount of international climate financing through diverse resource streams (private investment, traditional development aid, dedicated national funds, carbon markets, etc.), but it is fragmented both terms of its source as well as its destination (various line ministries, general budget support, national implementing agencies, private industry, etc.)
* Ministries of Finance have difficulty planning ahead for climate change priorities due to political constraints and discounting of future costs. Therefore, creating programs that have some short-term economic and political benefits can help give climate priorities more weight.
* It is more effective and politically tenable for countries to centralize their climate change portfolios, both financially within the Ministries of Finance, and policy wise in a national climate change program.
* There are a handful of financial mechanisms (traditional loans, grants, debt swaps, national climate funds, carbon markets, and insurance instruments) that Ministries of Finance can use to kick start their national climate change programs and begin to centralize the country’s climate financing related to both mitigation and adaptation.
* Aside from these innovative mechanisms, countries should look into clarifying and strengthening traditional line item spending for climate change, as that is how it appears the spending will continue into the future. Creating a definition for “climate change” as a spending category in the budget would be a useful way for countries to begin.
* The “best” mechanism should be tailored to the country’s economic circumstances and specific climate challenges, but the most successful mechanisms emphasize economic efficiency, work outside the political system, and have a minimal fiscal impact.

***Introduction***

There has been an undeniable increased focus on climate finance in recent years. The international community has agreed that it will be absolutely necessary to channel funds to developing countries to help them mitigate the effects of and adapt to climate change. Recent studies estimate the world’s annual climate flows are approximately USD $96 million.[[2]](#endnote-1) Given the nature of the climate challenges of the future, developing countries will be recipients of a majority of these flows. Developing country governments receive climate related-financial flows, however, through a wide variety of channels, including: official development assistance, private investment, carbon markets, etc.

Little research has been conducted on the receiving end of these financial flows. How should developing country governments organize their national climate change programs? How can they best use international climate flows to maximize their domestic climate, energy, and environmental goals? Which financial tools will be the most useful for this process? With an eye toward the Latin American and Caribbean (LAC) region, this policy brief outlines the financial mechanisms that could potentially be used to channel resources into countries’ climate change programs. It then offers lessons learned and policy recommendations given LAC countries’ experience with different versions of these mechanisms.

***The Mechanisms***

The following section describes the financial mechanisms that could be used to help countries reach their country’s climate change goals.

1. Budget Line Items

Designating line items in the budget for spending related to climate change goals is historically how countries have organized projects related to climate change. Typically, these line items come under the ministries that the programs are related to (forestry, transportation, agriculture, infrastructure, energy, etc.) and do not have a unifying climate change theme, but rather are the priority of the specific Ministry. This form of spending will likely continue into the future, even while innovative, extra-budgetary financial mechanisms for climate change are created.[[3]](#endnote-2)

It would be helpful for governments, therefore, to understand more clearly what constitutes their current spending related to climate change and whether it falls on the mitigation or adaptation side of the issue. As no official, standardized definition for climate change spending exists, countries should define this category for their country as first step. Governments could then implement a methodology to categorize their climate spending. Knowing exactly where they are now can help both budget offices and climate change policy specialists better match spending to the actual climate priorities that the country faces in the future.

1. Non-concessional and Concessional Loans

Multilateral and bilateral institutions are the principal intermediaries of international climate finance, delivering together 40% of the world’s annual climate finance flows.[[4]](#endnote-3) The vast majority of these flows are non-concessional and concessional loans. The size of the market rate loan flows from multilateral and bilateral institutions is estimated at around USD $18 million annually. The size of concessional loan flows from multilateral institutions is estimated at around USD $13 million annually. This dominance is not likely to change in the near future, so countries need to think critically about how to use the current loan streams to meet climate change goals.

Concessional loans can, however, be adjusted in the way they are integrated into the budget. In this sense, it may make sense to move beyond the one to one ratio of loan to project funding toward either general budget support or a more programmatic approach.[[5]](#endnote-4) This allows the financed projects to have a coherent, unified, and domestically-driven focus. Donor institutions can then support the broader climate change goals of the recipient country rather than dispersed projects across various ministries. In this case, clear processes need to be created for how the aid will be allocated to ensure they are actually diverted to climate change objectives. Recipient countries can facilitate this by creating national climate change plans with an associated portfolio of projects and clear, transparent budget mechanisms for allocating the international aid to those projects.

