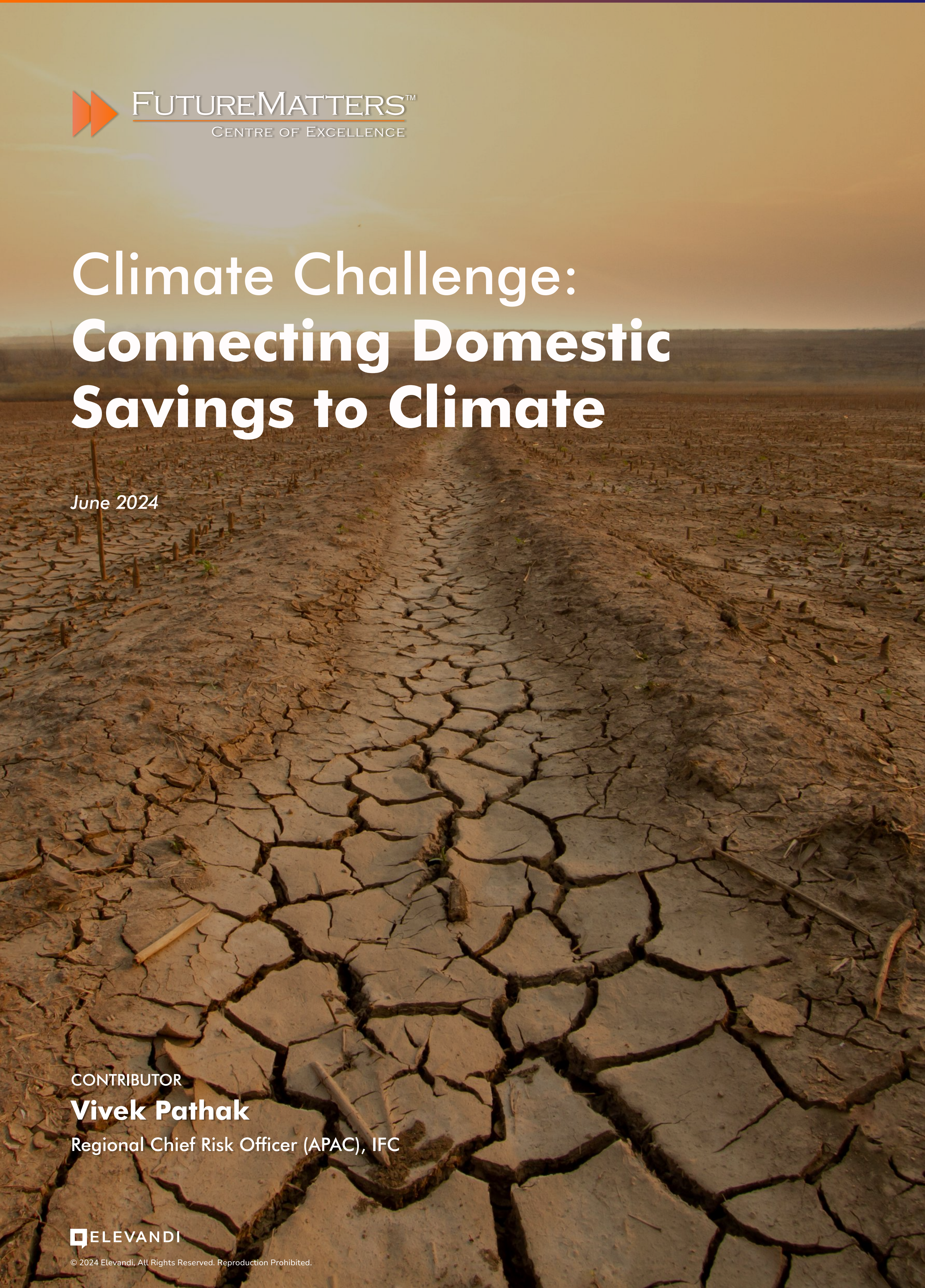

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Climate Challenge: **Connecting Domestic Savings to Climate**

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CONTRIBUTOR
Vivek Pathak
Regional Chief Risk Officer (APAC), IFC

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Content

INTRODUCTION

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A few years ago, I was on a flight from Venice to Frankfurt. The person beside me, who seemed like a wealthy pensioner, struck up conversation. On hearing that I worked in the climate change sector, she perked up and said the city of Venice needs to be saved from the dangers of climate change. I asked if she would invest her pension into climate projects in emerging markets—and got a resounding “no”.

Changing such perceptions is a key challenge: Emerging markets are struggling to raise capital to finance important sectors that will drive change. These include energy transitions, the decarbonisation of hard-to-abate sectors, and the agricultural value chain.

