IDB Invest

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DEBrief

Increasing Climate Finance Calls for More and Better Impact Reporting

- Latin America and the Caribbean (LAC) is one of the regions in the world most affected by climate change, yet climate finance flows in LAC lag behind other regions.
- The magnitude of the climate financing gap requires financial institutions (FIs) to increase green lending activities.
- There is a clear business case for FIs to operate in this space, including seizing new business opportunities and reducing risk.
- Rigorously measuring impact brings additional benefits for FIs such as demonstrating alignment to global initiatives, strengthening reputation and branding, and attracting investors.
- IDB Invest is helping FIs build capacity to better serve the green segment and measure the impact of these activities.

SUSTAINABLE DEVELOPMENT GOALS

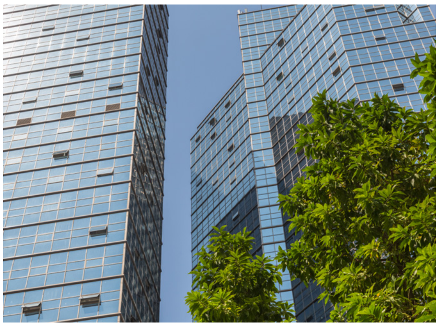
13 CLIMATE ACTION

INCREASING CLIMATE FINANCE

Latin America and the Caribbean (LAC) is home to some of the countries most affected by climate change. Out of the 20 countries with the highest climate-related losses as a percentage of GDP, nine are from LAC, with an average annual loss of 1.7% of GDP in Latin America and 3% in the Caribbean in the last two decades.[1] Climate change also exacerbates inequality since communities that are least able to afford climate adaptation measures are also the least able to bear the costs of climate change. Estimations predict that the effect of climate change will push 2.4 to 5.8 million people in LAC into extreme poverty by 2030.[2]

In order to address the climate challenge and support the green transition, which aims to achieve a resource-efficient and socially inclusive carbon neutral economy,[3] significant volumes of financing are needed. Climate finance, which comprises an important sub-set of green financing,[4] provides funding for activities that address climate change mitigation and/or adaptation. Mitigation refers to activities that anticipate the adverse effects of climate change and take action to prevent or minimize the damage they cause (e.g., adopting more sustainable transport options and renewable energy). Adaptation relates to activities that make the impacts of climate change less severe (e.g., strengthening infrastructure to withstand the impacts of climate change and diversifying towards drought-resistant crops).[5]

Given its size, LAC performs relatively well compared with other regions in terms of climate finance flows: while it comprised 5.7% of global GDP between 2019 and 2020, the region received 7.3% of climate finance flows during this period (an average of $35 billion), half from private sources (Figure 1).[6] However, this still falls short. Globally, to reach internationally agreed climate objectives by 2030, annual climate finance must increase by an estimated 590%.[7] Despite this, only 49% of Latin American banks offer green products and services, most of which are climate finance products, well below the 95% of international banks.[8]

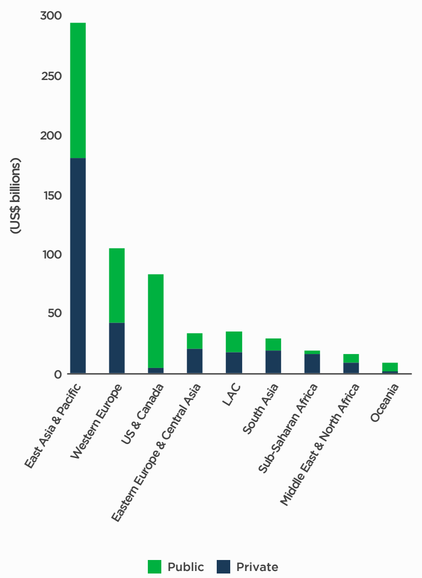


The aggregate numbers also hide important differences in climate finance flows. Capital flows primarily fund mitigation activities, with adaptation financing lagging behind despite its importance (representing a mere 7% of climate finance).[9] Part of the challenge is that adaptation needs are context-specific and therefore the same activity may or may not be considered climate adaptation, making it harder to identify adaptation investments. Even within the climate mitigation category, capital flows are heavily focused on renewable energy and energy efficiency, with less going towards critical areas such as land use, which is the largest contributor to emissions in LAC.

Addressing climate change calls for financial institutions (FIs) to step up their role in channeling capital flows towards climate finance investments. It also calls for FIs to better measure the impact generated by their climate finance portfolios in order to understand the progress being made and where gaps remain.

