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POLICY BRIEF

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UNLOCKING FINANCE: THE KEY FACTOR FOR INVESTMENT IN GREEN PROJECTS IN AFRICA LEADING UP TO THE COP22

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If the COP22 is going to be the COP of action and of Africa, finance is going to play a key role. To achieve the targets set forth at the COP21 in Paris, both in terms of mitigation and adaptation, drastic increases in investment are needed. This is especially true for emerging countries, which face the grim prospect of simultaneously being the most vulnerable to the effects of climate change and the least equipped for adapting to them. This will require action on the part of the public sector, which has an important role to play in injecting confidence into the system, but also the private sector, which has the funds and know-how needed to close investment gaps.

The problem is that current policies are failing to push the needed scope of action. There remains a mismatch between the characteristics of most green projects and those which investors, especially from the private sector, seek. This gap exists in terms of "perceived risk", timeline, and above all return on investment. As a relatively new industry, green projects are often viewed as lacking transparency, and those in emerging regions such as Africa are seen as carrying high enough uncertainty that they might not earn above-market returns.

The good news is that certain tools exist that can help make green projects more attractive to investors. The most important of these are guarantees, securitization, and green bonds. In addition, green projects already have profiles that should prove attractive for certain types of investors, **and for a shift from "risk" to "options".** This policy brief argues for renewed emphasis and action on these points to significantly boost investment. In other words, Africa is open for business.

KEY POINTS

- **A significant change in how investors approach green projects is underway.** The fight against climate change requires and will require increases in the amount of capital being devoted to green projects. This underlines the importance of mobilizing financial actors from the private sector. Their awareness of this need and **on the opportunities these investment give into re-defining the business,** is already, for some of them, becoming a reality.

- **We now have the opportunity to move towards a "decarbonization" of investment portfolios.** For investment to match climate change mitigation goals, we will need concrete moves towards decarbonizing portfolios. The tools to make this happen already exist.

TOWARDS THE COP 22: AFTER THE TIME OF DECISIONS, NOW IS THE TIME OF ACTION

In Paris 2015, 195 countries adopted the first-ever universal and legally binding global climate agreement. This was a demonstration both of the severity of the problem that we face and the motivation of the global community to finally address it.

However, if the COP21 conference represented a milestone, there is even more pressure at the COP22 to deliver on the promises and agreements set forth. In other words, there is still a long way to go before we can say that we will keep global temperature increases below the 1.5° C agreed upon last year.

There are two main facets of the fight against climate change that emerged from the Paris conference. The first is mitigation, which means reducing emissions and stabilizing the levels of greenhouse gases in the atmosphere. The second, adaptation, implies a need to adapt to the impacts of climate change that are already present and will continue to grow in the future.

It should seem fairly obvious that significantly high levels of financing will be needed to meet the objectives that have been laid out. These changes will come at a significant financial cost, especially in developing countries. But it's also important to realize the opportunity that this represents. This is what makes finance one of the key issues at the COP22. We keep hearing that this is the COP of action, but that action will require funding as well.

The location of the COP22 conference carries significance. Morocco is building the world's largest concentrated solar power plant in the Sahara Desert; the country is poised to have 50% of its energy provided by renewables by 2020. But it's not just Morocco. This is the COP of Africa. The opportunity for the continent is unprecedented: to showcase its potential in fighting climate change, to demonstrate its willingness to lead, and to show its attractiveness as an investment location. This is what is at stake.

FINANCE AS A SOLUTION FOR ADAPTATION: A CRITICAL ISSUE FOR AFRICA

In 2015, investments in green energy reached record levels: $286 billion. This came after years of rapid growth, and the trend doesn't look like it's going away anytime soon. In fact, renewable energy projects continue to represent the fastest growing category within "greenfield" foreign direct investment, the type of cross-border investment that involves new ventures. Growth rates are fastest in developing countries as well. A lot of this has to do with drastic reductions in the costs of green projects over the years, as well as a more mature market and greater transparency.

Despite this, current levels of investment are nowhere near those needed to meet the climate objectives agreed upon by the international community. Rapid and significant additional investment is thus needed. In fact, investments in this sector will need to double before 2015 and grow to more than three times current levels in the 2020s. Nowhere is this issue more evident than in Africa, where by 2030 renewable energy is predicted to increase to 22% on the continent, compared to only 5% today.

The problem from the perspective of investors is threefold. First, the time horizon of decision-making for firms doesn't match the long-term nature of climate change and green projects. Most investment managers have a time horizon of approximately three years or less; part of this is because regulations require them to have a certain amount of liquidity. This severely limits their ability to integrate issues such as climate change, which occurs slowly over a long period of time, into their investment decisions.

