



Climate Finance: Accelerating the Transition to Carbon Neutrality and Climate Resilience

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- » The Multilateral Development Banks (MDBs) approach to align their financial flows with the Paris Agreement includes the objective to increase climate finance.
- » This memo assesses how MDBs can ensure that all climate finance is aligned with the three goals of the Paris Agreement and identifies focus areas for climate finance.
- » We argue that not everything that is Paris-aligned will be climate finance, but everything that is climate finance should also be Paris-aligned.
- » We recommend that only those activities that will continue to be part of a decarbonized economy are eligible for 'climate finance'. Fossil fuel-related activities, even those that increase efficiency, should thus not be labelled climate finance.
- » Climate finance must be trackable, comparable and not at risk of double-counting in accordance with the Paris Agreement's objective of increased transparency.

Introduction

At COP24 the Multilateral Development Banks (MDBs) announced their vision to align financial flows with the objectives of the Paris Agreement, based on six building blocks identified as core areas for such an alignment. Following this, the MDBs further announced, at the margins of the United Nations Climate Action Summit (UNCAS) 2019, that they would collectively raise at least \$65 billion annually in climate finance by 2025. Within this amount, they intend to double their adaptation finance to \$18 billion annually. Furthermore, they aim to mobilize an additional \$40 billion in climate investments annually from private sector investors.

Through these commitments, MDBs provide important signals to other public and commercial investors. Mitigation and adaptation finance will need to increase significantly and, in many cases, will need to be provided on concessional terms, to enable all countries to champion a transition to net zero CO₂-emitting climate-resilient pathways.

Overarching Principles

To use climate finance to accelerate the transition to climate resilience and actively support low-emissions development pathways, Multilateral Development Banks (MDBs) will need to align their climate finance investments and climate co-finance with the Paris Agreement objectives. The following overarching principles lay the groundwork:

1 | Not everything that is Paris aligned will be climate finance, but everything that is climate finance should also be Paris aligned. Eligibility criteria for climate finance investments will thus need to ensure that (i) the activity is consistent with a low-carbon climate-resilient development pathway (Paris-aligned investment) and (ii) the activity is projected to be part of a decarbonized economy (Paris-aligned climate finance), thereby sending a clear signal to markets of where future-proof investment opportunities lie. CO₂-emitting activities that can be part of the pathway to decarbonization only for a limited remaining timespan between now and 2050 should not be eligible for climate finance under a Paris-aligned framework, independent of their lifetime.

2 | Accountability on climate finance requires that it is traceable, comparable and not at risk of double-counting in accordance with the Paris Agreement's objective of increased transparency. Data should be reported at aggregate and activity level. Methodologies across MDBs, across their different reports and with respect to other relevant actors, such as the OECD, need to be standardized to avoid double-counting and increase the level of disaggregation to increase comparability in order to build trust with the public and private sector.

3 | Article 9.4 of the Paris Agreement calls for a balance between adaptation and mitigation through the provision of scaled-up financial resources when addressing climate change. Achieving adaptation finance is key to ensuring a climate-resilient development pathway, especially for the most vulnerable. This does not necessarily mean that MDB mitigation finance and adaptation finance need to reach a 50:50 share, as MDBs use two different accounting approaches for mitigation finance (total project cost) and adaptation finance (incremental cost). Nevertheless, the overall share of adaptation finance in all climate finance needs to grow.

4 | Incentive structures should accommodate the nature of Paris-aligned projects. Internal incentive structures and key performance indicators must accommodate and favor the nature of climate finance projects, which might differ from MDBs' traditional portfolios. Staff compensation should be based on Paris-aligned climate finance-related performance indicators.

5 | All commitments related to the Convention and the Paris Agreement should be honored. International financial institutions that serve as international Accredited Entities (AEs) of the operating entities of the UNFCCC's Financial Mechanism need to comply with the obligations as set out under the UNFCCC's Financial Mechanism.

