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Task Force 2: Wellbeing, Environmental Sustainability, and Just Transition

The Role of the G7 in Strengthening the Global Landscape of Climate Finance for Adaptation and Loss and Damage

Mariya Aleksandrova, Senior Researcher, German Institute of Development and Sustainability, Germany
Urwah Khan, Research Fellow, Boston University Global Development Policy Center, United States
Archimedes Muzenda, Director, Centre for Urban Practice, African Urban Institute, South Africa
Steffen Bauer, Senior Researcher, German Institute of Development and Sustainability, Germany
Rishikesh Ram Bhandary, Assistant Director, Global Economic Governance Initiative, Boston University Global Development Policy Center, United States

Abstract

This year, 2023, offers political momentum for strengthening the global climate finance architecture under and outside the United Nations climate change regime. In November 2022, the 27th Conference of the Parties (COP27) to the United Nations Framework Convention on Climate Change (UNFCCC) marked a breakthrough on loss and damage with an agreement for establishing new funding

arrangements, including a fund. Parties also recognized the need for rethinking development finance and endorsed a plea to reform multilateral development banks (MDBs). In addition, parties to the UNFCCC and the Paris Agreement are currently negotiating a new collective quantified goal on climate finance, which is to be agreed by 2024. Japan, holding the 2023 Group of Seven (G7) presidency, carries a key responsibility for initiating relevant processes to revive the climate finance agenda together with the G7 partner countries. As the G7 countries are the main providers of adaptation finance, as well as the major shareholders having voting power to enable reforms of the MDBs, the G7 Hiroshima Summit must catalyze a debate for a systemic transformation and chart a long-term strategic outlook for the G7 states as global leaders on climate action. This policy brief makes three proposals to that end: (i) strengthen multilateral funding under the United Nations climate change regime; (ii) reinforce efforts to balance climate finance flows; and (iii) push for reforming the MDBs to strengthen their role and effectiveness in providing finance for adaptation and loss and damage.

Global Challenges

The 6th Assessment Report of the Intergovernmental Panel on Climate Change (IPCC) highlights the urgent need to enhance finance for adaptation and the growing need to respond to losses and damages resulting from climate impacts (IPCC 2022). Already, in 2009, developed country parties to the United Nations Framework Convention on Climate Change (UNFCCC) made a commitment to provide at least $100 billion a year by 2020 in climate finance for both mitigation and adaptation. While this target is expected to be finally reached in 2023, the current adaptation finance needs alone in developing countries are likely to be 5–10 times higher than the financing received (UNEP 2022).

It is upon Group of Seven (G7) countries, in particular, to close the adaptation finance gap. As a key prerequisite, it is in their self-interest to broaden the donor base with regard to the new collective quantified goal (NCQG) on climate finance beyond 2025 and prospective funding arrangements to address the losses and damages resulting from climate change. Importantly, the G7 Hiroshima Summit in May 2023 is an opportunity for the G7 leaders to deliver concrete proposals for strengthening the role of multilateral development banks (MDBs) in supporting finance for adaptation and loss and damage ahead of the Summit for a New Global Financial Pact, hosted by France in June 2023.

Current Climate Finance Is Insufficient to Meet Developing Country Needs

The available adaptation finance gap analyses do not account for all economic, social, or environmental costs resulting from climate change. A recent assessment of climate impacts on Vulnerable 20 (V20) economies indicates losses of about $525 billion in gross domestic product between 2000 and 2019 (V20 2022). Moreover, climate vulnerability has significant negative effects on sovereign lending and debt sustainability in developing countries as it increases the cost of capital (Volz et al. 2020). Researchers estimate that interest costs for V20 countries will increase by $146 billion–$168 billion over the period 2019–2028 due to climate risk premiums

(Buhr et al. 2018). In addition, significant, albeit uncertain additional costs can be expected to result from "limits to adaptation" (IPCC 2022) as climate impacts exacerbate poverty and inequality, involuntary migration and displacement, and the degradation of ecosystems and habitats as well as health risks.

Climate risks and climate-related hazards have been increasing in frequency and magnitude. In the first half of 2022, climate-related hazards caused losses of more than $75 billion—22% more than the annual average of the last decade (MunichRe 2022). European countries lost about €9 billion after experiencing the worst droughts in 500 years in 2022 alone (MunichRe 2022), while Pakistan was hit by devastating floods that affected more than 30 million people and incurred more than $30 billion in losses and damages (World Bank 2022). The total adaptation finance needs of African states are estimated at about $580 billion by 2030 to respond to climate extremes, exacerbated food and water insecurity, and climate-induced conflict and displacement (CPI 2022a).

