Economics & Finance

Zero Carbon Analytics

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Reforming climate finance: Unlocking funds from multilateral development banks

Key points:

- Multilateral development bank (MDB) funding is one of the fastest-growing sources of climate finance, increasing by nearly 3.3 times between 2012 and 2023.
- MDBs could unlock hundreds of billions of dollars more in financing if they implemented reforms such as taking on more risk, innovating and boosting transparency, according to a G20 report.
- Increased MDB funding will likely play an important role in the New Collective Quantified Goal (NCQG) – which will determine the amount of finance developing countries receive for climate mitigation and adaptation.

MDBs could unlock hundreds of billions in climate finance

Multilateral development banks hold over USD 1.8 trillion in assets globally and play a critical role in climate finance by providing and mobilising funds for climate mitigation and adaptation. In a report published in April 2023, Zero Carbon Analytics highlighted how MDBs, unlike commercial banks, have unique financial strengths such as callable capital and preferred creditor status. However, their capital adequacy frameworks (CAFs), which help them assess whether they have enough capital to absorb potential losses, still don't fully reflect these advantages. Risk aversion by MDBs, driven by a focus on maintaining AAA credit ratings, limits their willingness to expand lending, holding back billions in climate finance.

A G20 expert panel found that reforms by MDBs could unlock hundreds of billions of dollars of financing in the medium term, while posing negligible risk to their financial stability.[1] These reforms include taking on more risk, giving more credit to callable capital, innovating, improving credit rating agency assessments and boosting transparency.

This funding could be a step towards the USD 8.6 trillion in funding required annually to implement climate action plans globally by 2030.

MDBs make moderate progress on reforms

The Center for Global Development (CGD) has monitored progress by seven MDBs on several reforms, including the G20 recommendations.[2] In April CGD released an update to the tracker which showed that the majority of MDBs have indicated their intention to pursue most of the reform agenda items. In its October update, CGD said it was "a mixed picture, with promising signs of progress in some areas, while other important reforms

[1] For more information, see the Zero Carbon Analytics explainer: Climate change requires a new approach from international financial institutions.

[2] CDG reviewed progress by the African Development Bank, the Asian Development Bank (ADB), the Asian Infrastructure Investment Bank, the European Bank for Reconstruction and Development, EIB Global, the Inter-American Development Bank Group (IDBG), and the World Bank Group (WBG).

have not yet been initiated and relatively few reforms have been fully completed." The think tank added that some MDBs, including the Asian Development Bank and the Inter-American Development Bank Group, had made more progress than others.
At present, the progress the seven MDBs have made in implementing CAF measures could unlock up to USD 357 billion in additional lending headroom in the coming decade.

However, there are several further actions they could take to unlock further lending. S&P predicted that **MDBs could invest USD 500 billion–1 trillion more by revising their CAF policies**, while posing no risk to their current credit ratings. While Fitch Ratings found that a dozen **MDBs could collectively lend nearly USD 480 billion more before risking rating downgrades**.

Table 1: Progress by seven MDBs on reforms

CAF recommendation	Simple explanation	What progress has been made?
Redefine the approach to risk appetite for MDBs' Capital Adequacy Frameworks	Take more risk	Some limited progress has been made in this area. Less than half of the MDBs have pursued changes in shareholder-defined risk appetites, and the focus on capital efficiency has seen some MDBs attempt to open more lending headroom. However, there is significant room for improvement, particularly in adjusting leverage ratios or other capital adequacy metrics based on new risk tolerances.
Incorporate uplift from callable capital into CAF	Give credit to callable capital	Some progress has been made by institutions like the ADB which updated its CAF in September 2023, and IDBG which approved a new CAF that incorporates uplift from callable capital. These efforts are expected to unlock lending headroom. However, not all MDBs address callable capital explicitly.
Implement innovations to strengthen MDB capital adequacy and lending headroom	Innovate	Innovations like hybrid capital issuance are under consideration, but only AfDB has gone to market. Regular capital reviews are now a feature in more than half of the MDBs surveyed, although standardised metrics across institutions are lacking.
Improve credit rating agency (CRA) assessment of MDB financial strength	Improve credit rating agency assessments	There has been little progress, and it's still unclear if any top CRAs will agree to work with MDBs on reforming their rating methodology during the WBG/IMF Annual Meetings in October 2024.
Increase access to MDB data and analysis	Increase transparency	MDBs are making efforts to increase transparency and improve access to their data. Many institutions are working on implementing platforms and partnerships, including engaging with the Multilateral Investment Guarantee Agency and developing country platforms such as the Just Energy Transition Platforms.

Source: ODI, Data Dive: Unlocking a trillion dollars for development, September 2024 , CDG Are MDBs Actually Implementing Reforms?, April 2024, G20 Independent Expert Group on Strengthening MDBs: Implementing MDB Reforms: A Stocktake, April 2024 • Climate Finance Reform Compass, accessed October 2024

