International Financial Institutions: Enhancing their role in promoting sustainable development

Report by the Royal Institute for International Affairs and Forum for the Future

Brian Pearce, Director of the Centre for Sustainable Investment
Paul Ekins, Associate Director of Forum for the Future

Department for Environment, Food and Rural Affairs: London
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Executive summary

This is a report of a workshop held in October 2001 which was commissioned by the UK’s Department of Environment, Food and Rural Affairs (DEFRA) and Foreign and Commonwealth Office (FCO) in order to generate insights about the role of International Financial Institutions (IFIs) in promoting sustainable development. These insights would then be used to make an input as appropriate into the preparations for the World Summit on Sustainable Development in South Africa in 2002.

Ten years on from the Rio Earth Summit much conceptual work has been done to weave the environment and development strands of sustainable development into a more integrated whole, but the practice has lagged behind. Yet it is clear that unless investment flows are explicitly focused on and supportive of environmentally and socially sustainable economic growth, such growth will not be achieved.

This report seeks to reflect the richness of the discussion which the workshop generated, and to draw out of it clear recommendations for how IFIs can increasingly be part of the solution to problems of unsustainability.

AN OVERVIEW OF THE ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS

Several relevant aspects characterise IFIs financial flows today:

- IFIs have become small relative to private financial flows.
- The approach taken to sustainable development financing is ‘do no harm’ rather than ‘do good’.
- Sustainable development financing remains a niche IFIs activity and not mainstream.
- Large-scale industrial and infrastructure projects remain the focus of lending.

Three major areas of comparative advantage should shape IFIs approach to sustainable development financing:

- The ability to provide an incentive-based framework for private financial flows.
- A catalyst to leverage private financial flows.
- Knowledge of risks and other key information required for informed finance decisions by recipients and private financial institutions.
Barriers to sustainability exist in a number of key areas in IFIs development finance:

- Integrating sustainability into development lending.
- Leveraging private finance.
- The proper working of international transfer mechanisms.

Recommendations include:

- Creating appropriate internal incentives.
- Providing an incentive framework for private financial flows.
- Leveraging private finance.
- Building capacity.
- Promoting good governance institutions.
- Improving international transfer mechanisms.
- New IFIs focused in single issues.
- A portfolio of social projects where markets do not exist (focused e.g. on education or gender).

**POVERTY REDUCTION**

There is a crisis in development finance:

- Official development finance and domestic revenue raising is in decline.
- Growing non-concessional finance is not supporting sustainable livelihoods.
- Conservation finance restricting access to natural resources can be anti-poor.

While there is growing policy recognition, there are limited formal mechanisms for a focus on:

- The sustainable livelihood approach.
- Alternative financing models.

A number of barriers block support of sustainable livelihoods finance by IFIs:

- Lack of IFI comparative advantage in small-scale projects and in building social capital.
- Limited capacity of recipients and local financial intermediaries to access and use finance.
Recommendations include:

- Create a framework to enable private, non-concessionary finance, to reach SMEs.
- Redirect IFIs financial flows down from large-scale projects to providing support for small-scale micro-credit and mini-enterprise lending financial intermediaries.
- Build capacity with local financial intermediaries and recipients.
- Improve transfer mechanisms to compensate poor for the global benefits their natural resources provide.

**ENERGY**

The current situation in financing energy is not sustainable:

- One third of the world’s population does not have access to electricity.
- No chance of climate stability if developing country energy demand is met through fossil fuels.
- IFIs are focused on financing large-scale fossil fuel power generation rather than renewables.

Several major changes in energy lending policies are required:

- The adoption of strategic goals for providing access to electricity.
- A reorientation of finance towards small-scale, off-grid, renewable energy projects.
- Financial and capacity-building support for local financial intermediaries.

A number of barriers to reorienting IFIs finance towards renewable energy projects were identified:

- The small scale of renewable energy projects.
- Lack of capacity in financial intermediaries.
- Higher transactions costs.
- Greater risks.

Recommendations include:

- A higher priority should be given to renewables financing by IFIs.
- IFIs should develop innovative financing mechanisms to direct funds towards SMEs.
- Build capacity in local financial intermediaries.
- Use leverage with government to promote good practice in regulatory design.
WATER

The current water situation is characterised by:

- A growing shortage of fresh water and sanitation.
- IFI lending to this sector is marginal and likely to remain so.
- IFIs have leveraged this contribution by demonstration projects and building capacity.

