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Opportunities for IFIs to support the scaling of financing for the transition

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This note is a summary of Intellidex's key findings in its reports, commissioned by the African Climate Foundation (ACF), on financing and scaling strategies to support the just energy transition (JET). The findings presented in this document focus on the barriers and opportunities underpinning capital flows from the global North to the global South to drive JET initiatives in South Africa but are broadly applicable across EMs. The research included a large number of interviews with asset managers, asset consultants and regulators in the global north. We present an analysis of the existing barriers that impede the mobilisation of resources between the two regions, as well as recommendations on how to overcome them. Additionally, the document offers an overview of the challenges and opportunities related to financing the social justice aspects of JET and the actions required to address these issues.

Context

South Africa needs to unlock an enormous amount of financing to fund its just energy transition, sourced domestically and internationally, with estimates ranging from R4tn to R6.5tn (~$220bn-$465bn). Funding for the social justice elements alone come to about R2.5tn (~$137bn), according to the World Bank.

The highly complex process that will unfold over the next three decades will require concerted efforts from all stakeholders in the financial ecosystem to maximise the probability for South Africa to transition successfully to a net zero economy. Financing is required at scale, continually, in a way never seen before and the country will not be able to rely on the public sector.

Blockages for mobilising flows from North to South

A significant proportion of the funding needed for the just transition in South Africa, and the global South more broadly, needs to be mobilised from the global North. Several key blockages exist, particularly for mobilising private financing, including:

ESG and sustainable investing practices

- A rather perverse outcome of how ESG and broader sustainable investing practices are being applied is that it often results in financial flows being diverted away from the very markets that need to improve ESG metrics. This trend is at risk of accelerating as regulators across the globe are taking steps to implement legislative parameters on ESG integration, albeit at varying degrees of stringency and at different paces. Some of the most progressive markets (Europe) have already introduced prescriptive reporting requirements as well as limits on exposure to carbon-intensive jurisdictions, both at the corporate and sovereign levels. **This system imposes limitations on institutional investors' ability to allocate capital to emerging and frontier markets.** These markets are not only competing based on macroeconomic fundamentals but also on carbon intensity. With limited portfolio allocation

available for carbon intensive investments, only the best-in-class products will be able to attract much-needed institutional financing.

- Another way in which the wider adoption of ESG integration is having negative implications for emerging and frontier markets is through **exclusion criteria in the investment selection process.** Ratings and scores produced by various ESG agencies and disclosure bodies are used to screen out JET counterparties such as Eskom and Sasol, given their high carbon footprints. Yet the transition that needs to occur is precisely at such firms, ones that need to shift their infrastructure into sustainable business models. In addition to the exclusions related to climate aspects (ie, inability to allocate capital to carbon-intensive corporations and sovereigns), institutional investors' ESG allocation strategies risk diverting capital flows from emerging and frontier markets because these jurisdictions often do not have robust data and tend to score poorly on ESG metrics as currently constructed. This tends to materialise through screening that excludes regions based on their performance on criteria such as corruption, policy uncertainty and energy security. A typical example in South Africa is the Renewable Energy Independent Producers' Procurement Programme, which has suffered significantly from policy uncertainty.
- The **EU taxonomy for sustainable activities** is also considered a blockage because several pools of capital will be unable to participate in funding transition projects due to the taxonomy reporting requirements.

Liquidity, deal size and FX risks

- **Liquidity** is a major issue that emerged across all engagements with market stakeholders. To mobilise private capital at scale, JET instruments must be liquid.
- A lack of pooled-risk green bond markets is seen as problematic for funding renewable energy projects and other sustainable finance instruments (including social bonds and sustainability-linked loans). These will have to be adopted on a much larger scale to enable the funding of the just element of the transition. Banks in the future will play a key role in providing liquidity and will do so better with more standardised instruments.
- From a **deal size** perspective, structuring RE assets becomes an essential element that can either accelerate or stifle the rate at which scale can be achieved. The extensive due diligence process for offshore investors in particular requires large deal sizes (at least $250m), which means projects need to be aggregated into portfolios to bolster the appeal of investing. This will also help diversify risks.
- **FX risk** is a concern for all investors given the volatility of the rand, the hefty component of imported capital goods likely required (given limited onshore production capacity) and the way that this could sway the tight margins seen in many projects – especially when adding other risks such as capital goods inflation. At the same time, foreign investors are reluctant to take on exposure to the rand given the currency volatility and underlying macro risks and therefore any funding from foreign financiers will likely be in hard currency. This leaves the local market exposed to currency risks, which is problematic.

