Scaling up adaptation solutions: private sector involvement in climate finance

It is increasingly clear that the resources required to address global adaptation costs are dauntingly large, easily exceeding the capacity of traditional financing sources. Addressing the gap in climate financing options, mobilizing private sector actors and creating innovative financial instruments are all crucial.

Key messages

- There are limited public financing and financial mechanisms to enable developing and emerging countries, and lower income countries to develop pathways to adapt their societies to the unavoidable impact of the changing climate.
- The private sector has a key role to play in addressing climate change adaptation challenges but is often not aware of the business case around climate adaptation and resilience; hence remain untapped in terms of implementation capacity .
- More financial and policy instruments are needed to identify key incentives in different sectors of business and industry, using shared language and tools, and clear metrics and targets, in order to leverage the power of the private sector and trigger more adaptation financing.

Background

As the impacts of climate change increase in severity and frequency, many countries of the Global South are formulating policies and systems to scale up adaptation initiatives in their national adaptation plans (NAPs) or as part of their nationally determined contributions (NDC). The private sector is primarily motivated by maximizing the return on their investment. The defining characteristic of private finance for adaptation is **the demand for a reasonable, predictable, and relatively quick market rate of return on investment**. However, uncertainty associated with climate change makes the risk of adaptation investment difficult to calculate. Moreover, there is a lack of both metrics and tools to quantify adaptation in order to attract private investment on adaptation action. Among the private sector, the insurance industry is playing a critical and very aggressive role on climate change national policies. Climate risk insurance is a priority area for countries in order to implement the adaptation goal of the Paris Agreement at the national level: overall, 38 countries mention climate risk insurance approaches in their NDCs.

In parallel, there is little enabling policy to encourage the integration of resilience thinking in corporate strategy and investment decisions, particularly how multilateral development banks (MDBs) can mainstream resilience thinking into development financing strategies. Further, climate resilience needs to be mainstreamed into development planning, but this depends on a certain level of governance often lacking in developing countries. Although progress is being made, more work is required to address the gaps as to how MDBs are approaching climate change adaptation and resilience financing and how public policy and risk mitigation instruments can remove the barriers to private sector investment.

More is needed to identify key incentives in different sectors of business and industry, using shared language and tools, in order to trigger more adaptation financing.

What have we learned?

IDRC has been supporting research that enables the development of new and innovative financial mechanisms and encourages developing and emerging countries to develop pathways to adapt their societies to the unavoidable impact of the changing climate. Doing so with public financing is quite limited; however, the private sector is untapped both in terms of implementation capacity and in terms of significant financial resources. IDRC's support for research exploring new ways to improve the ability of countries in the Global South to mobilize private sector funding using innovative financial mechanisms is key. Given the diversity of the private sector and of current adaptation challenges, scaling up adaptation solutions requires leveraging new resources and tools specifically for the involvement of the private sector, such as:

Using a market approach to increase private sector engagement

Market-based approaches utilize aspects of commodity markets to put a price on adaptation strategies. This is used to promote or reduce the production of a certain service or good and can incentivize private sector investments in adaptation finance. However, adaptation markets face a number of barriers, especially the quantification of benefits, as many of these benefits are public goods. Two approaches have been identified for public actors to mobilize additional private investment: i) correcting the market imperfection (for example, altering market institutions or regulations, or providing tariffs, subsidies, taxation, restrictions on trade, etc.) and ii) compensating the private actor for the effects on the risk-return profile without correcting the market imperfection (commercial actors can be compensated for the negative effects of the market imperfection on their risk -return profile). Research is still in its early stages; the development of more comprehensive market instruments will help overcome several of the barriers to private sector investment in adaptation.

Create innovative models for investors

Mitigation activities have traditionally attracted private sector investment as their benefits are usually more tangible that of adaptation. Finding new ways to attract investors is key to establishing the conditions under which the private sector can respond to adaptation projects. New models, such as those created by the Private Finance Advisory Network, have been bridging impact investors with small and medium enterprises (MSMEs) focused on adaptation. A group of selected MSMEs participated in an intensive coaching process that supported and advised on project development and sourcing of financing, finalization of the investor-ready proposal and development of a bankable business plan. This work eventually created a pipeline of bankable adaptation projects which have the capability/potential to attract private sector financing. Important gaps still exist, particularly on defining return rate from adaptation, and in communicating the content and benefits of the projects according to the conventions and requirements of the investment community.