Implementing Building Block 3

Aligning MDBs' approach to prioritize, target and report on climate finance with the Paris Agreement

Review of MDBs eligibility criteria for climate finance

Since 2012 a growing group of MDBs are jointly reporting on the climate finance they invest and help mobilize, and in this context have developed joint eligibility criteria. The eligibility criteria do not yet reflect recent scientific findings of investment needed to achieve the Paris goals. The joint MDB Climate Finance Tracking Group has adjusted the method over time, increasing its stringency and, in 2015, harmonizing criteria with the International Development Finance Club – a group of national and sub-regional development banks. Since 2016, MDBs have directly referred to compatibility with low-emissions pathways as mentioned in the Paris Agreement as a criterion for eligibility for mitigation climate finance.

Yet, no clear definition of low-carbon or climate-resilient pathways or of criteria in line with net-zero CO₂ emissions and fostered climate resilience is included in the joint climate finance report. MDBs have thus begun a review process to strengthen the Common Principles for mitigation finance tracking, which is expected to be completed in mid-2020. MDBs also published a

paper on lessons learned from the Common Principles for adaptation finance¹ tracking, but have not yet announced further steps on the review of these.²

Under a Paris Alignment Paradigm, mitigation finance must go beyond the principles of reducing green house gas (GHG) emissions or enhancing GHG sequestration, towards financing the activities that actively support the Paris Agreement and thus a net-zero emissions and climate-resilient world.

In the power supply sector, climate finance that actively supports net-zero CO₂ emissions include power generation from solar, wind, small hydro, tidal, wave and ocean, or electricity system flexibility options. Transport infrastructure that actively supports this goal includes zero-carbon transport fueling infrastructure, non-motorized transport infrastructure, integration of transport and urban development planning, electric rail and rolling stock, electric public transport, transport and travel demand management measures.³ An updated eligibility list for mitigation finance would send a strong signal to markets about the activities that will continue to be part of a net-zero CO₂ economy.¹ Limiting climate finance to these activities, therefore, will add value towards Paris alignment efforts.