For countries to be successful in transitioning to a low carbon growth trajectory, the focus must be on Small- and Medium-sized Enterprises (SMEs), who play a critical role in shaping any economy. However, the likelihood of institutional investors financing SMEs in emerging markets is low, and it is clear we need another source of capital.

New roots

The world’s attention has been shifting toward bringing international capital—particularly, institutional investor finance—into the developing world.

While private investment flows into the top 20 emerging markets such as Brazil and India have grown almost 5x between 2010 and 2019 to US$29 billion[1], flows into 84 other emerging economies remained flat at US$3 to US$4 billion over the same period.

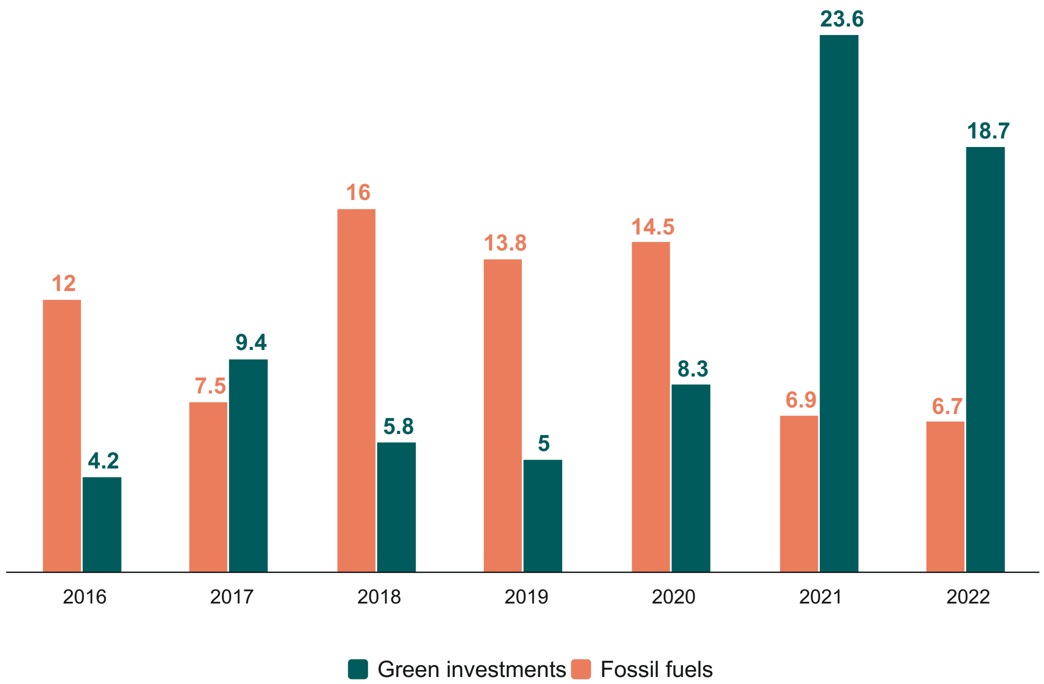
Sovereign wealth funds (SWF) are another important source of capital for long-term investment. In the past decade, we have seen a shift in SWF investments from fossil fuels to green investments. However, smaller emerging economies have only secured a minuscule part of this.

The importance of de-risking

For institutional investors, one obstacle is the scarcity of projects that meet the “risk-return” profile they are looking at, along with a lack of taxonomies and reporting standards.

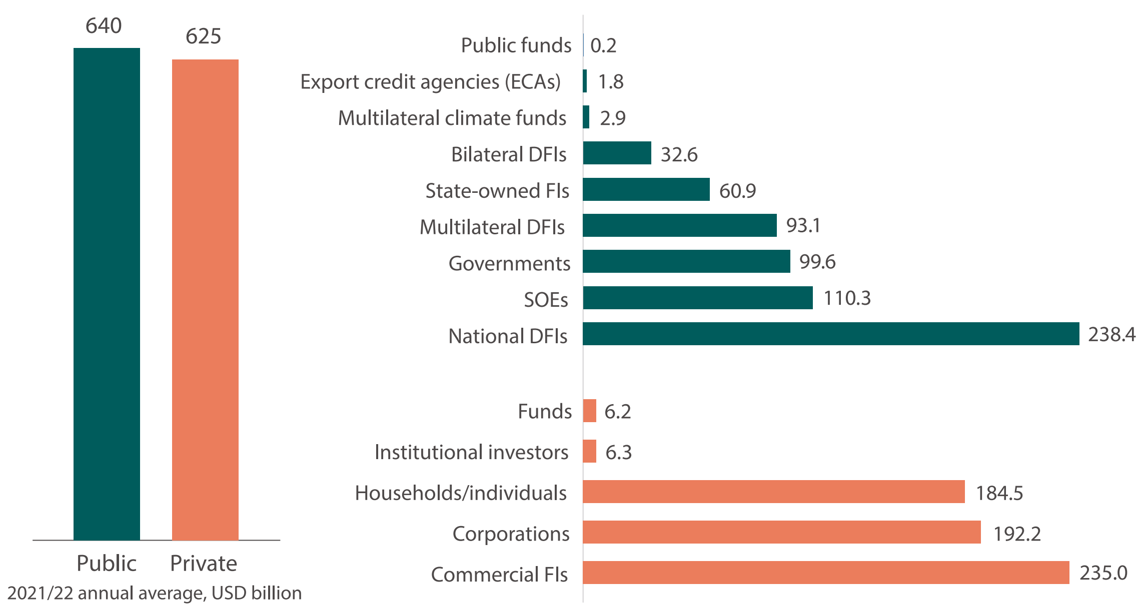
Another fundamental barrier is that clean energy technologies in developing countries typically require large upfront capital expenditure that is financed through foreign borrowing. Consequently, currency fluctuations must be borne by consumers—and ultimately, by the taxpayers of the borrowing country.