Second, green projects are still perceived as having higher uncertainty than other potential investments. The market remains relatively new and lacks the standardization that has been built up in other, more mature markets over years. In addition, green projects in emerging countries carry an entire other set of risks involving political uncertainty, exchange rate changes, etc. Since studies indicate that the majority of investors are risk-averse, this creates a mismatch in the marketplace.

Finally, combining these two lines of argument with other characteristics of green projects, the return on investment (ROI) for many of these projects simply isn't high enough to attract many classes of investors. This number, which represents a golden rule of investment, is based on comparing returns to risks and costs. Green projects tend to be smaller in nature than in other industries, which means higher costs per unit of output, especially in the form of transaction costs. When looking at projects in developing countries, the market is simply too small to ensure the kinds of returns investors seek.

GREEN FINANCE: MOVING FROM "RISK" TO "UNCERTAINTY"

Overcoming these market obstacles requires an acknowledgement of two simple facts. The first is that green projects *already* represent attractive investments for certain types of investors. The second is that financial tools currently exist to deal with the aforementioned problems for other types of investors.

It is well established that investors can be classified according to a wide and diverse range of classes. For some types, green projects have characteristics that match what they seek. Take institutional investors, for example. Given slow economic conditions in the developed world today, many investors from this category are seeking "real" types of assets that can offer a steady, inflation-adjusted income source that is weakly correlated to other investment types (this last point is due to the fact that investors prefer to spread uncertainty out by keeping a diverse portfolio of assets). Green projects provide stable and predictable cash flows (especially when backed by long-term contracts with international institutions that serve as counterparties – more on this in a moment), are often protected against inflation, and provide the long-term time horizons sought by institutional investors.

For the majority of investors that fall outside of this category, other solutions exist to make green projects more attractive as potential investments. We identify three here, which we believe have shown the most potential in specifically addressing the identified problems in this market.

First, guarantee instruments (also known as de-risking mechanisms) can serve as an insurance mechanism for several different risk sources. This category of instruments can include policy risk insurance, or political, credit, or currency risk guarantees. All of these imply action on the part of governments and/or international institutions, which then serve to allay investor concerns regarding uncertainties. These instruments are especially useful because they require little public outlay of capital (and often none at all given that payouts are not needed in many cases). However, they have an outsized impact on increasing private investment. Although there is some chance of moral hazard, in the sense that any guarantee can take away incentives to take common sense protections against risk, using partial risk guarantees and comprehensive screening have proven effective in overcoming this. We've seen these successfully used in the Ugandan Bujagali Project, which still represents the single largest private investment ever made in the country.

Second, green securitization can provide a means for overcoming the high transaction costs associated with green projects. These costs tend to stem from the smaller relative nature of these projects. Securitization solves this problem by packaging several loans together that differ in terms of risk, time to maturity, etc. In other words, high-risk projects can be grouped with low-risk projects to make the overall package low to moderate risk from the perspective of investors. Banks then sell these packages, which at that point meet size and liquidity requirements for investors. Suddenly, small projects become "bankable". However, this process will not work unless it is coupled with moves towards standardization of loan contracts for green projects and structures to enable pooling of assets across different originators.

Finally, we turn to green bonds, which have been experiencing enormous growth in recent years. Green bonds represent a long-term debt instrument with a fixed price, which makes them especially suitable for large-scale green projects. Green bonds also provide an excellent mechanism for encouraging securitization of small projects, leading to a reduction in the cost of capital and therefore a higher return on investment than would otherwise be possible. For bond issuers, green bonds help diversify and expand their investment portfolio by providing a long-term and stable source of income.

What should be clear is that, although these instruments are aimed at increasing private investment in green projects, they require action on the part of public and international institutions as well. Standardization and regulations are necessary elements to make all of these solutions viable. Since public institutions will have to bear many costs related to climate change, there is a strong incentive for them to analyze the potential for action on this front.

A COP OF UNPRECEDENTED OPPORTUNITY FOR ACTION AND AFRICA

The upcoming COP22 conference represents an opportunity that cannot be missed. In this policy brief, we have identified one of the key issues that will have to be tackled at the conference: financing. Agreements are now finally in place for a global fight against the existential threat that climate change represents. But a statement of intent can only go so far. What is needed now is action. To meet the objectives we as a global community have agreed upon, we need to rapidly and significantly ramp up investment in green projects.

Although bottlenecks are currently limiting our efforts, solutions exist to overcome these. We have proposed three here that we believe have high potential and high feasibility. The first is using guarantee instruments as an insurance mechanism against risk. The second is further developing securitization to overcome high transaction costs. Finally, the third is promoting wider use of green bonds.

If you accept our arguments and proposed solutions, we can begin to re-imagine the current obstacles as opportunities. A paradigm shift is on the horizon. Africa, and the world, should seize it.