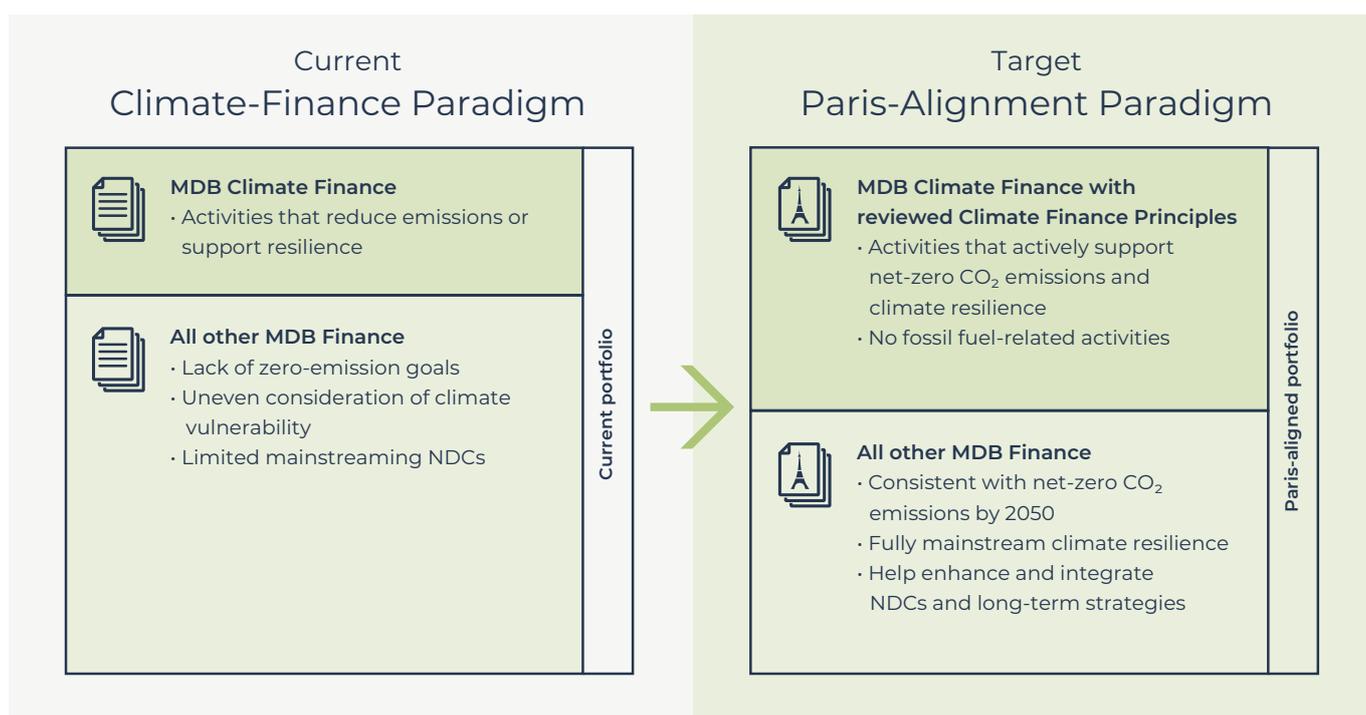


Figure 1 | New definition of climate finance under a Paris Alignment Paradigm (Own figure based on Larsen et al. 2018)

To support the signal of where the transformation is going, this memo recommends that bridge technologies and CO₂-emitting activities that can be part of the pathway to decarbonization only for a limited remaining timespan between now and 2050 should not be eligible for climate finance, independent of the lifetime of the investment. MDBs might nevertheless decide to continue to finance these for the remaining timespan using specific assessment criteria to assess alignment.

For adaptation finance, the existing qualitative approach for eligibility appears to be adequate also under a Paris Alignment Paradigm. In this area it is of most importance to integrate impact indicators into corporate results frameworks and climate finance reporting (see next section). In particular, not only resilience of investments but also resilience through investments needs to be strengthened (see Memo 2).

1. MDBs should use the **update of climate finance eligibility criteria** to focus resources on those activities that actively support net-zero CO₂ emissions and climate resilience, excluding any fossil fuel-related investments.

Revising climate finance reporting metrics

Transparency is a substantial requirement of the Paris Agreement and thus of Paris alignment. The current methodologies focus on harmonized reporting of aggregate volumes of finance invested in either climate change mitigation, climate change adaptation or cross-cutting sectors – covering each of the banks, source of funds, type of instruments used, covered regions, sectors grouping and recipient or borrower types.

It will be a key task for MDBs to develop indicators that also reflect impacts and to report on these. Finance volumes provide relevant information in the light of tracking progress in meeting investment needs. However, there can be a conflict of objectives between increasing volumes of MDB climate finance and investing in projects where fossil-free and climate-resilient options are hardest to achieve but potentially most needed. The latter represent the investment areas in which MDBs could bring about the

most additionality and transformational impacts. The banks have announced that they will develop impact indicators during the review of the climate finance methodology.

Accountability can only be ensured if climate finance is traceable at aggregate levels as well as at activity levels. The joint report currently does not reference project databases and individual banks' annual reports where further information on climate finance projects can be found. If this was to happen, then providing these links and ensuring that individual databases contain the standardized possibility to filter for (i) mitigation finance, (ii) adaptation finance and (iii) climate co-finance, as well as for (iv) country, (v) harmonized sector categories and (vi) year of commitment would now be desirable.

The MDBs' methodology to track climate co-finance (public and private direct and indirect mobilization for climate finance activities) differs from the OECD methodology to account for private finance mobilization. For example, in cases where several public actors (eg, MDBs and development finance institutions – DFIs) are involved in the same transaction mobilizing private finance, the MDB approach attributes all private finance mobilization to whichever MDB is the official arranger of the transaction, whereas the OECD approach attributes private finance mobilization proportionally to all public institutions in the transaction, also taking into account the risk taken and role played in the co-financing arrangement (eg, lead vs participant, senior vs junior investment).⁴ As MDBs as well as other public institutions are asked to report their private finance mobilization to the OECD Development Assistance Committee (DAC), this can lead to double-counting and attribution issues with other investors. Standardizing the two approaches would “help inform policies, ensure credibility [...] and build trust with the public but also the private sector”.⁵ Alternatively, MDBs could use both approaches in parallel: the MDB approach in MDB reporting to ensure comparability with historic reports, and the OECD approach when reporting to the OECD to avoid double-counting and to support international processes, such as tracing progress on the \$100 billion climate finance goal of the Paris Agreement and, more

