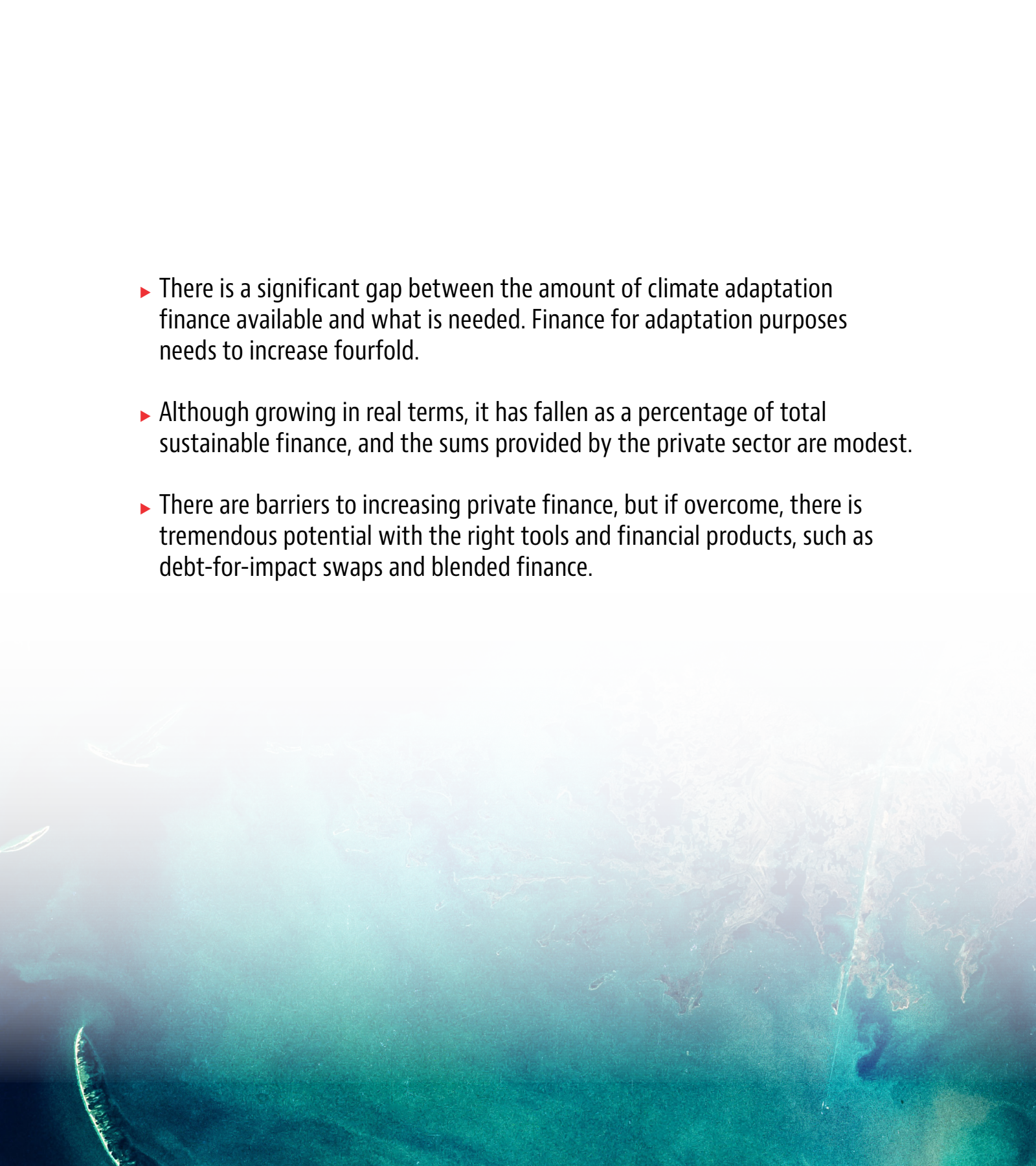


An aerial photograph of a coastal region, likely a delta or estuary. A prominent river or waterway winds through the center, surrounded by intricate patterns of wetlands, marshes, and agricultural fields. The water is a deep teal color, contrasting with the brownish-green land. The overall scene suggests a complex and vulnerable environment.

**Baker  
McKenzie.**

# **Climate Adaptation Finance**

**The challenge for institutional  
investors and commercial banks**

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- An underwater photograph showing a coral reef with a diver visible in the lower left corner. The water is clear and blue-green, with sunlight filtering through the surface.
- ▶ There is a significant gap between the amount of climate adaptation finance available and what is needed. Finance for adaptation purposes needs to increase fourfold.
  - ▶ Although growing in real terms, it has fallen as a percentage of total sustainable finance, and the sums provided by the private sector are modest.
  - ▶ There are barriers to increasing private finance, but if overcome, there is tremendous potential with the right tools and financial products, such as debt-for-impact swaps and blended finance.

