NeF DeF
New Frontiers in International Development Finance

Climate Finance for Equitable Transitions

The Climate Finance Architecture

Professor Celine Tan

Key Messages

- Climate finance is a key legal, policy and operational plank of the multilateral climate change regime; it is central to meeting international legal climate obligations and driving policy and operational change locally, transnationally, and globally.

- Developed countries are primarily responsible for providing finance and taking the lead on mobilising finance from a variety of sources and channels, and for aligning financial activities with international climate change commitments.

- Climate finance is embedded in and delivered through international finacial architecture (IFA) but realigning the global financial system to meet international climate targets is and will remain challenging due to the structural characteristics of the IFA.

- Asymmetries in the governance of the global financial system mean that regulatory and policy design is predominantly set by developed countries; regulatory fragmentation in the IFA is likely to impede coordinated climate action.

- Realigning the global financial system to meet climate targets must also include alignment of its governance and regulatory structures to the principles of the multilateral climate regime, including greater voice, representation and equity, transparency and accountability.

What is Climate Finance?

Climate finance broadly refers to the financial resources necessary for actions to address climate change at local, national and international levels. While operational definitions may vary, climate finance is generally understood to refer 'to the financial resources dedicated to **mitigating** and adapting to climate change globally, including in the context of financial flows to developing countries'[1]. Climate finance also refers to financial resources to address **loss and damage** from the irreversible impacts of climate change.

> Climate finance is central to ensuring the legal obligations of the global climate change regime are met.

Although climate finance may be used in tandem with other finance to achieve broad sustainable development and environmental objectives (such as sustainability finance or green finance), the term has specific meaning in international law and policy. Climate finance is central to ensuring the legal obligations of the global climate change regime are met. Obligations of countries to undertake mitigation actions, support adaptation measures and address loss and damage occurring from climate change are contingent on the availability of finance to do so.

[1] UNFCC SCF (2021), 'Fourth (2020) Biennial Assessment and Overview of Climate Finance Flows', Bonn: UNFCCC, p. 7'

Climate finance needs to be mobilised and deployed to support:

(1) developed countries' own mitigation obligations under the multilateral climate regime, and address their own adaptation needs; and

(2) developing countries' mitigation commitments, adaptation needs and climate change loss and damage.

Climate finance is also important for paving the way towards a low-carbon and climate-resilient development pathway for developing countries. It should be **additional** to existing financing commitments from developed countries to developing countries, such as official development assistance (ODA) for sustainable development and humanitarian relief.

Climate finance can be drawn from public or private sources and involve a range of different official, commercial, philanthropic or other non-profit private organisations and financial instruments. It can take the form of grants, loans (concessional and non-concessional), guarantees, equity, bonds and other securities.

While international commitments continue to underscore the significance of public funds, there is a growing emphasis on mobilising private finance for climate action. Broadening the pool of climate finance is critical to close the substantial gap between the estimated US$4.5-5 trillion cost of climate action a year, and the US$632 billion a year (approximately 12 per cent of that cost) currently channelled towards climate investments[2]. Under the Paris Agreement, developed countries made a commitment to mobilise US$100 billion per year by 2025 to developing countries, but continue to fall significantly short, with financial flows amounting to just US$83.3 billion in 2020[3].

Legal and Policy Architecture of Climate Finance

Climate finance is a key legal, policy, and operational plank of the multilateral climate change regime, central to meeting international legal obligations and driving policy and operational change locally, transnationally and globally. Climate finance is also embedded in and delivered through the global financial system and the international legal and regulatory framework that supports it. The interplay between the global climate regime and the global financial architecture not only impacts global collective action on climate change, but also on countries' broader progress towards decarbonisation and sustainable development.

> “ The interplay between the global climate regime and the global financial architecture impacts collective action on climate change

Climate Finance under the Climate Regime

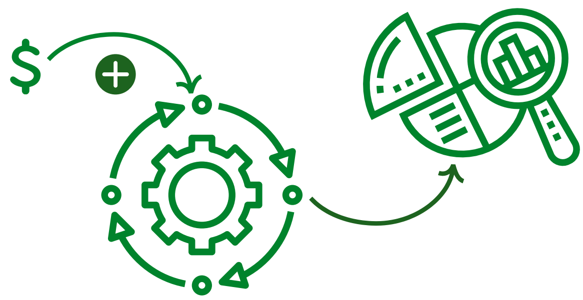
The UNFCCC is the main multilateral legal and policy framework for global action on climate change. Implementation of commitments under the **UNFCCC**, the **Kyoto Protocol** and the **Paris Agreement** are based on the principles of **equity** and **common but differentiated responsibilities and respective capabilities (CBDR-RC)**. All state parties to the UNFCCC agreements have obligations to combat climate change – but developed countries have greater obligations to undertake mitigation measures, and to support mitigation and adaptation in developing countries and address loss and damage from climate change impacts (Article 4 of the UNFCCC, Article 2 of the Kyoto Protocol and Article 2 of the Paris Agreement 2015).