Climate Finance Remains Unbalanced—Especially for the Most Vulnerable

Current climate finance flows to the African Union represent only 11% of actual needs (CPI 2022a), while adaptation-related finance provided by MDBs to least developed countries (LDCs) was only 38% in 2020 with no reports for financing Small Island Developing States (SIDS) and a general predominance of debt instruments (UNEP 2022). Moreover, climate-related official development assistance (ODA) aimed at Sustainable Development Goals (SDGs) that are critical to boosting resilience and reducing vulnerability, notably addressing poverty and inequalities, has been limited to date (Iacobuţă et al. 2022). Concurrently, the global climate finance architecture remains particularly inadequate to respond to slow onset climate impacts[1] and associated noneconomic losses, such as climate-induced human mobility, loss of territory due to sea level rise, or loss of ecosystem services due to land degradation (UNFCCC 2019). All of this indicates a stark imbalance in the channeling of available climate finance.

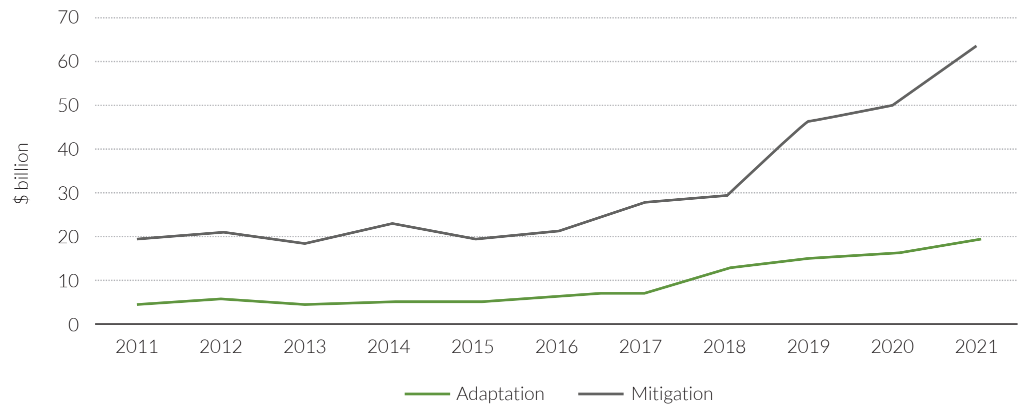
Over the past decade, almost 90% of global climate finance focused on climate mitigation, roughly 7.5% was allocated to adaptation, and the remainder had dual benefits for mitigation and adaptation (CPI 2022b). The imbalance is especially striking with regard to cities, which host more than half of the world's population and hundreds of millions of urban poor and vulnerable communities, especially in sprawling informal settlements. These communities are particularly exposed to climate risks due to urban geography (not least in coastal areas), high population density, and significant infrastructure development and economic assets. The World Bank estimates that $11 billion–$20 billion will be needed every year by 2050 to protect global urban infrastructure from climate risks (Chu et al. 2019). Yet, cities have received less than 5% of the global adaptation finance (CPI 2021). Ironically, urban populations are expected to increase even further as rural-urban migration is fueled further by climate hazards.

[1] The term "slow onset events," as used herein, refers to sea level rise, increasing temperatures, ocean acidification, glacial retreat and related impacts, salinization, land and forest degradation, loss of biodiversity, and desertification (based on UNFCCC [2010]).

Shortcomings in Climate Finance Flows Are Mirrored by Multilateral Development Banks

To date, MDBs have also allocated substantially more funds to mitigation than to adaptation. In 2021, for example, MDBs provided $19.2 billion for adaptation and $63.4 billion for mitigation (see Figure 1). Moreover, MDBs are dealing with the challenge of leveraging private finance for adaptation due to limited availability of public funding. They are also challenged by the need for improving coordination and coherence among various climate finance actors to effectively deliver adaptation finance to the most vulnerable communities and ecosystems. Hence, there is growing concern that MDBs are not doing enough to address the needs of climate-vulnerable countries and communities.