Mobilizing climate risk insurance for resilience

Climate risk insurance is a priority area for countries in order to implement the adaptation goal of the Paris Agreement at the national level: overall 38 countries mention climate risk insurance approaches in their NDCs. In addition, another four countries feature the topic in their more elaborated NAPs. Together these countries represent more than 4 billion people, including approximately half of the world's extreme poor (defined as those living on less than $1.90 a day). Bilateral and multilateral initiatives should strive for broadened impact of climate risk insurance approaches through increased support for climate risk insurance mechanisms, improved accountability of the pro-poor focus of existing initiatives, and the institutionalization of a partnership at the global level on climate risk insurance to overcome current implementation challenges. Finally, the Risk Transfer Clearing House should be fully operationalized as the central go-to place on climate risk insurance

Develop innovative strategies to create sustainable and resilient enterprises

the Framework for Private Sector Action on Climate Resilience developed by Business for Social Responsibility (BSR) aims to present climate risk to businesses and introduce a method to catalyze business leadership on resilience. The innovation of this framework is that it is flexible enough to assess the climate risks within a company's operations, its supply chain, and the communities in which it operates, including issues such as access, empowerment, human rights and the social dimensions of climate change. In parallel, B Corporations (B Corps) in Latin America have made strides in building their own resiliency against climate change. They are social enterprises ("hybrid companies") that are committed to fostering environmental sustainability or to creating public goods by leveraging the power of the private sector. This type of hybrid company helps reduce the gap between mitigation and adaptation investments and highlights the co-benefits of addressing both challenges simultaneously.

Invest in knowledge brokering

Knowledge brokers can support access to climate finance for developing countries. For example the 'Climate Finance Ready" portal, which was developed through a partnership between the Adaptation Fund and the Climate & Development Knowledge Network (CDKN), offers information, advice and case studies to support developing countries in their efforts to access climate finance: https://climatefinanceready.org.

Supporting an enabling policy environment for private sector investment

Governments and public finance institutions can enable businesses to unlock their creativity by supporting enhanced knowledge generation through, for example, climate data and risk assessments, and facilitating innovation through support for research and development or compensating for a technology spillover. Public policymakers should also use the diversification potential of adaptation-related projects, as some might be negatively correlated with other climate risks . There is also a need to account for the fact that the private sector in semi-arid lands for instance and more generally in many developing countries is often informal, that people are mobile, and that they often move in and out of different economic activities.

Build leadership on adaptation finance

The capacity of designing and implementing tailored interventions to mobilize public and private finance for adaptation is limited in countries in Global South. Fostering sharing of lessons and peer learning among the next generation of leaders active in climate adaptation to equip them with state-of-the-art knowledge on adaptation finance will help them to become “climate ambassadors” within the scientific community, the private sector and (future) policy makers in their respective countries.

What’s next? The way forward

Successful adaption solutions to the impacts of climate change exist, but an important barrier to their application to appropriate scale is too often due to limited finance mechanisms and means of implementation. More innovations are needed to find new models of engagement and to develop and validate new financial instruments. This can be done through:

- **Scaling up and mainstreaming adaptation finance to meet country-defined needs by leveraging private finance and engaging MDBs:** there is a gradual shift to align financial flows with low-carbon and climate-resilient development pathways on the part of the MDBs, and to exploring how their efforts can shift private sector strategy, potentially unlocking capital expenditure and procurement finance.
- **Engaging different private sector actors and donor partners to achieve impact at scale** to identify evidence-based research opportunities of common interest, capacity building needs, and options to bring tested solutions to scale.

Resources

- Mobilizing the Private Sector for Adaptation Finance: https://www.idrc.ca/en/project/mobilizing-private-sector-adaptation-finance
- Mobilizing Private Sector Investment in Adaptation to Climate Change: https://www.idrc.ca/en/project/mobilizing-private-sector-investment-adaptation-climate-change
- Climate Change Risks and Opportunities for B Corporations in Latin America: https://www.idrc.ca/en/project/climate-change-risks-and-opportunities-b-corporations-latin-america
- CDKN knowledge accelerator for climate compatible development : https://www.idrc.ca/en/project/cdkn-knowledge-accelerator-climate-compatible-development
- CARIAA—Pathways to Resilience in Semi-Arid Economies: https://www.idrc.ca/en/project/pathways-resilience-semi-arid-economies
- Supporting private adaptation to climate change in semi-arid lands in developing countries: http://www.lse.ac.uk/GranthamInstitute/publication/supporting-private-adaptation-to-climate-change-in-semi-arid-lands-in-developing-countries/
- Adaptation Finance: Linking Research, Policy, and Business: https://www.idrc.ca/en/project/adaptation-finance-linking-research-policy-and-business

A key part of Canada’s aid program, IDRC supports research in developing countries to promote growth and development.

International Development Research Centre
150 Kent * PO Box 8500 * Ottawa ON Canada K1G 3H9
Phone: +1 613 236 6163 * idrc.ca