Fossil fuel investments and green investments by sovereign wealth funds, 2016-2022 (Billions of dollars)



Source: UNCTAD, based on Global SWF, January 2023.

Sources of public and private climate finance (USD bn)



Sources of public and private climate finance (USD bn)

We must therefore find ways to better tackle the climate challenge without this currency risk.

Part of the answer lies in ramping up access to domestic capital markets and domestic savings to address our climate challenges.

Given that most countries lack deep capital pockets to provide long-tenor local currency solutions, which are needed to address our climate challenges, the solution could be to connect countries' domestic savings to local projects.

Examples of domestic savings include insurance, pension funds, private equity, and commercial banks.

Notably, moving in this direction would require policy reform, regulations, the development of yield curves, and a better understanding of the risks associated with this asset class.

In Sub-Saharan Africa alone, local pension funds collectively manage around US$350 billion in assets.[2]

Meanwhile, India's National Pension System (NPS) had an estimated US$107 billion of assets under management in 2023.[3] Imagine how far these funds could go towards financing affordable climate energy solutions.

Looking inwards

Another important consideration is that domestic financing is often the only source available to SMEs, who account for 90% of private companies and up to 70% of employment[4]. They are also responsible for the livelihoods of over 2 billion people[5] and half of all greenhouse gas emissions.[6]

As large companies demand that their global supply chains meet environmental standards, small suppliers are likely to face intense pressure to go green. For example, 79% of all multinational corporations[7] say they will start removing slow-to-transition suppliers by 2025.

Recognisably, the quantum of domestic savings will not be adequate in meeting these emerging markets' needs. But they can play a critical role during the early stages of the climate transition—and more so in smaller markets that may not provide the scale needed by global institutional investors. The key benefits of increasing dependance on domestic capital are:

a) **Risk absorption:** In the early stages, blended finance may be needed to de-risk domestic investors. However, it is likely that they will be better placed to understand and take these risks over time.

b) **Concession risks:** The probability of a government reneging on concessions financed by domestic pensioners is relatively low.

c) **Currency risks:** These will be eliminated.

d) **SMEs stand to benefit:** These pools of capital are better suited to finance SMEs.

The path ahead

Given the magnitude of the challenge, we need to work with urgency on all fronts. This includes:

I) Linking key players such as financial institutions, utilities, governments, pension funds, and the private sector.

ii) Building and deepening domestic capital markets.

iii) Equipping the domestic financial sector with the adequate knowledge to assess opportunities with a focus on SMEs, as well as roll out the instruments required to guide green finance—from green[8] bonds to sustainability-linked finance[9].

iv) Focusing on public finance and regulatory reform. Strong policy frameworks, with the right incentives, could make projects more attractive to local investors and entrepreneurs.

v) Identifying both international and domestic blended finance, which can de-risk investments, and in the process help to scale up existing opportunities and launch new ones.

The International Finance Corporation's Green Banking Academy[10] is one initiative that has been working to address that need. More of these advisory opportunities are required for domestic financial institutions to develop green portfolios, design new financial products, and assess their own vulnerability to climate-related risks.

To advance the climate transition, mobilising domestic savings is as important as attracting international finance—and could ultimately help to expand the local market for global investors.

ABOUT THE AUTHOR

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I write about climate and development.

The author Vivek Pathak has been in private sector development in emerging markets for over 25 years, and serves as Regional Chief Risk Officer at IFC (a member of the World Bank Group). He is passionate about climate, and connecting private capital to the climate space.

The author's views are his own and do not reflect those of the company or its staff.

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