Figure 1: Adaptation and Mitigation Finance Provided by Major Multilateral Development Banks



Note: The aggregate of major multilateral development banks comprises the African Development Bank, Asian Development Bank, Asian Infrastructure Investment Bank, European Bank for Reconstruction and Development, European Investment Bank, Inter-American Development Bank, Islamic Development Bank, and World Bank Group.

Source: Authors based on a dataset from the European Investment Bank et al. (2022) for major multilateral development banks.

The World Bank, as a critical provider of climate finance for the most impoverished countries, is even falling behind other MDBs in supporting climate-related initiatives. While several financial institutions, including the European Investment Bank, European Bank for Reconstruction and Development, and Asian Infrastructure Investment Bank, have set ambitious 50% targets for climate finance by 2025, the World Bank has only committed to 35% so far, albeit with a target to allocate by 2025 at least half of its climate finance to adaptation (MECC, Canada, and Federal Foreign Office, Germany 2022).

Opportunities for the G7 to Address Global Challenges

Proposal 1: Strengthen Multilateral Funding under the United Nations Climate Change Regime

G7 countries are among the largest contributors to multilateral climate funds. While funds established under the UNFCCC Financial Mechanism and the Paris Agreement[2] provided only about 9% of total multilateral adaptation finance in 2020, mostly in grants, these funds have a crucial role considering their specialization in climate change issues (UNEP 2022). Yet, these funds are so far limited in scope with regard to **losses and damages**. Funding for loss and damage has been provided through projects that support climate services and early warning systems, community-based and ecosystem-based disaster risk reduction, and sectors like food security and infrastructure (UNFCCC 2019). In addition, the Green Climate Fund (GCF) has supported projects related to slow onset impacts such as sea level rise, salinization, and ocean acidification (UNFCCC 2019). Overall, an urgent need remains for further policy interventions that would enable United Nations (UN) climate funds to broaden their coverage of climate impacts. Sector-specific responses, especially in social and environmental areas such as human mobility, social protection and labor market interventions (e.g., social housing support, skills development, and piloting climate-responsive social protection schemes), and human health and ecosystems restoration provide promising opportunities.

The establishment of a designated **loss and damage fund** is currently high on the multilateral climate agenda, albeit confronted with numerous challenges. First, this fund as well as corresponding funding arrangements should be suited to address both climate extremes and slow onset impacts and the associated losses and damages. Second, sources of finance, eligibility for support, and definitions and scope of activities that can be framed as "addressing loss and damage" are all critical questions not yet negotiated. Third, establishing a new institution or designated fund under an existing institution like the GCF or the Global Environment Facility (GEF) is likely to prompt several years of negotiations. Furthermore, parties will have to ensure that the fund will not relive the challenges characterizing other UN climate funds, including ensuring sustained long-term sources of finance and effective and impactful outreach to those most vulnerable. Finally, a separate fund alone cannot tackle the complexity of responses required to address loss and damage. Yet, political and financial support for such a fund by rich nations, especially the G7, is paramount to rebuild trust in multilateral climate governance, which in turn is vital to achieve the objectives of the Paris Agreement altogether (Bauer and Aleksandrova 2023).

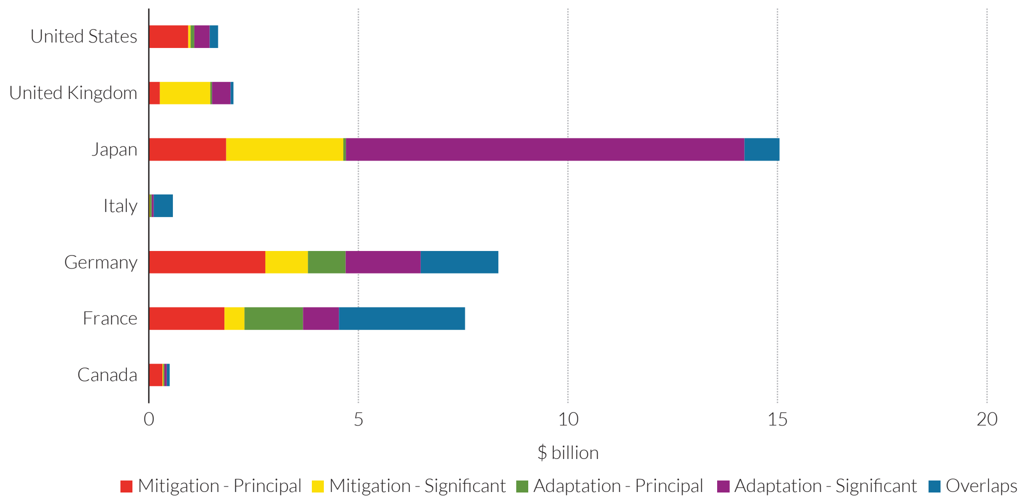
Scaling up finance through the UN climate funds is critical for many LDCs and SIDS to avoid reaching soft limits to adaptation. In light of the growing finance needs for adaptation and loss and damage, the ongoing negotiations on the NCQG on climate finance and the second replenishment of the GCF provide a window of opportunity for the G7 countries to increase their pledges and to deliver on past commitments.