To improve the sustainability of their lending to this sector IFIs must:

- Ensure that projects are responding to demand.
- Treat water as an economic good to ensure efficient use and allocation.

Barriers facing IFIs efforts to implement these changes include:

- Poor ability and willingness to pay outside the urban centres in peri-urban and rural regions.
- Contested supplies where watershed covers several countries.

Recommendations include:

- Building capacity through shaping ‘water wisdom’.
- Demonstration projects.
- Leveraging private finance.

CLEANER PRODUCTION

There are a number of features that characterise cleaner production financing:

- Cleaner production is a goal and not a thing to be financed.
- The SMEs are the key sector for the IFIs to influence.
- Cleaner production good practice varies widely by industry and sector.

The key change required to enhance IFIs influence in this area is:

- To raise awareness about the private and social benefits that arise from cleaner production.

The most important barrier to an enhanced role for IFIs in promoting cleaner production is:

- A lack of understanding and commitment to cleaner production principles.

Recommendations include:

- Pressure on governments to internalise the costs of relatively dirty production.
- Cleaner production criteria should be fully integrated into IFI lending decision-making;
- IFIs should mobilise private sector financing of firms developing cleaner production.

CONCLUSIONS

Unlike their private sector counterparts, IFIs are driven primarily by policy rather than private financial returns. When the Bretton Woods institutions were set up one of their roles was to take on large and risky industry and infrastructure projects. The strong message from the workshop was that the need for this financing from the IFIs has changed. It has changed both with the increasing volume of private financial flows into these projects and with the realisation that large scale infrastructure projects are not the best vehicles for delivering sustainable livelihoods and sustainable development more generally.

The common thread running through the debate (on poverty reduction, sustainable energy and water, and cleaner production) is that sustainable development in developing economies depends on financing small and medium-scale projects and enterprises, through leveraging private finance including the support of local financial intermediaries, and by capacity building to enable these institutions and their SME clients to access and utilise non-concessionary finance.

The comparative advantages IFIs can bring to bear on financing the key small-scale projects and enterprises include their: knowledge and capacity-building capabilities; role in setting out an incentive-based framework to direct private finance; ability to leverage private financial flows through innovative risk and cost sharing.

In order to significantly improve the contribution IFIs make to financing sustainable development the following recommendations need to be considered:

- IFIs need to reorient their financing away from large-scale industrial and infrastructure projects towards small-scale projects and enterprises by:
  - Changing volume-based internal incentives for IFI lending towards a more results-based incentive framework, including sustainable development targets.
  - Setting an incentive-based framework to direct private financial flows by overcoming disincentives, improving markets and creating missing markets such as the World Bank's Prototype Carbon Fund, encouraging sound regulation and providing information.
  - Leveraging private financial flows through local financial intermediaries such as the ADB-funded India Renewable Energy Development Agency, and through innovative financing mechanisms such as the IADB-supported Eco-Enterprises venture capital fund.
  - Building capacity with local institutions, including financial intermediaries such as the GEF-funded Energy Efficiency Advisory Service, and carry out demonstration projects.
  - Promoting good governance to ensure continuing monitoring and enforcement of project objectives, through local government and civil society participation as with the World Bank-supported World Commission on Dams.
The success of the Montreal Protocol Multilateral Fund points to a need for new single-issue IFIs to be set up:
- To finance sustainable energy and water.
- To support micro-credit and mini-enterprise lending for sustainable livelihoods;
- To provide competition for established IFI financing in these areas.

As a necessary complement to IFI financing there is a need for a substantial improvement in international transfer mechanisms to help pay for global sustainability benefits generated in the South.
CHAPTER 1
Introduction

This is a report of a workshop which was commissioned by the UK’s Department of Environment, Food and Rural Affairs (DEFRA) and Foreign and Commonwealth Office (FCO) in order to generate insights about the role of International Financial Institutions (IFIs) in promoting sustainable development. These insights would then be used to make an input as appropriate into the preparations for the World Summit on Sustainable Development in South Africa in 2002.