1. Global Center on Adaptation & the Government of Mexico (2021). A Green and Resilient Recovery for Latin America.
2. World Bank (2022). Consolidating the Recovery: Seizing Green Growth Opportunities.
3. United Nations Environment Program. Green Economy.
4. Green finance covers funding directed to climate activities as well as other environmentally sustainable activities.
5. European Environment Agency. Difference between adaptation and mitigation
6. Climate Policy Initiative (2021). Global Landscape of Climate Finance 2021.
7. Ibid.
8. International Finance Corporation, FELABAN & eco.business Fund (2017). Green Finance Latin America 2017 Report.
9. IDB Invest (2022). Scaling Adaptation Finance in the Private Sector.

Figure 1: Destination Region of Climate Finance, by Public/Private (US$ billion, 2019/2020 Annual Average)



Source: Climate Bonds Initiative (2021)

THE BUSINESS CASE FOR CLIMATE FINANCE & IMPACT MEASUREMENT

The business case for entering the climate finance space is clear. There is a significant and increasing demand for climate finance from businesses and households, which presents an opportunity for FIs that develop financial products and services directed at this segment. In LAC, low-carbon investments aligned to Paris Agreement goals are estimated to reach $1 trillion by 2040, with $600 billion materializing by 2030.[10]

At the same time, FIs face significant physical and transition risks from climate change. Physical risks encompass damage to FIs' physical assets due to climate change, which can result in damaged infrastructure, impairment of assets used as collateral, and increased insurance costs, among others. Transition risks arise due to changes in regulation, technologies, market preferences, and other factors as a result of the transition to a low-carbon economy. Financing the green transition can therefore minimize FIs' risks in a changing landscape, while supporting their clients' long-term viability through appropriate transition management and financing.

FIs that go beyond financing climate-friendly projects and build their capacity to credibly measure the impact of their climate portfolios–such as GHG emission avoidance, water and energy savings, and progression towards science-based targets–can gain an additional competitive advantage.

10. International Finance Corporation (2016). Climate-Smart Investment Potential in Latin America: A Trillion Dollar Opportunity.
11. Partnership for Carbon Accounting Financials
12. International Organization for Standardization

For example, rigorously measuring the impact of climate lending activities can demonstrate how an FI is contributing to key global initiatives such as the Paris Agreement and serve as a step towards more ambitious goals, such as achieving Net Zero Status. Measuring and reporting impact can also strengthen reputation and branding.

In addition, global investors are increasingly looking for opportunities to invest with a sustainable lens. By rigorously and transparently reporting on the impact of climate finance activities using standardized reporting methodologies, FIs can more readily raise large-scale financing for these activities while protecting investors from greenwashing.

REPORTING INITIATIVES

Despite these benefits, climate finance impact reporting is not yet common in LAC, often because FIs lack the capacity to segment their green portfolio, assess the credit risk of mitigation and adaptation investments, systematize data collection, and calculate the environmental benefits of such projects. That is why increasing the impact reporting capacity of FIs in LAC is essential to build a culture of accountability and further promote climate-related investments.

Several recent initiatives by regulators and other organizations aim to standardize impact measurement for climate investments. For example, the Global GHG Accounting and Reporting Standard for the Financial Industry[11] and the ISO 14020 standard,[12] which provide a set of international benchmarks against which companies can prepare their climate labelling. Also, there are financial instruments which aim at transparently measuring the impact of investments. These include certified green, sustainable, and sustainability-linked bonds and loans which should follow the International Capital Market Association (ICMA) impact measurement standards.

While FIs are increasingly measuring and reporting on the impacts of climate mitigation, measuring the impact of climate adaptation and resilience investments is still rare. Part of the challenge is the heterogeneity of adaptation investments, which makes it hard to aggregate results at the portfolio level. Several initiatives have emerged to address this gap, including the Resilience Rating System and the Climate Resilience Metrics Framework.

BUILDING IMPACT REPORTING CAPACITY

IDB Invest is partnering with FIs with different levels of sophistication related to green lending and impact measurement to create tailor-made plans to improve their capacity to better serve the green segment, measure the impact of these activities, and capitalize on opportunities in primary and secondary markets.

Climate change represents one of the greatest challenges of our generation. FIs have the potential to direct capital flows towards climate investments in a meaningful way, and they have a strong business case to do so. However, the LAC region lags behind its peers in the provision of climate financing, partly because FIs still lack the required expertise. As such, achieving the green transition will be just as much about enhancing the capabilities of FIs as supporting them financially. ■

Additional Information

Authors: Galia Rabchinsky & Samantha Todd

For more information, contact:
galiar@iadb.org

This DEBrief discusses the importance of building the impact measurement and management capacities of financial institutions in Latin America and the Caribbean in order to boost climate finance flows in the region. For more information, see this blogpost.

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