[2] These funds are the Global Environment Facility Trust Fund, the Least Developed Countries Fund, the Special Climate Change Fund, the Adaptation Fund, and the Green Climate Fund.

Proposal 2: Reinforce Efforts to Balance Climate Finance Flows

G7 countries have demonstrated varied commitments to strengthen their bilateral cooperation on adaptation (Figure 2), with Germany showing the most balanced split in its climate-related bilateral development finance. G7 efforts to support addressing loss and damage have so far been focused on climate and disaster risk finance, notably through the Global Shield against Climate Risks, a joint initiative of the G7 and V20 launched in 2022. Still, a considerable gap remains in positioning the G7 in the global finance landscape for addressing adverse slow onset impacts, such as loss of biodiversity or habitable land. Therefore, G7 countries should further their collective efforts toward **balancing finance for adaptation and the loss and damage resulting from both climate extremes and adverse slow climate impacts**.

Figure 2: Climate-Related Bilateral Development Finance Commitments by the G7 States in 2020 by Objective



Source: Authors based on OECD (2022) dataset.

The G7 Hiroshima Summit should also commit to **achieving a greater geographical balance** of recipient countries, considering the dynamic and complex nature of climate risks and broader development challenges. To make a more significant impact, the G7 countries can work toward enhancing resilience through increasing concessional finance, leveraging private sector finance, and promoting transparency and collaboration.

Not least, G7 leaders should commit to **invest in urban resilience**. The G7 Hiroshima Summit marks the second summit since the establishment of the Urban7 (U7) Alliance.[3] Through the U7

[3] The main organizations constituting the U7 Alliance are the Deutscher Städtetag, the Global Parliament of Mayors, ICLEI – Local Governments for Sustainability, and Core Cities UK.

Mayors Summit and the G7 Ministerial Meeting for Sustainable Development, the U7 Group has become a crucial platform for the G7 to amplify the voices of local actors—subnational governments—who are central to the implementation of climate adaptation and resilience initiatives at the city level. As the world recovers from the coronavirus disease (COVID-19) pandemic, the U7 Group also highlights the importance of developing globally networked resilience that can be achieved through cross-city partnerships. The Hiroshima Summit provides the G7 with an opportunity to make concrete steps toward increasing finance for urban resilience by also adopting the principle of governmental subsidiarity to ensure adaptation and resilience initiatives are allocated to and financed at the level of government that is best suited to implement them. As finance for adaptation is mostly allocated to national governments, there is a need to involve subnational governments at the city level to consider urban adaptation measures that tailor climate financing to the needs of local communities.

Proposal 3: Reform Multilateral Development Banks to Strengthen Their Role in Providing Finance for Adaptation and Loss and Damage

With the deepening of the climate crisis, climate vulnerable nations such as Barbados and Maldives have been increasingly advocating for fundamental reforms of the largest MDBs to establish a new operational model and vision fit for a changing climate. The Bridgetown Agenda led by Barbados identifies priorities to unlock capital for climate action, such as to expand lending from MDBs by $1 trillion. The World Bank as the largest MDB is facing mounting pressure from its shareholder countries, including G7 countries, to implement significant changes following the development of an "evolution road map." In this context, G7 leaders should call on MDBs to align their strategies and operational modalities with the needs of developing countries regarding finance and technical assistance for adaptation and loss and damage.