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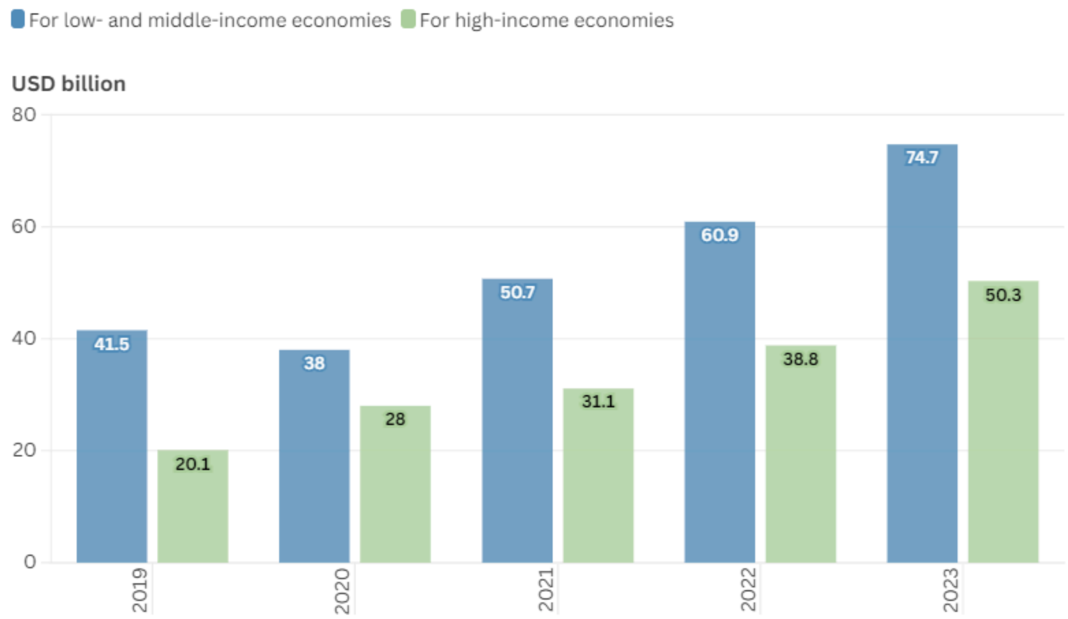
MDBs' current contribution to climate finance

MDBs' current contributions to climate finance falls short of the trillions of dollars required annually to address climate change. In 2022, USD 1.26 trillion was invested in climate finance globally- with MDBs providing 8%[3] of this amount. MDBs' contribution accounts for about 1% of the USD 8.6 trillion in climate finance needed annually by 2030. However, MDB's contribution to climate finance is increasing each year. In 2023, MDBs provided about USD 125 billion for climate finance, up 26% from USD 99.45 billion in 2022. The majority of this funding goes to climate mitigation. In 2023, 67% of funding by MDBs went to climate mitigation, while 33% went to adaptation.

In 2023, 60% of climate finance by MDBs went to low-income and middle-income economies – totalling around USD 74.7 billion. About 63% of this finance was provided in the form of loans[4] – in a context where 53% of low-income countries are in or at risk of debt distress.

Figure 1: MDB's climate finance per region per type of income



Source: Zero Carbon Analytics analysis; EBRD, 2019 Joint Report on Multilateral Development Banks' Climate Finance, August 2021; EBRD, 2020 Joint Report on Multilateral Development Banks' Climate Finance, August 2021; EBRD, 2021 Joint Report on Multilateral Development Banks' Climate Finance, October 2022; EIB, 2022 Joint Report on Multilateral Development Banks' Climate Finance, November 2023; EIB, 2023 Joint Report on Multilateral Development Banks' Climate Finance, September 2024.

Under-utilised finance tools by MDBs

In addition to the reforms in Table 1, MDBs could make greater use of several financial tools to scale up financing to developing countries. Equity finance currently makes up only about 1.8% of MDBs' climate finance commitments in emerging markets and developing economies, according to the IMF. Equity finance currently accounts for 1.8% of MDBs' commitments to climate finance in emerging markets and developing economies. However, equity investments by MDBs could draw in more private finance. Currently, every USD 1 invested by MDBs attracts USD 1.2 of private finance. By increasing equity

[3] Zero Carbon Analytics estimation based on USD 99.45 billion.
[4] Zero Carbon Analytics analysis based on USD 47 billion (page 55) channelled through investment loans.

investment, MDBs can signal to private investors that projects are viable and worth supporting. This can help reduce perceived risks and mobilise significantly more private capital.

Private sector actors often emphasise that guarantees – where MDBs commit to repaying a loan if the borrower is unable to – are useful for making investments viable as they reduce risk and lower debt costs. Guarantees also have the highest mobilisation ratios, attracting an average of USD 1.5 in private capital for every USD 1 invested by MDBs, outperforming loans and equities by six times. However, despite their effectiveness, guarantees currently only account for 4% of MDBs' total climate finance commitments.

Similarly, project development typically accounts for 2-5% of a project's total cost but can attract 20-50 times more early-stage investment. This leverage effect is critical in mitigating development risk, making early-stage funding more accessible and effective in advancing project viability. MDBs could leverage concessional financing to establish and expand project development facilities that offer technical assistance, advisory services, and customised models to foster earlier investment and help scale investment-ready projects in developing countries.

Role of MDBs in the NCQG

The NCQG on climate finance is currently being negotiated ahead of COP29 in Azerbaijan. The stakes are high — the outcome of the negotiations will determine the size, contributors to and the scope of the new goal to support developing countries' climate action. Achieving climate action (a four-fold increase in adaptation, resilience and mitigation compared to 2019), in developing countries excluding China requires additional annual investments of USD 1.8 trillion by 2030, while meeting SDGs needs extra spending of USD 1.2 trillion per year. The G20 expert group recommends channelling **USD 260 billion** annually through MDBs to achieve the goal, 78% of which should come from non-concessional lending.

In light of this, the NCQG is likely to target an amount significantly larger than the USD 100 billion climate finance goal set in 2009, according to Boston University's Global Development Policy Center. It would be difficult to meet the new goal "without major increases in MDB climate finance" the report said. MDB funding is the fastest-growing source of climate finance, increasing by nearly 3.3 times between 2013 and 2022. In addition, MDBs increased the amount of climate finance provided to low-and middle-income economies by over 26% in 2023 from 2022.

However, researchers have pointed out that while MDB climate finance is likely to play an important role in the new NCQG, it should complement, not replace, grant-based finance. The new NCQG should differentiate clearly between different types of public finance, so the growth in MDB finance does not displace other forms of climate finance.