1. Multilateral and Bilateral Grants

Grants also play an integral role in multilateral and bilateral financing. The amount of grant flows, however, is much smaller at around USD $4.5 billion annually. In the climate and environmental space, grants are normally provided for non-revenue generating activities in recipient countries, such as knowledge management programs, capacity building programs, ongoing activities that do not generate financial return, and technical and costing plans, among other projects. Given that these studies and efforts are necessary pre-cursors to designing sustainable and effective financial mechanisms, governments should look to leverage these grants for capacity and technical needs in the short-term. In the medium and longer-term, grants can be used to help capitalize the financial mechanisms related to adaptation, forestry, and environmental preservation, which are all areas grants have been directed in the past in the LAC region.

Overwhelmingly, the largest source for climate-related grants has been bilateral institutions. Dedicated climate funds, however, channel a growing portion of the climate grants.[[6]](#endnote-5)

1. Debt Swaps

Debt swaps involves the sale of foreign currency-denominated debt by creditor nation to an investor (either a non-profit organization or a central bank) who buys the debt at a price that enables a profit margin. The investor can then swap this debt with the debtor nation, in local currency, for shares in a national company or for a wide variety of development projects.[[7]](#endnote-6) Debt for environment swaps cover swaps that typically focus on conservation and other “green” projects. Only very recently have debt swaps been expanded to include climate change programs. Debt swaps are financed at no extra fiscal cost to the recipient government because, with *swap as you pay* transactions, payments are rerouted to domestic project coffers rather than creditor coffers.

Debt swaps are normally executed from bilateral debt, given political constraints around multilateral swaps. In targeting loans that may be viable to for a swap, it is important to maximize the net present value of the debt selected so that the monthly payments are large enough to solidify a climate change program.

As long as the same staff is around to manage the financial structure of swap, the technical details may not be as important as the design of the expenditure program that the swap will finance. It is important that these expenditure programs contain realistic, well-organized projects in line with both creditor and debtor priorities and housed within institutions with the necessary capacity to ensure their completion.

1. National Climate Funds

This long-standing macroeconomic tool has recently been revived to serve climate change goals. A national climate fund is a financial mechanism that allows countries to collect, blend, and manage all the incoming revenue streams, both international and national, related to climate change into one, centralized fund. This, in turn, competitively allocates resources to a variety of “green” projects in the country. These increasingly popular national entities have been playing a crucial role as an interlocutor between the national policies for pursuing low carbon development and the international mechanisms that deliver this aid.

The exact design of a national climate fund will depend on its stated objectives, which areas of the climate change problem focuses on, its scope, how it is capitalized, how projects are funded, and its management structure. The common structure for a national climate fund should include funding sources, governing bodies (both technical and administrative), a trustee, and implementing agents. Experience in the Latin American region with these funds indicates that the governance of the national climate fund should be connected to the government, but autonomous in its investment decisions, allowing it to be more agile and independent from political pressures. While there are certainly lessons learned from similar funds in the region, there cannot be a one size fits all approach to designing a national climate fund in general.

1. Carbon Markets

Carbon markets were the first international climate finance mechanism that attempted to use an efficient market mechanism to reduce global greenhouse gas (GHG) emissions by putting a price on those emissions. Once they have been created, national and sub-national governments have a smaller level of involvement in these mechanisms as they should function as a private market. While this means the carbon markets may not be a significant source of revenue for the country, it also maximizes economic efficiency and minimizes corruption.

Currently, carbon markets operate at the international level (through the Development Mechanism (CDM)), the national level (through Europe’s Emissions Trading Scheme (ETS), Japan’s Emissions Trading System (JETS), and Australia’s and New Zealand’s more nascent carbon trading schemes), and the city level (through markets like the Chicago Climate Exchange). Carbon markets can be both compulsory and voluntary.