⁴ To reflect innovation that cannot be anticipated, the eligibility list could in addition generally include activities that neither generate direct emissions nor induce significant indirect emissions (no significant emissions generated), but do reduce emissions as compared to a realistic project alternative (avoided emissions). To provide the best possible guidance, the eligibility list should be regularly updated and reflect scientific findings on activities in line with a decarbonized economy. In addition, the eligibility lists should be updated regularly to reflect innovation.

broadly to accurately measure the mobilization of finance for development purposes.

1. MDBs should include a set of harmonized mitigation and adaptation impact metrics into the joint report on climate finance, including indicators that reflect transformational impacts of projects.
2. MDBs should also ensure comparability and traceability of data back to activity level, making publicly available the file with the activity-level data that underpins the MDB joint report (with links to individual MDBs' own project databases and project documents).
3. MDBs should consider harmonizing their reporting on private climate finance mobilization with the OECD and reporting harmonized information to the OECD DAC to avoid risks of double-counting and to reduce internal and external transaction costs.

Aligning by better prioritizing and targeting climate finance investments

The common reporting coupled with individual climate finance targets have helped prioritize and thus increase climate finance volumes over time. As yet, not all the banks have announced post-2020 targets, and some do not have an individual climate finance target at all.^{ii, iii}

While absolute volumes of climate finance have increased for the six MDBs that have jointly reported on climate finance since 2011, this increase has not been constant over the years for all banks. Some banks have substantially increased their climate finance commitments, while others are significantly delayed in approaching their 2020 targets.⁶

Targets signal bank priorities to project managers, but more instruments are needed to achieve them. Internal incentives can have a strong impact on the probability of reaching climate finance targets, as the decisions of project managers significantly influence the activities of MDBs. Some MDBs already pay bonu-

ses depending on the achievement of climate-related indicators within individual project managers' portfolios. Indicators could reflect climate finance volumes or impacts of climate finance. For these incentives to work, they should be ambitious yet realistic. Monetary incentives could be considered either for all staff, for teams active in sectors with high climate-relevance or for climate teams that consult sector teams with regard to their project decisions.⁷

Article 9.4 of the Paris Agreement calls for: a balance between adaptation and mitigation through the provision of scaled-up financial resources when addressing climate change. At UNCAS, MDBs announced that they expected their joint adaptation finance to reach US\$18 billion annually by 2025, or around 27% of all climate finance. Note that the MDBs' adaptation methodology is based on the principle of incremental costs, whereas the mitigation methodology captures the full value of the activities. Therefore, it can be misleading to directly compare the two numbers. Nevertheless, all MDBs see the need to scale up adaptation climate finance.⁸

In 2018, the MDBs' collective climate change adaptation finance was around 30% of all climate finance.⁹ This share ranged widely between MDBs (8% to 49%). Arguably, different focus regions and business models can make it challenging for some MDBs to reach a balance between adaptation and mitigation finance. A number of MDBs are working on building resilience markets, but currently private sector clients in particular focus much more on mitigation than on adaptation. An adaptation finance target set by each individual MDB could help to strengthen the focus on adaptation finance in each institution.

Starting with concessional funds, dedicated and ambitious climate change adaptation finance targets by individual institutions, as implemented so far only by the World Bank and the African Development Bank (AfDB), could ensure that funding is directed towards adaptation. The AfDB and World Bank also happened to be the two banks with highest shares of climate adaptation finance in total finance in 2018.⁸

ⁱⁱ The following post-2020 climate finance targets have been set so far: The Asian Development Bank (ADB) has set a target to cumulatively invest \$80 billion in climate finance between 2019 and 2030. The World Bank has announced a target of \$200 billion of climate finance between 2021 and 2025 (from own funds and mobilized climate finance). The AfDB has set a target to double its commitments to climate finance by investing \$25 billion in the period 2020-2025.