Ten years on from the Rio Earth Summit much conceptual work has been done to weave the environment and development strands of sustainable development into a more integrated whole, but the practice has lagged behind. Yet it is clear that unless investment flows are explicitly focused on and supportive of environmentally and socially sustainable economic growth, such growth will not be achieved. Such a focus would mean that IFIs would need to re-think their programmes from their foundations, giving less weight and funding to the large (and often environmentally and socially destructive) infrastructure projects which still comprises a major part of their investment portfolios, and more weight and funding to projects which have as their objective the generation of economically, environmentally and socially sustainable livelihoods for poor people. Moreover, in view of the increasing dominance of private sector financial flows to the developing economies it is clear that the major part of IFIs’ influence on sustainable development must come through the leverage they can exert on these flows.

The workshop was intended to be primarily focused on the environmental dimension of sustainable development, and its structure reflected this intention, with sessions on how the sustainable use of environmental resources could contribute to poverty reduction, and on how IFIs could promote the sustainable use of energy and water resources and cleaner production processes. However, inevitably the other dimensions of sustainable development keep recurring in both the presentations and discussions, so that what emerged was a rich consideration of sustainable development in all its complexity, and how IFIs could act to promote it.

The workshop recognised at the outset that all IFIs now regard the promotion of sustainable development as part of their role, but also recognised that some IFIs were further down the track of implementing this perception than others, and that there was still much learning from best practice that could take place. The workshop was keen to explore fundamental issues of principle as well as detailed questions of practice. Should the promotion of sustainable development be a major or minor concern of IFIs? Should it be the concern of all IFIs, or only a subset of them, and, if so, which subset? What leverage on other sources of funds can IFIs exert in order to increase the overall financial flows to support sustainable development? How can IFIs do more of what they are already doing well in this area, and do less of what is still encouraging unsustainable development? How should IFIs be structured, and how should they relate to each other, in order to make them as effective promoters of sustainable development as possible? These were some of the deeper questions which the workshop sought to address, as well as practical issues of implementation.
This report seeks to reflect the richness of the discussion which the workshop generated, and to draw out of it clear recommendations for how IFIs can increasingly be part of the solution to problems of unsustainability.
There are several relevant aspects characterising IFIs financial flows today:

- IFIs have become small relative to private financial flows.
- The approach taken to sustainable development financing is ‘do no harm’ rather than ‘do good’.
- Sustainable development financing remains a niche IFIs activity and not mainstream.
- Large-scale industrial and infrastructure projects remain the focus of lending.

The role IFIs have in promoting sustainable development is not related to their size. Flows of finance through these financial intermediaries have become marginal, at least in terms of quantity. Table 1 shows that official development finance has both fallen in absolute terms and as a proportion of total financial flows to developing countries; to less than 18% of the total from over 50% just 10 years ago. Taking the water sector as an example, annual investment in developing countries is around $80 billion out of which IFIs finance only around $2 billion. Not only have private sector financial flows massively outstripped those of the IFIs in recent years but Public Private Partnerships have become an increasingly common financial structure, and the role of civil society in governance issues has developed significantly. As a result, the role of IFIs is changing towards that of acting as a catalyst and providing knowledge and leverage to private sector financial flows.

The approach to sustainable development financing taken by most IFIs remains one of ‘do no harm’ rather than ‘promote good practice’. Environmental screens are used to avoid projects that will excessively degrade the environment. Some of these institutions, such as the UK’s ECGD and the IFC in the World Bank group, are now moving beyond this ‘boycotting’ approach to a positive and active promotion of sustainable development through a rethinking of their lending policies. Examples of good practice are shown in the boxes distributed throughout this paper. These examples of good practice sustainable development financing do not reflect mainstream lending policies in most IFIs. As a result, critics have pointed to the unsustainable development that is currently financed through IFIs, such as

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2 This section draws on the papers and contributions of Lars Vidaeus (World Bank), Alex Wilks (Bretton Woods Project), David Allwood (ECGD), Tim Murphy (EBRD), Glen Armstrong (IFC), Clea Gebara (Danish ECA), Mark Kenber (WWF-UK), Derek Osborn (UNED-UK), Tariq Banuri (Stockholm Environmental Institute, Boston), Stephen Anderson (USEPA), Jake Werksman (FIELD) and comments from other workshop participants.


4 DfID (2001) Addressing the Water Crisis, Strategies for achieving the international development targets.
Export Credit Agencies (ECA) support of carbon-intensive investments in developing countries. The World Bank has an ‘environmental’ loan portfolio of $15 billion but 80-90% of its lending through sector and structural adjustment programmes is not subject to any scrutiny for its environmental or social impact. The impression and analysis suggests that sustainable development has been relegated to environmental conditionalities i.e., development as usual with its environmental impact minimised. A more integrated approach to sustainable development financing would need to look at alternative development models.