## Introduction

Climate change adaptation is a critical but underfunded element of the goals in the Paris Agreement. Currently, most adaptation finance comes from the public sector — a stark contrast to the sums provided by institutional investors and commercial banks for adaptation that make up **reportedly less than 3%**.

The amount of finance needed is substantial, and the gap between what is available and what is required presents a huge opportunity for institutional investors and commercial banks. Moreover, according to the **Global Center on Adaptation and the Climate Policy Initiative**, despite the growth in adaptation finance, it has fallen as a percentage of overall climate finance. It also reports that developing countries need adaptation finance flows to increase fourfold. Similarly, the **UN Environment Programme estimates a gap for developing countries of USD 187-359 billion** per year this decade.



## COP initiatives

**At COP26 in 2021**, developed countries were urged to double their collective provision of adaptation finance from 2019 levels by 2025. **During COP28 last year**, countries set a number of 2030 targets for the Global Goal on Adaptation and its framework (the United Arab Emirates Framework for Global Climate Resilience) and contributed new pledges of nearly USD 188 million to the Adaptation Fund.

There is much anticipation as to whether a New Collective Quantified Goal (NCQG) on climate finance to replace the current USD 100 billion per year goal will be agreed upon at COP29. This climate finance goal is a key part of the Paris Agreement to support developing countries in their climate actions post-2025, to inform the next round of Nationally Determined Contributions and addressing adaptation (among others). The agreement of a fair and ambitious NCQG is **COP29 Presidency's top priority**. The NCQG could also make clear to the private sector how it could contribute to global climate goals.

The COP29 Presidency has also announced the **Climate Finance Action Fund** as one of its initiatives, which will be capitalized with voluntary contributions from fossil fuel producing countries and companies, to catalyze the public and private sectors across mitigation, adaptation, and research and development with additional special facilities.

There is, therefore, tremendous scope to scale up the role of the private sector, and mobilizing private finance for adaptation continues to be a focus at COP29.



## What is adaptation finance?

Adaptation finance refers to helping people, businesses and countries adapt to the impact of climate change. Building in climate resilience is closely related to adaptation. Adaptation aims to reduce the risks posed by climate change while positioning infrastructure and systems for the future. Examples of adaptation projects include relocating infrastructure from areas likely to be flooded; in agriculture, providing drought-resistant seeds; and improving water management in areas prone to drought. The EU Taxonomy Regulation's six environmental objectives incorporate climate change adaptation and, under its **technical screening criteria**, certain economic activities may qualify as contributing substantially to climate change adaptation (e.g., the installation, etc., of renewable energy technologies).

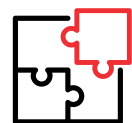


# Barriers to the private sector

However, there are various barriers to private finance, including the following:

- 1 There is a lack of common market language, standard definitions and a classification framework**, as explained in **industry reports**. In comparison to transition finance, which now has structures in place to identify activities and help inform decision-making, the world of adaptation finance is more nascent. There are no adaptation equivalents of green loan principles, although these can be applied in a modified form. The EU Taxonomy Regulation does provide a classification framework, so to the extent the conditions are met, adaptation finance can be deemed “green,” allowing, e.g., the use of an EU Green Bond.
- 2 There is a lack of detailed information**, on climate risk relevant to specific projects that can obscure its environmental benefits.
- 3** These challenges are compounded by **difficulties around the disclosure and sharing of information**. They derive variously from client confidentiality, commercial sensitivity and data protection. All this is important as the market, whether borrowers, lenders or advisers, needs to be comfortable around financing risk and due diligence.
- 4** Another issue arises from **relatively long timelines** as institutional investors and commercial banks need to see a return within a reasonable timescale. Therefore, while any transaction must satisfy adaptation criteria, commercial entities need to see that it makes sense in balance sheet terms.
- 5** All this can make it **difficult to properly price and calculate risk and return**. Actual monetary revenue can be modest; sometimes much of the value derives from the benefit in avoiding the effects of climate change.





# Bridging the gap

To address the barriers to closing the finance gap — some more perceived than actual — a range of measures is necessary, including greater support from governments, the use of standardized approaches, and increased disclosure and reporting of information relevant to financing projects. A better understanding of the opportunities and the potential to achieve a commercial return is of course fundamental. As the market develops and more information is available, this should drive better pricing of transactions.

