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Reset Canada's Approach to International Climate Finance

Submission to Climate Finance Consultation

Prepared by Canadian International Development Platform (CIDP) & Engineers Without Borders Canada (EWB)

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As the Government of Canada's (GoC) backgrounder notes "climate change is one of the greatest challenges facing humanity today and one that affects all countries". 'Greening the economy' and Canada's global footprint are key features of GoC's "building back better" narrative. Climate change has varied and complex effects on Canada's foreign policy, development cooperation, national security, and global standing. Climate risks threaten to undo gains in several domains of development policy, from food security to health and nutrition to economic security, gender equality and human rights. Given this context, based on our analysis, **Canada's approach to international climate finance (ICF) requires a hard reset**. The main reasons are as follows:

- The overall level, type, and structure of financial support for ICF from Canada is out of step with its ambitious global rhetoric.
- Canada's approach to ICF is increasingly incoherent with its own 'feminist' development strategy.
- Budget constraints, limited internal capacity, and pressures to demonstrate too many inconsistent "results" out of the same quantum of investment leads to a program that fails to clearly define objectives, prioritize meaningful climate outcomes, let alone other areas.
- A key weakness is GAC's ill-defined approach to risk; its unpreparedness and inability to work with the private sector or leverage private capital and know-how.
- These factors explain Canada's very lopsided climate finance portfolio (in terms of the balance between channels, bilateral vs multilateral; and instruments, grants vs debt) and makes it an outlier among climate donors.

Since the PM announced the CAD$2.65bn 2015-20 ICF commitment in the lead up to COP21, it is difficult to conclude that Canada's approach has been driven by anything other than bureaucratic efficacy or the need to 'get money out the door quickly'. This is not best way to pursue, let alone achieve, tangible climate results. Global Affairs Canada (GAC) has been unable to convincingly demonstrate what precisely has been achieved in terms of climate and development outcomes via this investment or that it was the best possible use of scarce budget room.[1] For these reasons **Canada's approach to ICF now requires nothing short of a hard reset**.

Rethink Canada's international climate finance (ICF) contributions from the ground up

Canada's ICF contributions are managed almost exclusively by GAC and financed entirely out of the International Assistance Envelope (IAE). This is routine given the IAE funds almost all of Canada's eventual "ODA" or foreign aid, and all ICF is expected to qualify as ODA. However, **things get problematic when the IAE which is best used to support grant-based ODA, is used to finance other instruments, or, becomes exposed to budgetary vagaries outside of programming control**. Such vagaries if not matched by commensurate increases in the IAE, very directly lead to less money for other grant-reliant aid programs in essential sectors (such as health and education) that for better or worse are being made to compete for the same resources.

A close examination (of not always transparent data) will show that this is precisely what has happened since Canada announced a so-called "doubling" of climate finance in late 2015. The announced CAD$2.65bn (which in fact was not a doubling) was not matched with a commensurate increase in the IAE. **The result is 'robbing Peter to pay Paul'.**

[1] At a more disaggregated level – project/investment specific – most projects do not report results, but only "expected outcomes". This is unlike other donors. For e.g. the UK's ICF produces an annual report that details emissions reduced or avoided. Other donors (Norway, France) do similarly at the fund/program level.

It merely gives the impression of an increase. Which is corroborated by the fact that Canada's ODA levels and ODA/GNI ratios have remained static if not declined (in real terms).

Almost all of Canada's CAD$2.65bn has gone to multilateral institutions (upwards of 92% in some years since 2016). Our analysis demonstrates that the main climate investments (principal level) have gone from entirely grants (pre 2015) to **almost exclusively debt-instruments (over 80% in 2018)**. **Yet these are "debt" in name only.** Canada's largest climate finance investments are inputs to multilateral trust funds. While officially recognized as "debt", for all practical purposes they are grants. While they support 'on-lending' i.e. loans, none of the yield is earned by Canada, repatriated, or used to recapitalize further investment. In essence**, Canada is using scarce grant resources to pay multilateral institutions' (non-transparent and not insignificant) fees to further subsidize their on-lending which we already support via other contributions.[2] This is a highly problematic use of scarce aid money.**

We discuss the move from grants to debt further below, however a factor that gets little attention worth highlighting here is the treatment of currency effects. During this period (since 2015) the CAD$ depreciated meaningfully against the USD, the main currency of multilateral institutions. **Because Canada has relied so heavily on multilateral institutions to intermediate its climate finance a key issue is how currency effects are accommodated. Our analysis indicates that other areas within the IAE (e.g. 'core development') have had to "absorb" the currency effect stemming from international financial institution (IFI) commitments**. In the context of no or limited inputs into the IAE this very directly implies less money for competing grant-reliant aid investments.

In funding ICF 2.0 GoC (primarily Finance Canada and PMO) must seriously think through the following questions:

- Should the IAE be the sole source of Canada's ICF, including funds that on-lend?
- Should the management of these resources be led by GAC?
- Should grant-like IAE resources be used to subsidize multilateral on-lending, at the expense of other important grant-reliant areas?
- Is it worth the high fees paid to multilateral institutions to host Canada-branded trust funds?