Table 1: Net long-term financing flows to developing countries

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<tr>
<td>Net long-term flows</td>
<td>100.8</td>
<td>123.1</td>
<td>152.3</td>
<td>220.2</td>
<td>223.6</td>
<td>254.9</td>
<td>308.1</td>
<td>338.1</td>
<td>275</td>
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<td>Official development finance</td>
<td>56.9</td>
<td>62.6</td>
<td>54.0</td>
<td>53.3</td>
<td>45.5</td>
<td>53.4</td>
<td>32.2</td>
<td>39.1</td>
<td>47.9</td>
</tr>
<tr>
<td>Concessional</td>
<td>44.8</td>
<td>51.0</td>
<td>44.0</td>
<td>41.5</td>
<td>45.8</td>
<td>44.7</td>
<td>40.1</td>
<td>33.4</td>
<td>32.7</td>
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<tr>
<td>Non-concessional</td>
<td>12.1</td>
<td>11.6</td>
<td>10.0</td>
<td>11.8</td>
<td>-0.3</td>
<td>8.8</td>
<td>-7.9</td>
<td>5.7</td>
<td>15.2</td>
</tr>
<tr>
<td>Private finance</td>
<td>43.9</td>
<td>60.5</td>
<td>98.3</td>
<td>167.0</td>
<td>178.1</td>
<td>201.5</td>
<td>275.9</td>
<td>299.0</td>
<td>227.1</td>
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<tr>
<td>Bank credit</td>
<td>3.2</td>
<td>4.8</td>
<td>16.3</td>
<td>3.3</td>
<td>13.9</td>
<td>32.4</td>
<td>43.7</td>
<td>60.1</td>
<td>25.1</td>
</tr>
<tr>
<td>Bonds</td>
<td>1.2</td>
<td>10.8</td>
<td>11.1</td>
<td>37.0</td>
<td>36.7</td>
<td>26.6</td>
<td>53.5</td>
<td>42.6</td>
<td>30.2</td>
</tr>
<tr>
<td>Equity</td>
<td>3.7</td>
<td>7.6</td>
<td>14.1</td>
<td>51.0</td>
<td>35.2</td>
<td>36.1</td>
<td>49.2</td>
<td>30.2</td>
<td>14.1</td>
</tr>
<tr>
<td>Direct investment</td>
<td>24.5</td>
<td>34.4</td>
<td>46.1</td>
<td>67.0</td>
<td>88.5</td>
<td>105.4</td>
<td>126.4</td>
<td>163.4</td>
<td>155.0</td>
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Box 1: Montreal Protocol Multilateral Fund

The Montreal Protocol Multilateral Fund was established in 1990 to financially and technically assist developing countries in doing their part to protect the stratospheric ozone layer. Its success in cost-effectively halting the use of ozone-depleting substances provides useful lessons for co-operation on other global environmental issues such as:

- The circumstances favouring a new IFI rather than a new programme in an existing IFI. There was no proliferation of bureaucracy as feared, and costs were kept at <3% of disbursements.
- The advantages of a single purpose fund.
- The advantages of democratic and transparent decision-making, including equal representation by developed and developing countries.
- The cost-effectiveness generated by requiring business plans, performance contracts, market mechanisms and efficient fund distribution.
- Stakeholder support through industry, environmental NGOs and the Technical Assessment Panel providing sustainable technology options, but leaving the decision with the recipient.

5 Daphne Wysham (Institute for Policy Studies) reported in her presentation that during an average year of financing the carbon content in OPIC and Ex-Im financed fossil fuel projects will contribute greenhouse gases to the Earth’s atmosphere roughly equivalent to three-quarters of annual US emissions.

6 Lars Vidaeus (World Bank) presentation.

The experience of many recipients of IFIs finance is that development has been most successful when it has supported the development of social capital within and between local communities, the productivity of local natural capital, and financed small and medium-sized enterprises. This is not the typical project financed by an IFI, which concentrates on large-scale industry and infrastructure projects often criticised as poorly suited to promoting sustainable livelihoods and development. Moreover, nowadays the comparative advantage for large-scale project financing often lies with the private sector not IFIs.