Two promising funding methods to address these barriers and reduce the finance gap are as follows:

## 1 Debt-for-impact swaps

Under a debt-for-impact swap, a sovereign debtor whose debt is trading at a discount repays existing debt via an issuance at or near par of a lower face amount, and directs a percentage of the savings to finance local climate adaptation projects. A good example is the **debt-for-nature finance swap** by Ecuador in 2023, the largest in value to date. Ecuador's existing sovereign bonds with a face value of over USD 1.6 billion were exchanged for a USD 656 million loan funded from the proceeds of a marine conservation-linked bond. Crucially, the new bonds benefitted from political risk insurance and a development bank guarantee, meaning they were issued at more favorable terms than the existing Ecuador bonds, which traded at a substantial discount.

In return, Ecuador agreed to spend more than USD 300 million of its "savings" on marine conservation around the Galápagos Islands, a national park and marine reserve. This is now a tried-and-tested model, but it currently depends on credit support provided by multilateral banks and development finance institutions, which have limited capacity. As the market develops, private finance must step into these roles, providing insurance and guarantees, thereby ramping up the potential number of transactions. By imaginative debt management for impaired sovereigns, governments can allocate proceeds that would otherwise go to creditors to impactful projects such as adaptation (as well as obtaining fiscal space for their budgets).

## 2 Public/private partnerships

Under the auspices of the UN, an international partnership of development finance institutions, **ARIC**, is working to scale up private investment. It is looking to build expertise, develop pipelines of bankable investments and support early-stage ventures. Here, the COP29 initiative around the Climate Finance Action Fund discussed above is relevant.

One specific tool is blended finance that "combines concessional public finance with non-concessional private finance and expertise from the public and private sector" (**UN, 2015**). By reducing investment risk and through incentivization, it could unlock private finance's collaboration with a wide range of partners to invest in adaptation projects, especially when the return on investment would be otherwise inadequate. There have been many initiatives to develop innovative ways for public finance to draw in long-term private finance. One approach that has been used for long-term renewable energy projects is the combination of a development fund to finance the early stages of the project life cycle and a second element, an equity fund to meet the majority of the project's costs (e.g., construction). This has the advantage of simplifying traditional project finance structures and thereby facilitating such schemes. The challenge is to scale these initiatives and ensure adaptation finance gets equal focus as other forms of climate finance, such as mitigation finance.



# Other financing instruments

For the sake of completeness, the **Global Center on Adaptation and the Climate Policy Initiative** have identified a range of instruments that can help bridge the adaptation finance gap, a number of which are especially relevant to concessional finance. These reflect the choice between the use of equity where risk and reward are shared with investors or debt, which must be serviced with interest. In either case, concessional finance acts as an added incentive to participate. We set out some of these instruments below.

Instrument	Description	Use example
Debt-for-impact swaps	A sovereign debtor whose debt is trading at a discount repays existing debt via an issuance at or near par of a lower face amount, and directs a percentage of the savings to finance local climate adaptation projects.	Finance local climate adaptation projects
Project finance	Direct debt or equity investments into a project via a special purpose vehicle, whether on a commercial or concessional basis, for example, first-loss debt, off-taker guarantees, direct infrastructure investments and public-private partnerships financing.	Long-term infrastructure projects
Financing facilities	Debt or equity funding for projects that benefit from concessional finance to different degrees employing subordinated debt and equity, private equity funds and other debt facilities.	Versatile use across a range of project types
Results-based finance	Debt or grant funding for a project dependent on achieving specific goals. This may include impact notes, climate bonds and conservation trusts.	Suitable for blended finance, offering favorable repayment terms or bonuses for achieving KPIs
Grants	Nonrepayable or interest-free funding. Such grants help with technical assistance funding and project preparation facilities.	Suitable for projects with little commercial potential or where funding is required to bring them to an investable stage
Guarantees	Third parties guarantee to repay funding where a borrower defaults.	Useful where a borrower has a poor credit record or it is otherwise necessary to lower project risk
Liquidity instruments	Grant or debt facilities that provide immediate access to funding.	Appropriate in emergency situations, especially where there is insufficient financial and technical capacity
Local currency swaps	Protects long-term finance options in local currency through fixed and inflation-linked swaps designed to mitigate the risks of currency and interest rate fluctuations for climate investments.	Commonly deployed to support investments in emerging markets, to hedge against currency and interest rate volatility



# The future

The key is to find the political will to allocate resources — both financial and nonfinancial — to climate change and adaptation. Resources are scarce, and the geopolitical landscape is uncertain. While serious impacts have yet to be felt, time is of the essence to close the gap.

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