Under the Paris Agreement, countries are required to 'prepare, communicate and maintain' nationally determined contributions (NDCs). These NDCs set out each country's efforts to reduce national emissions and adapt to climate change (Articles 4(2) and 7(1), Paris Agreement 2015).

[2] In 2019-20; see Buchner, B et al (2021), 'Global Landscape of Climate Finance 2021', December 2021, Climate Policy Initiative.
[3] OECD (2022), 'Climate Finance Provided and Mobilised by Developed Countries in 2016 – 20202: Insights from Disaggregated Analysis', Climate Finance and the USD 100 Billion Goal, Paris: OECD. The original goal was set for 2020 and this was extended to 2025 in 2015.

The principles underpinning the climate regime recognise the historical and contemporary contribution of developed countries to climate change (commonly known as the 'polluter pays' principle) and reflect their greater capacity to mitigate and adapt to climate change, compared to developing countries. The UNFCC also makes the relationship between climate change and sustainable development clear, stipulating that measures to combat climate change should not undermine economic growth in developing countries, and that therefore, the onus is on developed countries support transitions to a low-carbon and climate-resilient global economy. This includes obligations to provide financial resources to assist developing countries mitigate and adapt to climate change. Negotiations are ongoing to develop binding commitments on funding to avert, minimise and address loss and damage from climate change.

The UNFCCC is an international treaty; commitments undertaken by state parties to the Convention and associated agreements are binding international legal obligations. The provision of climate finance should be treated as an obligation on signatories to the agreements. The UNFCCC and Paris Agreement commit developed countries to providing financial resources to support mitigation and adaptation costs of developing countries (Articles 4(3) and 4(4) of the UNFCCC and Article 9(1) of the Paris Agreement). This means that while climate change considerations can form part of other resource transfers from developed countries to developing countries, including ODA and finance to meet the UN Sustainable Development Goals (SDGs), climate finance should be **new and additional** to existing financial flows. Other principles governing the mobilisation, administration and delivery of climate finance under the UNFCCC include predictability, accountability and transparency of resource flows.



Several funds have been established under the multilateral climate regime to provide financial resources to developing countries. The UNFCCC established a financial mechanism to provide finance support obligations under the Convention, with two designated operating entities: the Global Environment Facility (GEF) and Global Climate Fund (GCF). Other special funds have been established to support specific objectives under the climate regime, including the Adaptation Fund, Special Climate Change Fund (SCCF) and the Least Developed Country Fund (LCDF). The governance and oversight of the financial mechanism and the other funds rests with the UNFCCC member states, under the Conference of Parties (COP).

At the COP27 meeting in 2022, member states agreed to establish new funding arrangements for loss and damage, with a Transitional Committee tasked with the responsibility of operationalising this new fund. This fund is expected to complement existing work by the Warsaw International Mechanism for Loss and Damage associated with Climate Change Impacts (WIM) and the Santiago Network on Loss and Damage.

Climate finance is also delivered through other channels, notably through multilateral development banks (MDBs) such as the World Bank, and regional development banks, bilateral aid agencies and development finance institutions (DFIs). In fact, substantial volumes of climate finance are channelled through institutions and platforms outside the supervision of the UNFCCC COP.

MDBs play a significant role in the mobilisation and disbursement of climate finance via their own resources or external resources channelled through the banks, including as trustees to financial intermediary funds (FIFs) and as implementing agencies of UNFCCC funds. For example, the World Bank is both trustee and implementing agency of the GCF and the GEF so manages for these funds but also receives funds from the GCF and GEF to disburse to recipients. Bilateral and multi-donor initiatives are also proliferating in the climate finance arena, including the high-profile Just Energy Transition Partnerships (JETP) launched at COP26. Despite the proliferation of climate funds and increase in climate finance outside the UNFCCC, it remains challenging to accurately map, track and account for these flows, including assessing whether such flows meet the aforementioned principles established by the UNFCCC.

Climate Finance and the Global Financial Architecture

The global financial system is an increasing focus of the multilateral climate negotiations and vice-versa. One of the three long-term goals of the Paris Agreement is a commitment to '[m]aking finance flows consistent with a pathway towards low greenhouse gass emissions and climate-resilient development' (Article 2(1)(c) of the Paris Agreement). While there remains no agreed definition or common understanding of the scope of Article 2.1(c), this provision is seen as a key driver for calls on the private sector to play a more significant role in delivering climate finance and scaling up investments for climate action alongside Article 9(3) of the Paris Agreement which commits developed countries to take the lead in 'mobilizing climate finance from a wide variety of sources, instruments and channels', including private finance.