2.1 COMPARATIVE ADVANTAGES FOR FUNDING SUSTAINABLE DEVELOPMENT

There are three major areas of comparative advantage that should shape IFIs approach to sustainable development financing:

- The ability to provide an incentive-based framework for private financial flows.
- A catalyst to leverage private financial flows.
- Knowledge of risks and other key information required for informed finance decisions by recipients and private financial institutions.

IFIs may have little impact through the quantity of their lending, but they do have a major role to play in setting out an incentive-based framework for private financial flows to developing and transition economies. It has been argued that not enough is being done by IFIs to energise and improve the sustainability of private financial capital. Some steps have been taken. For example, the World Bank created a market in developing country carbon emission reductions where none existed, through establishing its Prototype Carbon Fund (PCF). This and other initiatives could form a framework overcoming disincentives, improving the functioning of markets and promoting good governance.

In many situations IFIs act as a catalyst to leverage private financial flows and other influences to promote sustainable development. Sharing risk in difficult markets is a major contribution made by IFIs to sustainable development financing in circumstances where the domestic tax base or the capacity to attract private finance is weak.

The role of IFIs as 'knowledge banks' is an important if controversial recent development. This knowledge revolves around: IFIs extensive experience with capturing the benefits from global public goods; presenting the business case for environmental and social stewardship based on the view that the environment is an asset with poverty reduction and other dividends rather than a liability with potential costs; carrying out demonstration projects; and providing leadership more generally. There is a widely held view that this experience and understanding should be made available to developing country recipients and other financial institutions. A note of caution is sounded by some that see this role as imposing a Northern agenda on the South. A model for good practice in this regard is the World Commission on Dams, a World Bank-sponsored multi-stakeholder process for the planning of future water and energy projects (see Box 11). This was seen to make best use of both Northern and Southern knowledge about sustainable development in a process that allowed all parties to buy into the recommendations.

8 Tariq Banuri (Stockholm Environment Institute, Boston) presentation.
9 Tariq Banuri (Stockholm Environment Institute, Boston) and Alex Wilks (Bretton Woods Project) presentations.
2.2 BARRIERS

There are a number of key areas in IFIs development finance where there are clear barriers to sustainability, three of which are:

- Integrating sustainability into development lending.
- Leveraging private finance.
- The proper working of international transfer mechanisms.

Why has sustainable development not been integrated into mainstream development lending in the World Bank and other IFIs? The reasons include the existence of difficult trade-offs between, for example, development objectives and environmental sustainability. It will not always be possible to find win-win projects that meet development, environmental and social objectives. Moreover, there is limited institutional capacity in the IFIs to operationalise non-efficiency objectives. Economic efficiency creates winners and losers; a situation powerful elites can capture and render projects unsustainable. This situation is often accentuated by a lack of public awareness of sustainable development issues, which hinders effective governance. An important issue for the ECAs is that they and the exporters they finance are in competition, so any unilateral requirement for costly impact assessments will put them at a disadvantage.

There are also some important barriers that hinder the leveraging of private finance other than for the large-scale industry and infrastructure projects. Transactional barriers include: long project lead times; small project sizes; often the relative inexperience of the project sponsor; the newness of the technology; less established markets, a high ratio of capital to operating costs, unfamiliarity of the project to the financier. There are also market distortions arising from competitors using under or unpriced resources or from an excess of concessional finance.

International transfer mechanisms such as the Global Environment Facility (GEF) and the PCF are important complementary institutions to the IFI lending institutions, and important means by which the North finances sustainable development in the South. At least they offer that potential since their funding is modest. Moreover, there are some important barriers to their effective operation. A key criticism is the perverse incentives that often result from the incrementality requirement; it pays a developing country to do nothing rather than mitigate. A further difficulty in developing counties in particular is the verification of counterfactuals and the continued monitoring of performance relative to it.

2.3 RECOMMENDATIONS

These include:

- Creating appropriate internal incentives.
- Providing an incentive framework for private financial flows.
- Leveraging private finance.
- Building capacity.
• Promoting good governance institutions.
• Improving international transfer mechanisms.
• New IFIs focused in single issues.
• A portfolio of social projects where markets do not exist (focused eg, on education or gender).