ⁱⁱⁱ As climate finance eligibility criteria will need to be updated and thus become stricter to reflect Paris alignment, there could be a concern that targets based on the old methodology could become harder to achieve. However, although the climate finance eligibility criteria had already improved in the past, climate finance has increased substantially over time. If desired nevertheless, an option to overcome potential concerns might be to continue reporting also on the old methodology until the target year. MDBs that set new climate finance targets should take the new methodologies into account. also on the old methodology until the target year. The MDBs that set new climate finance targets should take the new methodologies into account.

1. **MDBs should define a post-2020 climate finance target, ideally containing an absolute as well as a relative (share-in-total-commitments) target.** If previous targets exist, new ones should go beyond previous efforts, taking into account an updated climate finance eligibility methodology. New MDBs could start with adopting the necessary processes for tracking and with reporting on climate finance in line with the joint MDB methodology as a first step, setting absolute rather than relative targets as a second step,^{iv} and adopting both relative and absolute targets as a third step.
2. To effectively incentivize implementation of climate finance targets, **MDBs should provide internal incentives (eg, bonuses) related to climate finance** (including for adaptation finance).
3. **MDBs should also include climate finance volume and impact indicators into results-measuring frameworks.**
4. **Beyond a joint MDB target^{v,10} we recommend that MDBs set their individual adaptation finance targets to complement current climate finance targets in areas where finance goals are not yet achieved.** To begin with, MDBs should at least set an adaptation target for concessional funds available to MDBs.
5. **A new target for private capital mobilization for climate finance** could also help prioritize de-risking instruments to crowd-in private investments and create markets for climate business.

Aligning climate co-finance and private sector investments

How can MDBs better align private climate co-finance with the Paris Agreement?

The OECD estimates that \$6.9 trillion in infrastructure investments are needed annually to meet the climate and development objectives, with \$600 billion of it needed to make the investments compatible with the Paris goals.¹¹ Seventy percent of these investments are expected to go to low- and medium-income countries.

These needs for investment vastly exceed the available public climate finance and therefore require active participation by the private sector.

MDBs play a critical role in guiding private investments towards Paris alignment through de-risking of investments, such as anchor investors and the provision of knowledge among others. To this end, MDBs have a large set of instruments available to them: grants, equity, guarantees, loans, line of credits, etc. While all MDBs have different business models, loans are the predominant instrument for climate finance.

In 2018, MDBs mobilized \$28.2 billion in private climate finance through private direct mobilization and private indirect mobilization.¹² It is unclear how the different instruments contributed to the mobilization, as MDBs do not disclose this information according to each instrument. Comparing MDBs' own data suggests that MDBs' private direct mobilization only has a small share originated from climate-relevant projects, while its private indirect climate mobilization includes a larger share.¹³

Meanwhile, according to the OECD, bilateral and multi-lateral providers mobilized private climate finance by using the following instruments: 52% investments in special purpose vehicles and companies, 21% guarantees, 12% credit lines and 9% loan syndications, with the remainder through investments in funds and simple co-financing schemes.¹⁴

It has been particularly challenging to mobilize the private sector on adaptation. The OECD reports that only 3% in private finance mobilized is directed at adaptation, and another 3% at cross-cutting investments that contribute to mitigation and adaptation. Similarly, MDBs co-finance indicates that just slightly over 10% are directed at adaptation (no figures are reported on private adaptation finance mobilized). Meanwhile, recent research suggests that a mere 3% in additional upfront costs, on average, could make investments climate resilient and that every dollar invested in resilient infrastructure generates four dollars in benefit.¹⁵

^{iv} As new MDBs start with a small but growing portfolio, any additional project could change the percentage share of climate finance in total commitments significantly, making it challenging to predict ambitious yet reachable relative targets. The likelihood of achieving absolute targets can be easier to predict for these banks.

^v At UNCAS, MDBs jointly announced that their joint adaptation finance by 2025 would amount to US\$18 billion.