While the private sector and market mechanisms have always formed a small part of the existing climate finance framework, the imperative to close the climate finance gap have led to an acceleration of a private finance agenda, and efforts to hardwire climate considerations into the global financial system, with the aim of scaling up climate finance from billions to trillions, to meet international climate targets.

The Glasgow Climate Pact – the outcome of the COP26 – called on 'developed country Parties, MDBs and other financial institutions to accelerate the alignment of their financing activities with the goals of the Paris Agreement'. Since then, a range of different initiatives and platforms have been proposed and/or established to reaffirm the centrality of the financial system to the mobilisation and delivery of climate finance.

Mobilisation and Delivery

Public Finance

- Multilateral climate funds
- Bilateral agencies
- Development finance institutions
- Multilateral development banks
- Multistakeholder partnerships

Non-Profit Funds

- Philanthropic foundations
- Charities
- Non-governmental organisations

Private Finance

- Business
- Corporations
- Commercial banks
- Pension funds
- Insurance companies
- Venture capital
- Other investors

Climate Finance Architecture

International Climate Finance Commitments

- **Article 4(3) UNFCCC**: [Developed countries] shall provide new and additional financial resources to meet the agreed full costs incurred by developing country Parties in complying with their obligations under Article 12, paragraph 1. They shall also provide such financial resources, including for the transfer of technology, needed by the developing country Parties to meet the agreed full incremental costs of implementing measures that are covered by paragraph 1 of this Article.
- **Article 4(4) UNFCCC:** [Developed countries] shall also assist the developing country Parties that are particularly vulnerable to the adverse effects of climate change in meeting costs of adaptation to those adverse effects.
- **Article 4(7) UNFCCC:** The extent to which developing country Parties will effectively implement their commitments under the Convention will depend on the effective implementation by developed country Parties of their commitments under the Convention related to financial resources and transfer of technology and will take fully into account that economic and social development and poverty eradication are the first and overriding priorities of the developing country Parties.
- **Article 2(1)(c) Paris Agreement**: Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.
- **Article 2(2) Paris Agreement**: This Agreement will be implemented to reflect the equity and principle of common but differentiated responsibilities and respective capacities, in light of different national circumstances.

Epistemic Communities

Glasgow Financial Alliance for Net Zero
Global Sustainable Development Alliance
Network on Greening the Financial System

Regulation and Governance

International Monetary Fund (IMF)

Political Coordination Groups

- G7
- G20

Regulatory Authorities

- Central banks
- Monetary authorities
- Financial regulators and supervisors
- Regional arrangements, eg the European Commission and European Monetary Union (EMU)

Transgovernmental Networks and Informal Coordination Mechanisms

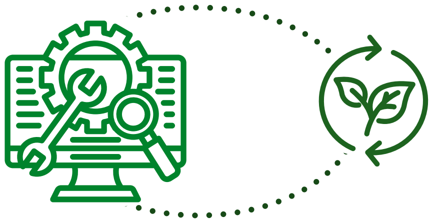
- Basel Committee on Banking Supervision
- Financial Stability Board
- International Organisation of Securities Commissions (IOSCO)
- Paris Club

Standard-Setting Agencies

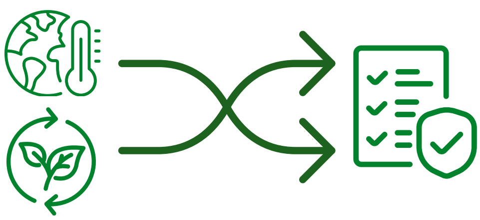
- International Capital Markets Association (ICMA)
- International Sustainability Standards Board (ISSB)
- Taskforce on Climate-Related Financial Disclosures (TCFD)

Three key policy directions for the global financial system can be discerned from international negotiations going forward:

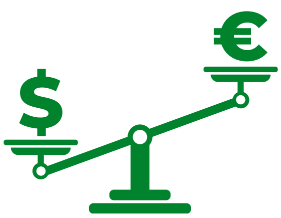
(1) **Mainstreaming climate considerations and climate action into financial policymaking and regulatory action** at domestic and international levels, including developing policies to integrate climate risks into financial decision-making, and promote green and low-carbon investments through international financial institutions (IFIs), central banks, monetary authorities, and financial services regulators.