Firstly, MDBs can leverage their global presence and expertise to **collaborate with local partners and stakeholders in vulnerable regions** to identify the most pressing climate change impacts and prioritize adaptation interventions. This process can involve working with governments, civil society organizations, and communities to develop participatory approaches that empower vulnerable populations to participate in the adaptation process and contribute to the design and implementation of climate-resilient projects. MDBs can enhance their monitoring and evaluation frameworks to better capture the impacts of climate change on vulnerable communities and ecosystems, for instance by incorporating indicators that capture changes in natural resource availability, agricultural productivity, health outcomes, and other key metrics that are sensitive to climate variability and change. Such indicators can help MDBs to identify and prioritize interventions that are most needed by vulnerable populations. Further, MDBs can account for vulnerable populations in their allocation of funding by integrating climate change considerations into their lending and investment operations. This can involve ensuring that all projects are screened for climate risks and opportunities, and that funding is directed toward climate-resilient infrastructure and other interventions that address the most pressing climate change impacts.

Secondly, to address the limited availability of public funding, MDBs can **explore innovative financing mechanisms**, such as green bonds, climate risk insurance, and blended finance, to mobilize private sector capital for adaptation finance. This can involve engaging with private sector investors to make a business case for investing in adaptation finance and working with governments to create favorable policy environments for private sector investment. By doing so, MDBs can incentivize the private sector to play a more active role in adaptation finance, thereby increasing the overall pool of available funds for climate change adaptation. Another approach is the use of climate risk insurance, which provides protection against the financial risks associated with climate-related events. This can encourage private sector investment in adaptation projects by reducing the perceived risks of such investments. Finally, blended finance can be employed to bring together public and private sector resources to finance adaptation projects. This involves combining concessional public finance with private sector investments to support adaptation projects that might otherwise be considered too risky or unattractive by private sector investors alone.

Thirdly, to address the lack of coordination and coherence among climate finance actors, MDBs can **strengthen collaboration and coordination** among themselves and with other climate finance actors, such as bilateral and multilateral donors, climate funds, and private sector investors. This effort can involve sharing best practices, coordinating investment strategies, and aligning standards and criteria for climate finance. The latter involves working together to establish common standards and criteria for assessing the climate impact of investments. This can help to ensure that investments are accountable, transparent, and consistent with global climate goals. By aligning their standards and criteria, climate finance actors can also avoid confusion and duplication of effort.

Implementation: Recommendations to the G7

The 2023 G7 Hiroshima Summit should foster a dialogue on developing a long-term strategic vision for adaptation and loss and damage funding that aligns with the priorities and needs of recipient countries and communities. Actions could include the following:

- Increase support for adaptation and loss and damage through multilateral and bilateral development cooperation, including **financial pledges based on robust understanding of needs**.
- Adopt **region-specific approaches** to allocating finance for adaptation and loss and damage.
- Broaden the scope of proposals on **finance and funding for loss and damage**, including a forward-looking joint vision for responses to adverse slow onset climate impacts through multilateral and bilateral channels.
- Strengthen partnerships aimed at **integrated strategies to build financial resilience**, e.g., by supporting the incorporation of climate-related risks in fiscal risk assessments and by developing debt relief mechanisms.
- Advance commitments for **building urban resilience**, including through the Urban7 Alliance.

Furthermore, G7 countries could use their collective economic and political influence to help shape the direction of MDBs, including the World Bank, and push for reforms that align with its members' priorities and values. These reforms include the following:

- Endorse a **capital increase** for the World Bank and regional development banks to enable these institutions to increase their scale of concessional financing for adaptation and loss and damage.

- Expand **concessionality to climate vulnerable countries** by shifting away from income-based criteria for eligibility to concessional lending and integrating resilience-building needs into MDB allocation frameworks.
- Set ambitious **targets** for adaptation and operational modalities for providing technical assistance and finance for addressing residual climate impacts and risks (**loss and damage**).
- Adopt a **risk-sensitive approach** to decision making that recognizes the unique vulnerabilities of developing countries to climate change, e.g., through the development of risk assessments and the integration of climate risk considerations into the investment decisions of MDBs.
- Increase the use of **results-based financing mechanisms** to support climate-resilient infrastructure in low-income countries and incentivize greater private sector investment in climate-related projects.
- Promote **transparency and accountability** to enhance the quality of climate investments by improving transparency in tracking climate-relevant investments, to align them more closely with climate strategies and planning processes, and to ensure that all climate financing complies with environmental and social safeguards, upholds human rights, and promotes gender equality with meaningful stakeholder engagement throughout the project cycle.

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