A number of the workshop participants made the point that lending practices would not change without a change of internal incentive structures which, at present, are volume-based favouring large-scale projects. This would involve at the strategic level a shift from ‘do no harm’ conditionalities to a more positive ‘promoting sustainable development’ approach, including development impact and debt sustainability alongside environmental and social objectives. Transparency, particularly in how policy advice is reached, would assist both internal incentives and legitimacy with recipients. At the operational level appropriate incentive structures would be results-based, perhaps through setting new sustainable development targets for mainstream lending as well as the ‘environmental portfolio’. It was suggested that the World Bank’s genuine savings measure of sustainability could be improved by the use of locally-determined indicators of sustainability, following the example of the UK’s Quality of Life sustainability indicators. Hiring and promotions policy could also incorporate requirements to demonstrate or acquire competence in sustainable development finance.

**Box 2: UK Export Credit Guarantee Department and sustainable development screening**

The efforts to integrate sustainability into its export credit insurance and structured financing by the UK’s Export Credit Agency give a model of good practice for ECAs world-wide:

• Core business principles:
  - We will promote a responsible approach to business, and will ensure that our activities take into account the Government’s international policies, including those on sustainable development, environment, human rights, good governance and trade.
  - We will provide a customer orientated, efficient and professional service and we are committed to continuous improvement.
  - We will be open and honest in all our dealings and will expect the same from others.
  - We will, in developing our services, consult widely and take account of the legitimate requirements and expectations of our customers and other interested parties.
• Impact questionnaire for exporters covering environment, occupational health and safety, social and human rights issues.
• Transparency through the annual publication of a list of all projects financed.

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12 ECDG’s Business Principles, Export Credit Guarantee Department, December 2000; and, ECDG and Sustainable Development, a presentation by the ECGD. www.ecgd.gov.uk
There are a number of avenues through which IFIs can create incentives for the private sector to finance sustainable development. One is to overcome disincentives through the creation of markets for global public goods such as the PCF and GEF concessional financing. A second is to improve markets through encouraging sound regulation and the internalisation of external costs. Full and effective provision of information is a third avenue.

The recommendations of the U.K. ECGD offer a model for ECAs with a requirement for public disclosure of information (including comprehensible Environmental Impact Assessments) during project development, and the inclusion of sustainability information in requests to exporters to tender.

Leveraging private finance offers a particularly promising avenue for effective promotion of sustainable development. There are a number of boxes below that illustrate the initiatives taken already by IFIs to: provide seed finance and project preparation advice; support micro-credit financial intermediaries; mini-enterprise lending; and private equity funds. The International Finance Corporation (IFC) directed almost 50% of its lending to other financial intermediaries during the past fiscal year.

Capacity building is a major contribution that IFIs could make to sustainable development finance. Northern financial institutions as well as small-scale Southern intermediaries need to develop tools and an understanding of how to integrate sustainability into financing decisions. It was argued strongly that the focus of sustainable development finance should be on the demand-side, that is building capacity in local financial institutions and recipients to access market credit, rather than supply-side efforts to mobilise concessional finance.

**Box 3: International Finance Corporation’s Intervention Framework**

This framework, developed by the sustainable development group at the IFC, is a good example of the strategic thinking required to move away from ‘do no harm’ to a more proactive approach.

**SUSTAINABILITY: AN INTERVENTION FRAMEWORK**

- **Make Markets**
  - Set vision here
  - Leadership interventions focused here
  - Remove all subsidies/distortions by internalizing costs
  - Proactively develop sustainable projects

- **Project Selectivity at Region/Sector Level**
  - Project selection and investment strategy significantly influenced by sustainability criteria

- **Incremental Change at Project Level**
  - Provide incentives to maximise sustainability attributes at project level

- **Apply ‘Do Good’ criteria**
  - Project Selectivity at Region/Sector Level

- **Set goals**
  - Make Markets

- **Apply minimum environmental and social standards**
  - Now

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13 Tariq Banuri (Stockholm Environment Institute, Boston) presentation.
14 Harnessing the Role of the Private Sector to Deliver Sustainable Development, A presentation by Glen Armstrong, senior Advisor, sustainable development, International Finance Corporation. www.ifc.org
Promoting good governance institutions will be a vital element to delivering continued sustainability performance for IFI-backed and other projects. The market cannot be relied upon to monitor and enforce compliance with sustainability objectives. Key elements to promote good governance include: Southern ownership, the involvement of civil society groups, influencing local government.