The international carbon market’s mechanism, the CDM, has been notoriously difficult to access for most LAC countries (aside from Brazil and Mexico). As a result, Latin American countries have begun to create voluntary markets, such as Chile’s Santiago Climate Exchange and the Brazilian Carbon Market. These markets rose out of a desire to stimulate national private industry as well as from frustration with the backlog of actionable projects in the CDM pipeline. Due to a lack of regulation, high transaction costs, and diminished incentives for private sector involvement, however, very little trade has occurred in these local exchanges.

1. Insurance Instruments

The best approach to mitigating the risk from weather-related disasters is a combination of risk prevention and risk transfer mechanisms. Risk prevention mechanisms should be used by the government for low to medium loss events that happen relatively frequently; lower probability hazards with high-costs and potentially devastating consequences are better covered by risk financing instruments. Low to medium loss events should be mitigated by budget expenditures that reduce vulnerability and create reserve funds.[[8]](#endnote-7) When it comes to lower probability events, country governments have historically financed their post-disaster expenses by reallocating budget resources and relying on both loan and grant assistance from the international community.[[9]](#endnote-8)

Economically, it is more efficient to create risk transfer mechanisms that can provide the resources for these types of climate-related disasters and shift loss responsibilities from the sovereign government to the capital market investors. Recent developments in insurance analysis and modeling have resulted in instruments that compensate for some of the market failures that have prevented governments from using these instruments in the past. There are a wide array of these types of mechanisms, ranging in financial complexity, specificity, and management, used by country governments and private sector entities around the world. The following mechanisms present viable options for financing the type of risk that Latin American and Caribbean countries face in the future:

* Insurance linked securities,
* Contingent capital,
* Contingent credit and loans, and
* Multi-country risk facilities.

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|  | **PROS** | **CONS** |
| **Budget Line Items** | * Tradition and historical patterns typically allow Ministries to continue to move spending through these channels. | * Continues to centralize spending the Ministry of Finance. |
| **Concessional and Non-Concessional Loans** | * Tried and true process that Ministries of Finance are accustomed to and have experience managing. * Loans will likely continue to be the bulk of international funding in the region. | * Donor overcrowding and lack of strategic organization in the climate change portfolio. * Unpredictability of donor flows disrupts budgetary planning capacity. * Tightened fiscal environment makes new climate change focused loans unlikely. |
| **Multilateral & Bilateral Grants** | * Grants present no fiscal cost to the government. * Technical and cost studies associated with the mitigation and adaptation to climate change are ideal candidates for grant assistance. | * There is a difficult political economy of grant giving in donor countries. * It is difficult to guarantee the funds will be spent on climate priorities. |
| **Debt Swaps** | * Debt swaps present no fiscal cost to the government. * Debt for environment swaps can help kick start the development of long term project pipelines. | * The viability of a debt swap is contingent upon the availability of appropriate bilateral debt. * Debt swaps employ a centralized decision making process on the nature of the expenditure program. |
| **National Climate Funds** | * Systematizes and centralizes a country’s climate change agenda. * Fosters competition among project developers. * Allows a more transparent assessment of funding associated with climate change. * Portrays an attractive portfolio of projects for international donors. * Allows for national ownership of a country’s climate change agenda. * Serves as a seed for piloting new ideas. | * Susceptible to clientilism and corruption. * National climate funds remain largely in their pilot stages. * National climate funds create another level of bureaucracy and require human capacity. |
| **Carbon Markets** | * Stimulates the private sector and promotes economic growth. * Less government involvement, so projects are more economically efficient. | * Relatively little national capacity is built as a result of carbon markets. * Carbon markets fail to reduce emissions at scale * There are high transaction costs for participants. |
| **Insurance Instruments** | * Provides short-term liquidity for government spending in the face of immediate need. * Defends against long-term fiscal insolvency. | * High premiums are hard to justify in times of fiscal austerity. * Difficulty of incorporating cost uncertainties into budgets and fiscal frameworks. * Insurance mechanisms are inherently reactive. |

***Key findings***

Each of the financial instruments discussed in this document is only appropriate in specific economic and country contexts. There can be no one size fits all approach to creating these instruments. It merits to the time to think carefully about which instrument is most appropriate, why the instrument is the best fit, and how to design the mechanism to ensure incentives are aligned. New financial instruments can be promising, but if not understood fully and regulated properly, could potentially have an unforeseen negative impact on the economy. Therefore, investing time at the outset of creating the mechanism to fully understand its design and the implications of its impact is extremely important. Furthermore, staff consistency during the design and implementation of instruments is helpful to ensuring the policies can actually meet their original goals.

