Mainstreaming Environmental Finance into Financial Markets
Relevance, Potential and Obstacles

2008 KfW Financial Sector Development Symposium

Greening the Financial Sector –
How to Mainstream Environmental Finance in Developing Countries?

Session 1

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1. Environmental Finance and its **Relevance**
2. **Demand Side**: Key factors for Environmental Investment and Finance
3. The crucial double role of **subsidies**
4. **Supply Side**: Problems of commercial financial supply for environmental activities
5. **Challenges** for the **Financial Institutions**
6. **Perspectives** and the Role of **Donor** Support
7. **Conclusions**

1. Environmental Finance:
What are we talking about?

- **Environmental Finance**: financing activities contributing to promote renewable energy and/or energy efficiency and the (global) common good "environment".
- **Environmental finance through the financial sector**: Any kind of financial services (credit, equity, guarantees and insurance) to the demand side consisting of SMEs, service companies, smaller municipalities and households within the **normal product line** and **client range** of a financial institution
- **Mainstreaming** environmental finance into the financial sector = making environmental finance a standardized product for the down-market

1. Environmental Finance:
Development Relevance

Environmental finance through the financial sector can

- **Have an impact on the environment** and
- improve directly and indirectly the **living conditions of the poor**.

Highly relevant to achieve the **MDGs**:

- achieve sustainable development (MDG 7);
- develop further an inclusive financial system (MDG 8);
- improve income conditions; poor countries -> reduce poverty (MDG 1);
- through improved school facilities and lighting at home improve education (MDG 3), and
- through less pollution, and better air quality improve health conditions (MDG 4 and 6).

2. Demand Side:
Potential Clients and their activities

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Potential clients for Environmental Finance and their environmental activities			
	Households	**MSMEs**	**Municipalities**
Renewable Energy	Solar Water Heating; Solar-Photovoltaic; Biogas	Biomass; Small Hydro; Wind Solar Heating	Small Hydro, Waste to energy; Wind Solar PVs
Energy Efficiency	Lighting Domestic Appliances Eco-efficient Housing	Industrial Energy Efficiency Eco-efficient Buildings	EE Public Lighting, EE Public Buildings, Small Power Distribution Networks
Clean Production		Resource Efficiency incl. Recycling End of pipe approaches, like sewage Plants	
Climate Insurance		Small Farmers	
Supply Chain		Equipment Production Service Companies	

Wide range of activities which are technically and economically viable

2. Demand Side:
Typical Investment Amounts

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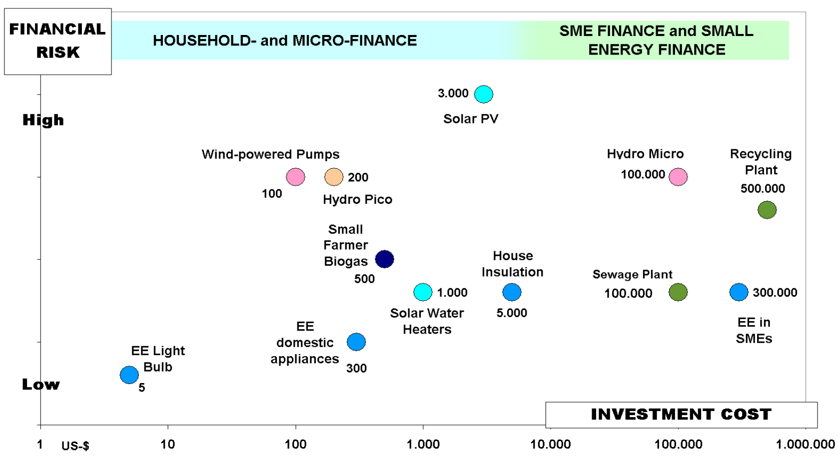

2. Demand Side:
Factors of low demand

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1. **Rationale** of decision makers (households, MSMEs and municipalities)
   - doubtful material/financial benefit of environmental activities ('greenbacks' are much more important than green thought)
   - even if positive, because of other needs rank low on priority list, which is cut-off by limited funds
   - time horizon: long pay-back periods not attractive
   - *With higher prices for energy this situation may probably change*
2. Lack of systematic, solid and up-date **information**
3. Lack of **experience** in practical investment in these fields
4. Lack of access to appropriate funding
5. Local **availability** of the corresponding equipment and services
6. Unfavorable **framework conditions** (Disincentives for RE, lack of enforcement for pollution control)

