

Climate smart adaptation finance: From theory to practice

Climate finance aims at reducing emissions, enhancing sinks of greenhouse gases and reducing vulnerability of, and maintaining and increasing the resilience of, human and ecological systems to negative climate change impacts, as defined by the United Nations Framework Convention on Climate.

Climate adaptation finance is a type of climate finance, which focuses on incorporating into the design of financial products the possible effects of climate change to its clients, trying this way to promote the implementation of adaptation measures. Significant amounts of finance are demanded especially in developing economies to help them adapt to climate change.

The main financial products targeting climate adaptation are loans, grants and equity financing, which incorporate impact monitoring of the funding provided.

These three products are usually combined with risk mitigation mechanisms such as insurance and guarantees, as these allow to transfer risks from finance providers to guarantors and insurers, for example, who have a better capacity to accept such risks. Such mechanisms increase the chances that projects will obtain commercial financing.

The main actors that provide loans are international public financiers and either international or national private financial institutions. Moreover, grants are mostly provided through international and domestic public finance, mainly in the form of technical assistance, and equity is provided by national and international private financial institutions. Some examples of actors can be governments, development finance institutions (DFIs), financial institutions and impact investors.

Climate smart adaptation finance is currently demanding access to new sources of financing since there is much need for these financial products and current barriers, such as uncertainty regarding returns on investment, high upfront costs of technology, and a lack of technical and institutional capacities in the project hosts, do not encourage enough private capital. There is a UNFCCC study that estimates that the investment needed for climate change adaptation in 2030 could amount to USD 50-170 billion, and from this amount, USD 14 billion would be required for agriculture, forestry, and fisheries. In order to meet this high demand of climate adaptation financing, new business opportunities for private companies are being developed, such as leveraging private finance for climate change adaptation through public funds. In this sense, institutional investors are catalysts for change, as they influence the decisions and strategies adopted by companies and banks on climate change adaptation.

One of the best tools to establish and visualize the implementation process of climate adaptation finance in practice is the **Theory of Change (ToC)**. The ToC allows stakeholders to intervene in a social or environmental issue by determining positive long-term outcomes they want to achieve and backward-mapping the specific steps towards them. Thus, if the ToC has a correct design, implementation and evaluation, it can achieve a transformative change.

To develop a precise and practical ToC for climate adaptation finance, the first aspect to be defined is the stakeholders to be involved in this process, as different views can bring varied ideas from different experience perspectives. Stakeholders could involve microfinance institutions (MFIs) which want to develop a climate smart adaptation product and institutional investors which are willing to finance the development of that product.

Secondly, the problem has to be analysed and described in detail, as it is key to understand the problem in order to find ways to address it. For example, lack of climate resilience of communities in developing economies.

Additionally, the outcomes pathway has to be mapped, where the cause-and-effect relationships between the long-term goal and outcomes are defined. This pathway is central to justify the choice of activities and resources, and the development of indicators. Once the pathway is agreed, the activities that can support the achievement of each outcome have to be defined.

Having the main structure of the ToC in place, the assumptions and barriers have to be identified. Even though it may not be obvious, the defined process will be shaped by assumptions about how change happens, thus, it is important to make realistic assumptions, preferably backed up with evidence to justify them. Barriers could include the interest rate at which the MFI's competitors provide the same financial product, which limits the interest rate margin for the MFI.

Then, thresholds and indicators have to be defined, an especially important aspect for climate change, since effective adaptation is not completely defined yet. It is important to remember that factors outside of a given project can contribute to the success. Lastly, the diagram and narrative have to be articulated.

In summary, focus on climate smart adaptation finance is demanded in emerging markets, as it can improve resilience in low-income communities, mainly for smallholder farmers. If ToC is suitably structured, it can be one of the best tools to decide which climate adaptation financial product to develop, addressing the main deficiencies in finance related to climate adaptation. As it can be seen, there is still a long path to follow in climate finance in which all key stakeholders mentioned should be involved.

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References

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