The answer in our view is clear - no. Funds that on-lend can be supported via balance sheet (for e.g. crown corporation) and need not be exclusively grant funded. **The funding structure, level, type, and expectation of Canada's investment needs to be rethought from the ground-up at the input side**. Each of the Canadian branded multilateral climate funds i.e. at the Inter-American and Asian Development Bank and at the International Finance Corporation, are follow-ons. The original funds were created at a time when GAC lacked authorities to carry out such investments. This is no longer the case since approval of its International Assistance Innovation Program (which has been merged into climate finance). The same or **better results can be achieved at lower cost working more directly with climate fund managers and local partners, including Canadian institutions with relevant expertise**.

Respond to the lack of coherence between Canada's approach to ICF and its FIAP gender targets

The pressure to meet too many objectives with the same limited quantum of resources is clearest to see in the incoherence between Canada's ICF and its FIAP gender targets. **Clearly gender and feminist approaches to development are hugely important in their own right, but combining "climate washing" with "gender washing" serves neither objective and fails both**.

[2] And yet the net effect is that Canada's relative standing within climate multilaterals is declining. A case in point is the recent replenishment of the Green Climate Fund (GCF) (signed in March 2020). Despite hosting the GCF – an organization whose senior management was in shambles until a recent executive overhaul – in Ottawa in 2019, unlike other serious climate donors (e.g. Norway, to which Canada lost its UNSC bid) Canada failed to increase its support which was held at the CAD$300mn level. However due to currency effects, Canada's USD contribution and relative standing in the GCF declined.

The FIAP's aggressive gender targets (95% gender-integrated, including 15% gender-principal investment by 2021-22) present a significant challenge because **there is simply very little overlap between gender and climate investments. Approximately 60% of DAC climate finance either does not target or is not even screened for gender**.

Since the launch of FIAP, gender-principal investments account for less than 2% of Canada's climate finance. Canada's preferred approach since 2015 - increasing use of debt instruments intermediated via multilaterals - further limits the ability to focus on gender within climate finance. This approach raises questions regarding the coherence of Canada's ICF strategy from the perspective of the FIAP's gender targets.

In pretending that climate principal investments can be made gender principal anywhere near the FIAP's ambition, Canada is setting itself up for failure. ICF 2.0 would do well to first and foremost go beyond generalities and recognize the limited practical overlap between climate and gender investment. ICF 2.0 needs **fresh and additional resources, and the right fit between modalities and objectives**. **To pursue gender objectives in the climate space Canada needs to allocate a greater level of bilaterally allocable grant funding** that can be directed to niche partners. GAC must honestly and critically examine whether such objectives are practically achievable. Most climate specialists are not, nor can be expected to be, gender specialists. The experience of other donors shows pursuing climate and gender simultaneously may require significant investment in capacity building and technical assistance. It is up to GoC/GAC to prioritize among competing expectations. Stapling on more conditions makes little sense.[3]

Define Canada's approach to risk and parameters for private sector engagement (PSE)

Canada's risk tolerance and approach to risk, as relates climate finance specifically but also more generally, remain ill-defined. While this starts at the input side, i.e. political direction, and oversight, from Finance Canada, Treasury Board, and ultimately Prime Minister's Office (PMO), arguably **the weakest link in the chain is GAC's ill-considered (seemingly highly risk averse) approach**.

GAC's approach is limited by lack of internal capacity and a myopic perspective on risk-return. Climate finance is subject to multiple overlapping and inconsistent expectations with little prioritization. Our research, including for GAC itself, has repeatedly shown that **the department is unprepared and or simply unable to work with the private sector**, and contrary to much of its blended finance policy rhetoric, lacks understanding of leveraging private capital.

Clear evidence of this is GAC's much hyped International Assistance Innovation Program announced and approved in Budget 2018 as a "doubling" of assistance provided using "innovative finance tools". To date, this program has **failed to approve a single project** of note. The program has been merged into climate finance and is being "rebooted". **These again are CAD$1.5bn of IAE funds that could have been put to better use elsewhere**.

Despite years of 'integration' GAC's approach to the **trade-development nexus** – a priority across most major donors – **remains unclear and weak**. ICF could have been an ideal space to forge such links, given the unique value proposition many innovative Canadian companies bring to the climate space and the recognized importance of leveraging private capital. However, ICF 1.0 was a missed opportunity in this regard. To our knowledge **not $1 of private capital has been leveraged by this investment**.

The only possible conclusion to draw from the above is that GAC's approach to risk and record on private sector engagement is alarming even by its own exceptionally low standards and demands a serious review. Other government departments which have much greater climate science and PSE expertise (e.g. Environment ECCC; Natural Resources NRCan; Industry ISED; GAC Trade) should empowered to play a much bigger role in ICF 2.0. This does not require more resources but a more balanced whole of government approach to ICF.[4]

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[3] As GAC officials did recently during consultations by adding gender goals within climate also need to blend private capital and be consistent with the decision to prioritize loans over grants.
[4] Over 90% of Canada's ICF flows through GAC. For the UK and France only approx. 75% is channeled via DFID, AFD respectively; US less than 50% via USAID; Germany only 40% via BMZ.