**Box 4: Inter-American Development Bank and the Eco-Enterprises Venture Capital Fund**

This initiative is a good practice example of how innovative financing can promote sustainable development rather than just ‘do no harm’. Set up by the Inter-American Development Bank’s Multilateral Investment Fund and The Nature Conservancy the Eco-Enterprises Fund (www.ecoenterprisesfund.com), provides venture capital and technical assistance for sustainable businesses in Latin America and the Caribbean. The fund has closed at $10 million but expects to expand later to $25-50 million and by 2010 the Fund expects to be financing around 30 small and medium-sized ventures. It provides capital and advice to start-up businesses in sustainable agriculture and forestry, non-timber forest products and eco-tourism if the venture:

- Employs sound environmental practices in its operations.
- Provides financial benefits to the community and local environmental organisations.
- Passes rigorous environmental and social screens.
- Meets the Fund’s financial criteria (target returns on equity of 18-20%).

The improvement of international transfer mechanisms will become increasingly important as the North looks to the South to provide more global public goods, such as climate stability through the reduction of greenhouse gas emissions. Given the problems noted above there is a need to simplify to paying for global values. One key improvement to GEF and other mechanisms would be to include capacity building in incremental costs.

There may be specific circumstances that would favour the creation of a new time-limited IFI rather than a new programme within an existing institution. The lessons of the Montreal Protocol suggest similar single-issue multilateral funds may be appropriate for promoting solutions in, for instance, sustainable energy and water and sanitation.
CHAPTER 3
IFI’s role in promoting sustainability in selected areas

3.1 POVERTY REDUCTION

3.1.1 Current situation
There is a crisis in development finance:

- Official development finance and domestic revenue raising is in decline.
- Growing non-concessional finance is not supporting sustainable livelihoods.
- Conservation finance restricting access to natural resources can be anti-poor.

A steady decline in official development finance and deteriorating domestic revenue raising has sharply reduced support for programmes of poverty reduction and environmental conservation. While non-concessional financial flows, from IFIs, private credit and direct investment, are growing (see table 1), their focus is on large-scale industry and infrastructure projects which generate relatively few jobs. The small and medium-scale sectors, which do have the potential to create large numbers of sustainable livelihoods, are generally not reached by this growing segment of development finance. The lack of integration of poverty-reduction and conservation financing can cause problems when access is restricted to natural resources used by the poor without any compensation for the global values they are providing.

3.1.2 Change required
There is growing policy recognition, but limited formal mechanisms, for a focus on:

- The sustainable livelihood approach.
- Alternative financing models.

DFID and IFIs such as the World Bank argue that the most effective use of development finance for reducing poverty and advancing the goals of Agenda 21 is the creation of sustainable livelihoods. This approach views poverty as vulnerability to shocks and aims to enhance the resilience of communities to cope with such shocks, through helping the poor build their asset base and improve access to and management of social and natural capital.

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15 This section draws on the papers and contributions of Adrian Davis (DFID), Tariq Banuri (Stockholm Environment Institute, Boston), Maryanne Grieg-Gran (IIED) and comments from other workshop participants.

This approach argues for a focus on building developing country capacity to access and use non-concessional finance, rather than the supply from IFIs of relatively short-term financial interventions.

A smaller project scale is required to create the numbers of sustainable livelihoods required. The large projects generally financed by IFIs and private financial flows are in capital-intensive sectors where there are substantial economies of scale: fossil fuel power generation, steel, oil refining, petrochemicals, cars. However, relatively few jobs are created. India, for example, needs to create 12-15 million non-farm jobs a year to reach full employment by 2015 yet the modern industrial sector barely generates 2 million because of high capital costs per job. By contrast, scale is not relevant for sectors such as water, construction and the supply of basic goods to rural communities, where enterprises can be commercially viable at quite small scale. Lower capital requirements often mean a higher return on investment and a more rapid recovery of scarce financial capital.

A different sequencing is also suggested by this approach. The development of large-scale infrastructure projects is not the first priority. This priority is usually to build social capital through existing community institutions, then to develop human capital through capacity building, followed by the development of institutions such as micro-credit to encourage the poor to save. Only once these assets are built and in place is it appropriate for the financing of large-scale infrastructure to help mobilise the use of these assets.