(2) **Mobilising and leveraging private finance for climate action**, including incentivising new and adapting existing financial instruments for climate investments, such as green and sustainability-linked bonds and loans, and green asset-backed securities, providing catalytic finance through blended finance mechanisms and public-private partnerships (PPPs) and creating enabling legal, policy and regulatory environments to scale up private finance.



(3) **Retooling public finance to climate action**, including decarbonising MDB and DFI investment portfolios, creating new public finance facilities to support climate investments, and developing innovative mechanisms for addressing climate action and impacts, such as debt-for-nature swaps.

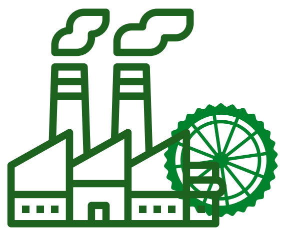


Realigning the global financial system to meet international climate targets will remain challenging, due to the inherent structural characteristics of the IFA. Unlike other areas of the global economy, there is no single framework for regulating global financial flows. Instead, a patchwork of regulatory networks and political coordination structures have emerged to deal with the challenges of global financial regulation. This policy and regulatory fragmentation is likely to impede coordinated action in aligning the financial system with climate objectives.

> No single framework regulates global financial flows – policy and regulatory fragmentation is likely to impede coordinated action to align the IFA and climate objectives

The International Monetary Fund (IMF) remains at the notional apex of this system of financial regulation, but its role is primarily reserved for policy advice, programme lending, risk assessments, technical assistance and capacity building, development of diagnostic tools, and surveillance of national economic policies. It can prescribe policy reforms as part of conditionalities of its lending and/or provide financing specifically related to climate-related fiscal constraints of member states, such as through its Resilience and Sustainability Trust (RST) or the Catastrophe Containment and Relief Trust (CCRT).

The IMF is also central to managing sovereign debt. Its debt sustainability assessments – the sovereign risk and debt sustainability framework (SRDSF) for market access countries and the joint IMF-World Bank debt sustainability framework (DSF) for low-income countries – provide the basis for global and national surveillance of debt-related risks, as well as sovereign debt restructuring negotiations and IMF lending programmes. Given its governance structure (which favours developed country members) and mandate, the IMF's influence is concentrated mainly on developing countries, who are reliant on its function as a lender of last resort[4].



[4] Bretton Woods Project (2020), 'IMF and World Bank Decision-Making and Governance', 7 April 2020,
2 UNFCC SCF (2021), 'Fourth (2020) Biennial Assessment and Overview of Climate Finance Flows', Bonn: UNFCCC, p. 33.'

Developing countries are rule-takers rather than rule-makers – institutional and policy design in the global financial system reflects existing economic and financial inequalities, leading to poorer outcomes for developing countries

Beyond the IMF, the climate finance agenda may be set by political coordination groups, such as the G7 or the G20, but climate finance policies will primarily be developed and operationalised through domestic monetary authorities, financial regulators and supervisory agencies, with coordination through transgovernmental networks, such as the Basel Committee on Banking Supervision and the Financial Stability Board (FSB), and private and multi-stakeholder standard-setting agencies, such as the International Capital Markets Association (ICMA) and the recently established International Sustainability Standards Board (ISSB). This reflects the regulatory landscape of international financial law and regulation, which is governed less by binding, formal rules than by so-called 'soft law' – non-binding norms and standards – and informal regulatory coordination.

Developing countries have less voice and representation in the global financial system compared to the multilateral climate regime, due to systemic asymmetries. They remain, for the most part, rule-takers rather than rule-makers in the IFA. Regulatory, institutional and policy design in the global financial system tend to reflect the interests of major financial centres and large capital markets; the composition of transgovernmental networks and private and multi-stakeholder standard-setting organisations do not have the same breadth of representation nor equitable structures of decision-making as intergovernmental fora, such as the UNFCCC. Instead, these networks can and do reproduce existing economic and financial inequalities among countries, and compound existing political and economic power disparities, leading to poorer outcomes for developing countries.

It is therefore imperative that the alignment of the global financial system with commitments under the multilateral climate architecture be accompanied by an alignment of the principles governing both regimes, including the principles of equity, CBDR, transparency and accountability, and a reform of the existing legal and regulatory landscape of international finance.

Further Resources

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About the Author

Professor Celine Tan
Professor of International Economic Law
University of Warwick
celine.tan@warwick.ac.uk

go.warwick.ac.uk/celinetan

About CLiFT

The Climate Finance for Equitable Transitions (CLiFT) project is a multi-institutional and multi-stakeholder initiative aimed at exploring the climate finance supply chain within the context of the multilateral climate change regime, international financial architecture and the multi-layered landscape of international economic law. For more information, please visit: go.warwick.ac.uk/nefdef/climatefinance