Canada's principal level ICF portfolio is now almost entirely debt instruments intermediated via multilateral institutions. In a recent analysis **we compared Canada's debt-based climate finance portfolio with the 4 other major donors in this space** (Japan, Germany, France, Korea). Main findings are as follows:

- **Canada's trend in the use of financial modalities contrasts that of most donors**. In recent years DAC donors have shifted away from loans to increasing use of grants. Canada has done just the opposite. **Grants make up about 60% of most donor's principal ICF, they only make up 20% of Canada's (2018).**
- Canada's use of debt differs markedly from other donors as it is channeled exclusively via multilaterals. This is unlike any of the **major debt providers who use debt more directly** to support developing country governments and or public and private institutions that undertake project finance in the climate space.
- **Investment ticket sizes differ by an order of magnitude**. In 2018, major debt providers' ticket sizes routinely ranged between $500mn to over $1billion. By contrast, Canada's largest individual investments (e.g. via IFC) were under $40mn.
- **Attribution of impacts (as well as risks) for other donors is much clearer and more direct** because donor investment makes up a much larger share of projects. Canada's share of onward program investment tends to be much smaller (e.g. 10%-15% in the case of IFC).
- Major investments tend to support large-scale infrastructure (high-speed rail, metros, roads, power plants), and **Japanese, German, French, and Korean infrastructure majors are typically heavily involved** in donor-funded projects in developing countries. By contrast **Canadian private sector involvement in Canada's climate finance projects is non-existent**.
- Our analysis points to **serious questions regarding Canada's multilateral ICF investments** which are difficult to address fully due to lack of transparency:
    - **Who is really calling the shots? While these funds are branded "Canadian" this is an exaggeration**. A typical example is CCFPS2 at the Asian Development Bank (ADB). In this case ADB is entirely responsible for the selection, approval, and monitoring of projects.
    - **Who exactly is being 'de-risked'?** Canadian funds support highly concessional loans (sr. loans, subordinate debt), but not equity, provided to non-sovereign guaranteed small projects. Canadian investments never exceed 50% of total cost. We looked at participation alongside Canadian funds. **In most cases the only other participant is the multilateral institution itself**.
    - **Is there any evidence of leveraging private capital?** This question requires a detailed portfolio review and access to information beyond our purview. Leveraging private capital is the key principal underlying 'blended finance' which features prominently in GAC's ICF rhetoric. Our analysis found **no evidence of private capital mobilization**. Moreover, multilaterals have a poor and worsening record on private leverage. According to their own reporting, **for $1 in climate finance the ADB mobilized only $0.28 in private capital, IDB $0.16, World Bank $0.39**.
- **Far from demonstrating leverage, Canadian funds may very well be distorting the market**. Canada provides excessively cheap financing (below 2%) which prices private investors out. Canadian funds are being used in effect to de-risk risk averse multilateral institutions. This makes no sense.
- **Why does it happen? The main reason is GAC/GoC's ill-defined and ill-considered approach to risk**. Multilaterals, by definition, are viewed as low risk. This makes it easy to 'get money out the door' (i.e. bureaucratic efficacy). While multilaterals deliver little by way of private leverage, they do succeed in giving the impression of leverage. This seems to fit Canada's requirements. **GAC and Finance need to ask the following: do these trust funds provide something additional that the multilaterals don't already provide?**
- The answer we suspect is no. If serious about attracting private capital, **Canada should price its inputs higher, take appropriate risk, offer equity,** work with mid-market companies or with climate funds of which there are several across a wide risk spectrum. In the long run this will be far more impactful than working exclusively via multilaterals.

Resources

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About the Canadian International Development Platform (CIDP)

CIDP is based at the Norman Paterson School of International Affairs, Carleton University (Ottawa, Canada). We conduct independent, non-partisan policy research and data analytics in 3 main areas: foreign assistance; trade and investment; migration and remittances. The goal of the Platform is to provide a comprehensive picture of Canada's engagement on global development and engage Canadians on development issues by grounding discussions in the best available evidence. We maintain the most comprehensive, accurate and up-to-date high-quality data on Canada's aid, trade, investment, migration and remittances, and conduct policy analyses based on the same which are available at: www.cidpnsi.ca

About Engineers Without Borders Canada (EWB)

EWB brings people and ideas together to tackle the most crucial causes of poverty and inequality. The organization provides systems change leadership training and opportunities for 1,800+ active members through a network of 40 chapters in Canada; seed funding, talent and mentorship to social entrepreneurs in sub-Saharan Africa, enabling them to scale their success and transform the lives of people in their communities; and evidence-based policy recommendations on Canada's international development assistance and financing activities by working collaboratively with researchers, civil society and parliamentarians across the country. EWB is a registered Canadian charity. For more information on its work and global impact, visit www.ewb.ca.