Systems level approaches

Advocacy related to rethinking existing ESG integration practices

- Emerging and frontier markets are struggling to attract capital flows for transition purposes due to the way in which investors are integrating ESG into their investment decision-making processes. **This is a systemic risk to the global transition.**
- Philanthropic funders with a climate mandate need to provide **evidence-based research to regulators and industry bodies in developed markets to demonstrate the adverse implications of some of the existing ESG practices. They need to advocate for changes to these practices to enable emerging and frontier markets to access capital more easily from developed market capital allocators**. It will be difficult for any one country to undertake this type of advocacy and further work is required to map the full ecosystem of causal factors, but we think this is a crucial unblocking point not just for JET financing but for all EM financing from developed markets.

Designing investment instruments that can unlock financing at scale

- Constraints related to liquidity, concentration risk, FX risks and lacklustre demand can all be eliminated through **product development**. Stronger adoption of sustainable finance instruments listed on exchanges is needed to grow the market and increase liquidity.
- To achieve this, **local capital markets need more robust engagement with transactors to obtain clarity on what is crippling appetite for faster adoption and widespread utilisation of these instruments**. At the same time, banks need to think about how these instruments can be pooled into funds to improve the risk profile for institutional investors, including liquidity and credit risks.
- Development funders have a role to play from **a liquidity and FX risk perspective**. For example, **multilaterals can create fund structures that will help overcome the issues related to deal size and investment due diligence costs**. Developing a renewable energy fund, for example, will de-risk the investment from a portfolio diversification perspective. To enhance the appeal for commercial capital, development funders can provide first-loss capital, guarantees or FX hedges. While recognising that financing at scale hinges upon standardising these credit instruments, it is crucial that they are also flexible and able to take into account the needs and market infrastructure capacity on a local level.
- While this function has traditionally been fulfilled by multilateral development funders, **philanthropists can also act in a similar capacity for funds developed by commercial asset managers**. For example, grant funding can be applied as catalytic capital through the provision of guarantees, FX hedging or first-loss capital. Utilising these tools will bolster the appeal of the fund for commercial investors and help blend in these additional sources of capital.

Building capital market infrastructure

- Considering the relative newness of sustainable finance for the mainstream market, an iterative process is required to ensure that a balance is found between making instruments accessible to the institutional market and achieving sustainability objectives.

- An alternative (and perhaps controversial) option is for development funders (local DFIs, MDBs or philanthropists) to engage with transactors to encourage issuers to adopt these instruments. **Given the costs associated with listing a transition bond, including compliance with all the listing criteria as well as obtaining third party assurance, there is an opportunity for development funders and philanthropists with a climate mandate to provide technical assistance to help develop this market.** There might also be an opportunity to collaborate with heavy emitters and hard-to-abate organisations in the private sector to help advance the transition agenda. Some actors of size in the system (like Eskom) will have to grab the bull by the horns in terms of market development even if the first mover may have questionable financial incentives to do so (where philanthropies etc can support).
- A collaborative effort could unlock the necessary resources to develop the transition bond market and potentially overcome the financial disincentives undermining the mobilisation of capital from the global North to the global South.