2. Demand Side:
Drivers for higher demand

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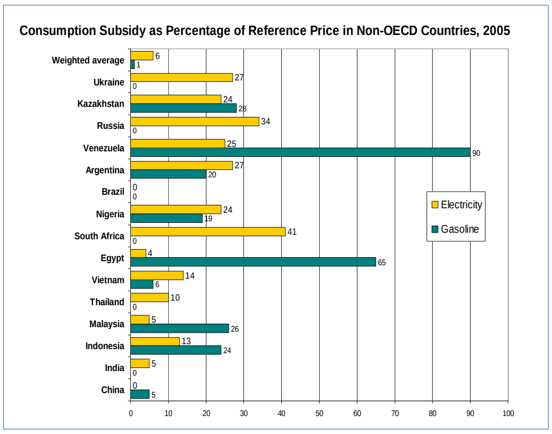
→ Economics of Globalization and Environmental Aspects created strong drivers for higher demand:

- **Energy Prices**
- Pressing **environmental** problems and hard-hitting impacts
- Trade agreements and environmental **requirements from foreign buyers**
- Pressures from **NGOs**
- **Policy Change** in Emerging Markets

3. The crucial double role of subsidies
Subsidies for fossil energy

- At present: upward playground for environmental investment as a result of **subsidized** prices for **fossil fuels**
- The World subsidies on energy (net of taxes) are estimated at US-$ 280 billion per year
- Government support to RE is about US-$ 10 billion each year worldwide
- **Reverse the subsidy balance** in favour of sustainable energy and environmental solutions.



4. Supply Side:
Attitude of financial institutions and low supply of environmental finance

Stages integrating environmental aspects into the policy and action of financial institutions:

- **Defensive banking**: opposing environmental aspects, because they are perceived not to be profitable enough on their own or even “undermine” ongoing business;
- **Reactive banking**: Including of environmental aspects in internal activities; integrating environmental issues in the credit risk assessment processes;
- **Competitive sustainability advantage**: Proactive, full integration of the external side, offering environmentally friendly finance, continuously looking for win–win solutions;

Most of the banks in **emerging markets** are in the **early stages** of integrating environmental aspects into their internal procedures and offer only a few financial services and products in this field. Reasons for **low supply**:

- Limited understanding and sectoral knowledge in the financial institutions
- Sufficient other opportunities to earn higher returns at lower risks with other products and clients

5. Challenges for Financial Institutions

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Address barriers to financing in environmental activities

- **Knowledge**: Relevant and reliable information about the opportunities and benefits of investing in these areas of business
- **Institutional capacity**: Scarce systematic information, limited practical experience, and lack of corresponding training contribute to the failure of many loan officer to be able to assess potential investment opportunities
- **Matching financial conditions**: 3-dimensional gap of environmental finance between the needs and the supply (instruments, funds, conditions).
- **Opportunity costs** due to lower returns: Many of these environmental activities are relatively small in size and have high transaction costs
- **High set-up costs**

6. Perspectives and the Role of donor support

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- **Demand** will rise. Financial institutions will have to build up the **capacities** and extend financial **capabilities;**
- **Cooperation** at an international level will be crucial. **Donors** and global funds should support through funds, risk-instruments and technical assistance:
  - Support to private industrial sector – MSMEs, equipment producers, vendors, service companies - by providing enterprise development support, seed capital, debt finance, mezzanine finance and equity;
  - Support for Specialized Financial Institutions and Funds;
  - Creation of new financial vehicles such as funds, credit lines, contingent business loans;
  - Reduction of (commercial) risks through financial guarantees and insurance schemes;
  - Technical assistance, such as staff training, access to industrial risk briefings and practical tools such as software for environmental assessment.
- Past **experience** has been mixed, but as the market conditions and business perspectives are changing, so is the willingness of the banks to cooperate and work systematically in this field.

Key Messages

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- 1. High **potential** to contribute to sustainable **development** (MDG 7) and poverty alleviation (MDG1) as it can reach a vast number of households and MSMEs directly.
- 2. **Past and present demand** was **low**, as in a context of subsidized prices for fossil energy and low enforcement of pollution control the benefits of environmental activities are too small to rank high on the priority list of the households and MSMEs.
- 3. Because of the same rationale, with increasing energy **prices** financial benefits of investment will grow. And so will the **real market** and the **demand** for finance of environmental activities, characterized by a massive number of small and medium amounts, mainly in the medium to long-term range.
- 4. This will mean a two-fold **challenge for most of the financial institutions**: to build up the institutional capacity to address and manage this demand and to provide finance at adequate terms.
- 5. **Donors** can support this process by providing means in form of **funding** and **risk instruments** to leverage the efforts of the private financial sector and provide **technical assistance** to improve the institutional capacity.

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Energy is money,

Environment protection means business

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and money and business are bankable

THANK YOU for Your Attention!

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