At the same time, trillions of dollars are invested in low-yield and money-losing investments, as investors have to prioritize investment-grade projects, while many projects in emerging markets are below investment grades. At the September 2019 UNCAS, institutional investors worth over \$2.4 trillion in investments announced that they plan to align their portfolios with net-zero emissions by 2050. Furthermore, banks with assets worth \$47 trillion agreed on the Principles for Responsible Banking, as part of which they pledge to align with the Paris Agreement.

The main risks for investors to finance long-term infrastructure investments are regulatory uncertainty, in particular changes in the legal framework, exchange rate risks and risks associated with construction.^{16,17} Further challenges constitute the lack of bankable projects, the absence of reliable data on corporate performance, and track records in emerging markets. While MDBs could ease these issues through risk-mitigation instruments, less than 5% of all of MDBs' infrastructure projects make use of the available risk mitigation instruments.¹⁸

Similarly, local financing institutions face regulatory uncertainty and often suffer from asset-liability mismatches along with a general lack of understanding of climate investments, resulting in a mismatch of perceived and real risk.¹⁹ MDBs could help circumvent these issues by providing long-term financing in local currency, as well as by building knowledge on climate investments, which would have the added benefit of helping their clients make the transition towards Paris alignment.

1. **MDBs should provide data on private climate finance mobilization on a more disaggregated level** by providing information on instruments, mitigation, adaptation and region by bank, and in a comparable manner with other MDB publications on private finance mobilization.^{vi}
2. **MDBs should strengthen their support of institutional investors in aligning their investments with the Paris Agreement** (in accordance with Article 2.1.c of the Paris Agreement) by partnering directly with the investors, de-risking investments through increased application of risk-mitigation instruments and eliminating bottlenecks (eg, the

lack of a Paris-aligned infrastructure asset class, a pipeline of investable projects, and high-quality performance data on national companies).

3. **MDBs should scale up and standardize innovative climate finance instruments that have been piloted**, including through other initiatives such as the Climate Finance Lab.^{vii} These instruments include insurances, risk mitigation facilities and securitization. A particular focus should be on enhancing local currency lending and guarantees for climate investments to local financial institutions, both public and commercial, to build local capacity in financing climate investments. As translating innovative instruments takes time and often seed capital, shareholders should consider increasing concessional sources for this purpose.
4. **MDBs could facilitate private adaptation finance by supporting the collection and provision of high-quality data and information that demonstrate how private climate finance contributes to climate change adaptation.** Moreover, the banks could work towards establishing pilot projects in this regard to increase and disseminate knowledge of the positive returns on adaptation projects, and systematically including adaptation and resilience in their exchanges with the private sector.

Aligning technical assistance with the Paris Agreement

How can MDBs better align technical assistance with the Paris Agreement?

Technical assistance is a major instrument that MDBs can use to build their clients' capacities to design and implement bankable mitigation and adaptation projects, to put in place enabling policy frameworks, to gain access to the necessary finance and/or to conduct climate change-related research – all in line with the Paris Agreement goals.

As financial institutions and knowledge hubs, the banks have a competitive advantage in delivering high-quality technical assistance, particularly in the area of sustainable finance and fiscal policies as well as in risk and opportunity assessments.

^{vi} The default option should be to disclose this information. A definite list could define exclusions, describing what kind of disclosure cannot be undertaken and why there are confidentiality constraints. Data that typically is publicly available, eg, when searching for the project online, should not be labelled as confidential.

^{vii} Some MDBs already cooperate with the climate finance lab.

Ministries in charge of policy dialogues with MDBs are, in many cases, finance, economic or development ministries. Naturally, staff in these ministries are often less aware of climate change risks and opportunities than staff of the respective national environment ministries. If finance ministries do not include climate change action into budgetary planning, fiscal policies and regulation for sustainable finance, targets set by environment ministries cannot be reached. There is thus a major role for MDBs to bring the different ministries together and to provide technical assistance on climate change and its integration into different policies.

Countries and regions whose economies currently depend largely on fossil fuels may be more hesitant to set off an ambitious transition aligned with climate goals. These regions can be supported by MDBs in developing comprehensive transition strategies that ensure the structural changes required go hand in hand with economically beneficial perspectives.