Opportunities and barriers for financing the social justice elements of the JET

Opportunity	Barriers to overcome	Actions required from IFIs
ESG investing: The easiest starting point for getting investors and funders to start planning for JET issues is to incorporate JET dimensions into existing ESG strategies. We recommend the adoption of the Impact Investing Institute's Just Transition Framework to structure new investments and reporting on their effects (Spengler et al., 2021). The framework addresses both environmental and social dimensions of the transition.	ESG investing as currently practised is very risk oriented and tends not to seek out opportunities to actively promote ESG outcomes. Subsequently, capital is being diverted from certain markets (for example carbon-intensive economies such as South Africa). This bias will need to be overcome to enable capital to flow to new areas where it is needed.	A redesign of ESG strategy (or a rebalancing that focuses on opportunities as well as risks) is the onus on all corporate, banking and other financial actor boards. Asset managers and financiers must take the lead in designing new investment vehicles and proactively identifying JET-aligned ESG investing opportunities. Involving philanthropists would be useful due to their potential provision of catalytic, first-loss capital in blended structures for new investment vehicles without proven track records. Foundations will also need to integrate JET considerations into their organisational strategies/missions.
Place-based impact investing: These are investments aimed at yielding appropriate risk-adjusted financial returns as well as generating positive local impact, while also addressing the needs of specific places to enhance local economic resilience, prosperity and sustainable development (Impact Investing Institute et al., 2021). The aim is to address structural constraints to economic growth and regional development, chiefly access to finance, to reverse the long-term decline of, in particular,	Fiduciary duty; lack of pipeline; aggregation of smaller opportunities for larger investors; not enough local investors.	As community trusts become active investors (for example in other energy utilities), they can consider more localised roles in PBII. They can do so, for example, via support to small businesses that will have been beneficiaries of grant-based support offered under IPPs' or trusts' enterprise development and socioeconomic development interventions (which could be seen as preparing for investment-readiness). Larger financial institutions must also reconsider their lending policies which tend to discriminate against smaller, black-owned and/or more remote business

small towns that once hosted significant industries (Impact Investing Institute et al., 2021).		owners. Finally, there is a role for philanthropy in coordination: that is, originating and publicising deals/investees; matching investors to investees.
JET funds: The establishment of private debt and/or private equity funds for JET-promoting businesses can help to get funds to flow into economic activity that maximises green and social outcomes. These could be capitalised using blended structures.	Communities in transition will need solutions that are designed from the ground up and community objectives might not align with commercial investor objectives. Blended structures require multi-stakeholder coordination which can be difficult to manage.	Asset managers will need to work on developing this market, for example by consolidating private equity/venture capital investors and investors in existing business incubators; adopting a JET lens and then working towards investment readiness for inclusion in JET funds. Marketing of the funds globally (where JET is increasingly an area of interest for investors) and locally (where significant advocacy will be required).
Transition bonds: These instruments can be used to support hard-to-abate sectors to transition from carbon-intensive to net zero over the next three decades. It allows organisations to continue accessing funding despite performing poorly on climate metrics, granted that an issuer has strategically embedded a pathway to net zero.	The transition finance market is still nascent and issuers are hesitant to utilise these given the lack of an evidence base as well as risks associated with greenwashing. Mixing social and environmental KPIs in a single instrument might not be feasible and thinking around how transition bonds can include social KPIs must be developed.	There is limited movement in the development of standards for transition instruments, largely due to the conceptual differences between transition (process) and other types of bonds (eg, green and outcome-focused bonds) and fears about greenwashing. The onus will lie on companies to develop convincing, actionable and measurable plans that demonstrate how they intend to become better corporate citizens. The same applies to banks and other investors in relation to their investees and companies in their portfolios.
Market-based products for renewable energy: The market for financial products to finance renewable energy projects is small but the rapid expected growth of solar represents an opportunity for financial institutions to develop more, better products, and to specifically develop products for the mass market. The bulk of the population is currently not conceived of as a target market for solar energy and this is a large missed opportunity for banks and the mass rollout of cheaper, cleaner solar energy.	The stringent financing terms by commercial banks' asset managers for small-scale renewable energy projects/ developers. Small-scale solar is still seen to suffer from risky and/or untested business models particularly where this is outside familiar contexts such as installations in residential complexes or large businesses. Pilot projects and innovative first-movers from financial institutions are required.	Banks must take the lead in designing more inclusive financial products for low(er)-income consumers and for small Energy Saving Companies (ESCOs) to enable broader participation in the new solar sector. In relation to community renewable energy projects, foundations have a key role to play in funding demonstration projects to prove (or disprove) sustainable business models for renewable energy SMMEs. Finally, academia must be involved in robust research testing alternative models.