Given the characteristics of the LAC region and the constraints created by the fiscal and political situation currently associated with climate change finance, the following lessons learned can help guide policymakers contemplating which climate finance mechanism may be “right” for their country context.

* The decision about which financial mechanism is most appropriate should proceed from a clear understanding of the exact nature of the climate challenges that a country will face, consequently there is a need for more information on mitigation and adaptation scenarios and their associated costs.
* Countries that have created and successfully capitalized climate finance instruments normally have done so in tandem with a national policy plan for climate change. A complementary national climate change plan facilitates the execution of the financing mechanism.
* Create a portfolio of viable, well-vetted climate change projects will not only create a channel factor for international investors, but it will also help Ministries of Finance evaluate its country’s climate change portfolios as a whole.
* Coordination between the Ministry of Finance (especially the Office of Public Credit) and Ministry of the Environment is essential. Without a clear understanding and communication between the two ministries the process of creating the instrument can stagnate.
* Since some financial mechanisms redirect funding to the Ministries of Environment it needs to strengthen its ability to execute projects in an efficient and timely manner.
* Financial instruments are more successful when they are set in a conducive regulatory and legal environment.
* Government efforts to mitigate the risk/return ratio for the private sector will increase financing flows for the government by leveraging private investment.
* The mechanisms that exist outside political bodies have demonstrated the greatest implementation capacity.
* It is critical to develop a strategy within the Ministry of Finance for contingent liabilities, including adverse weather events.
* Given the level of specificity and technical expertise required, creating a climate change unit within the Ministry of Finance will better equip it to understand, manage, and finance climate change priorities.
* Create a group or designate an individual within the executive branch that can oversee all of the climate change mechanisms supported by the government.
* Climate change capacity building should not only be focused on the government, but also on civil society organizations; the Ministries of Finance should work to build relationships with national civil society organizations.

***Policy Recommendations:***

The aforementioned lessons learned feed directly into the following policy recommendations for decision makers in public finance regarding climate change and public finance.

* Given the current fiscal environment in most Latin American and Caribbean countries, the most economically appropriate mechanisms will likely be ones that have a limited fiscal impact on the countries’ budgets and/or are revenue neutral.
* Given the diversified streams of incoming financial flows related to climate change, it will behoove countries in the region to flesh out their climate change project portfolios by organizing them both politically, into national climate change action plans, and, economically, into national climate funds.
  + With the crosscutting nature of climate change, related projects tend to be stretched across ministries and levels of government, more so than other national issues; therefore, climate change projects require a concerted effort to centralize.
  + Having this portfolio will attract international donors and new revenue streams.
  + Having this portfolio will make it easier for the Ministry of Finance to prioritize projects by cost and urgency.
  + Different point persons should be able to access and advocate for this climate change project portfolio.
* Comprehensive technical, economic, environmental, and political studies need to be undertaken to understand a country’s exact climate change priorities and the potential implications of before any financial and/or fiscal mechanisms are created.
* Countries in the region need to take concrete steps toward incorporating implicit contingent liabilities in the budget. With the increased frequency and severity of adverse weather events due to climate change, there could be serious fiscal repercussions and depressed revenue and growth if the government does not properly incorporate climate liabilities into the budget. In relation to climate change, this should be done in three concrete steps:
  + Understand which public assets, across various sectors, are most vulnerable to climate change impacts, these assets’ net present value and valuable life, and which are absolutely necessary to protect in order to keep the economy functioning at an acceptable level.
  + Implement a low cost, risk prevention strategy for high probability, low cost events.
  + Design insurance instruments for low probability, high cost events to pass the risk along to better-equipped international markets.
* Any climate change instrument should emphasize economic efficiency as much as possible so as to create a sustainable path toward a low-carbon future. Government mandated programs can depress innovation, create economic inefficiencies, and invite corruption. When designing a financial mechanism—whether it is a debt swap, a national climate fund, or an insurance instrument—it is important create a competitive process for accessing these funds.

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