In addition, many MDBs are international Accredited Entities (AEs) of the Green Climate Fund (GCF) serving the Paris Agreement. As part of compliance with the GCF, all international entities are asked to “indicate how they intend to strengthen capacities of, or otherwise support, potential subnational, national and regional entities to meet, at the earliest opportunity, the accreditation requirements of the Fund in order to enhance country ownership and that they report annually on these actions” (GCF decision B.10/06). In 2018, the National Designated Authorities (NDAs), however, expressed the view that “international AEs do not engage sufficiently with partners” (GCF/B.20/04).

1. Non-environment ministries play a major role in implementing climate-related activities when implementing Nationally Determined Contributions (NDCs and long-term strategies (LTSs) and in their capacities as client governments of MDBs. **MDBs should provide them with technical assistance to strengthen their understanding of climate change and the Paris Agreement, especially for finance ministries on budgetary planning, fiscal policies and sustainable finance.** MDBs should focus on providing technical assistance to demonstrate the economic gains and commercial viability of low-carbon alternatives as well as the capacity to conduct feasibility studies on these.
2. **A second and related focus of MDBs’ technical assistance could be to support fossil fuel-dependent clients in designing transition strategies.** These should focus on establishing new future-proof industries or services in the region early on and re-training of the workforce, as well as on fiscal policies and incentives that ensure the transition is economically attractive for those undergoing the transition. MDBs can support the design by conducting feasibility studies, providing policy options and supporting multi-stakeholder dialog that includes all relevant decision makers as well as region-based academia, employers, worker unions and civil society.
3. **MDBs should support their clients with technical assistance to analyze the feasibility and potential economic and financial risks and opportunities of Paris-aligned alternatives.** Prior to sending any fossil fuel project to the Board for approval, it should be shown that no non-carbon project is feasible and a decarbonization plan should be developed.
4. **MDBs should support the principle of direct access to international climate finance funds by providing technical assistance to the Direct Access Entities of these funds.** For example, MDBs could support National Accredited Entities to align their environmental and social safeguards (ESS) with those established within operating entities under the UNFCCC’s Financial Mechanism serving the Paris Agreement (Adaptation Fund, Global Environment Facility, Green Climate Fund, Least Developed Countries Fund and Special Climate Change Fund Support also needs to include fiduciary standards and project development capacities.

Recommendations

1. **MDBs should update their eligibility criteria to exclude fossil fuel-related investments from being labelled as climate finance.** Fossil fuel-related, but potentially transformational projects, in high-emissive sectors could be considered for Paris alignment under Building Block 1 and Building Block 2. In addition, we recommend that MDBs develop indicators to reflect transformational outcomes for climate finance as well as for all other finance.
2. **MDBs should ensure joint reporting on aggregate volumes and impacts, and should provide links to their individual databases** to ensure traceability of climate finance comparable climate impact and risks information at activity level. Exclusions where links cannot be reported due to confidentiality should be clearly defined.
3. **MDBs should consider setting additional climate finance targets, such as a climate relevance target, an adaptation finance target, a post-2020 climate finance target and a target for private capital mobilization for climate finance,** which would help to strengthen current targets.
4. **MDBs could additionally increase private climate finance mobilization by partnering directly with institutional investors,** by expanding the use of policy-based lending to strengthen support for environments and ensuring that all (or most) prior actions focus on climate mitigation or adaptation, and by scaling up innovative climate finance instruments such as local currency lending.
5. **Private climate finance mobilization data should be provided on a more disaggregated level** and continue to be reported to the OECD based on OECD methods to ensure the international community has a standardized activity-level dataset across bilateral and multilateral providers.
6. **MDBs should allocate sufficient technical assistance to non-environment ministries to increase their understanding of climate change and Paris-aligned solutions** through budgetary planning, fiscal policies, sustainable finance and direct access to existing climate funds. They should also provide technical assistance to their clients to understand the economic and financial risks and opportunities as well as feasibility of no and low-carbon alternatives.

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