**Box 5: Micro-credit offers alternative financing model**

Micro-credit has been a major conceptual and practical breakthrough in financing sustainable development in developing countries, seeking to enhance access to market credit rather than a switch to possibly unsustainable subsidised credit. Micro-credit schemes developed through the work of the Grameen Bank which established the legitimacy necessary to borrow at low rates and lend to extremely small-scale borrowers at markets rates. Most schemes have the following features:

- Based on group lending and relying on peer and community pressure to facilitate recovery.
- Small but formal groups are formed, usually followed by training and awareness raising.
- Additional members can receive loans only after earlier ones are repaid.
- Interest rates, covering intermediaries costs, can be high (20-25%) but are lower than traditional money-lenders.

Micro-credit and the next step up, mini-enterprise lending, provide finance at the small and medium scale now widely thought to be required to generate the sustainable livelihoods that do not have access to larger-scale IFIs finance. A key role for IFIs is to provide credit and capacity building to these small-scale financial intermediaries.

Financing these small and medium-scale enterprises requires alternative finance models such as medium scale partnering projects, small-scale franchising, mini-enterprise lending and micro-credit. The transactions costs and risk of lending at this scale usually rules out direct involvement by the relatively high-cost IFIs. Micro-credit has been a significant advance although it has worked effectively in only a handful of countries and caters only for a small but significant niche (see box 5). The remaining problem is that both micro-credit and large-scale project finance do not help the bulk of the SME sector. Mini-enterprise lending is starting to fill this gap but far more is required.
3.1.3 Barriers to change

There are a number of barriers to the support of sustainable livelihoods finance by IFIs:

- Lack of IFI comparative advantage in small-scale projects and in building social capital.
- Limited capacity of recipients and local financial intermediaries to access and use finance.

The incentive structure in IFIs does not favour direct involvement in lending to the SME sector in developing countries; transaction costs are relatively high; IFIs do not have the local business knowledge required to monitor these loans; and internal incentives anyway support large-scale lending. Moreover, IFIs have a comparative advantage in financing large-scale industrial and infrastructure projects rather than in building social capital, human resources or small-scale financial intermediaries.

The major problem identified by workshop participants was that there was limited capacity in recipients and local financial intermediaries to access and efficiently use non-concessionary credit. There are generally low technical and managerial skills, limited access to technology appropriate to SME scales, inadequacy of marketing channels and local purchasing power and the absence of financial mechanisms geared to needs.

Box 6: IFC-sponsored mini-enterprise lending

There have been some steps by IFIs to support this critical scale of sustainable development financing. IFC have sponsored mini-enterprise lending in Pakistan, Jamaica and other countries. The record has shown that such small-scale borrowers have excellent repayment records and mini-enterprise lending can be commercially viable. The experience, for example, of Oryx in Pakistan shows that providing the lending agency adapts its operational style to local conditions and maintains close monitoring of loans, recovery can be extremely high, often above 98%.

3.1.4 Recommendations

- Create a framework to enable private, non-concessionary finance, to reach SMEs.
- Redirect IFIs financial flows down from large-scale projects to providing support for small-scale micro-credit and mini-enterprise lending financial intermediaries.
- Build capacity with local financial intermediaries and recipients.
- Improve transfer mechanisms to compensate poor for the global benefits their natural resources provide.

A framework to leverage private financial flows to the SME sector will need to reduce both transactions costs and risk. Reducing both of these will require increased transparency through IFIs encouragement of the adoption of monitoring mechanisms combining the strengths of models such as the Grameen Bank to build borrower track records, and network-based reporting systems (such as the Global Reporting Initiative) to increase

accountability. Because of the need for local business knowledge, established relationships, and low costs to make these higher-cost loans commercially viable, the comparative advantage lies with local, small-scale finance intermediaries. Financial support for these micro-credit and mini-enterprise lending financial intermediaries is an important means by which IFIs can leverage private finance into generating sustainable livelihoods.

The IFC have already moved in this direction, as described in box 6, and now 40% of their lending is to other financial intermediaries.

Capacity building and institutional strengthening is perhaps more important than the supply of finance to these institutions. Not much attention has so far been given to the issue of building capacity in accessing and utilising small-scale finance. There is an important role for IFIs to help strengthen local institutions to intermediate small-scale development finance, building on the recommendations of the OECD’s Development Assistance Committee. Capacity building is required for both borrower and small-scale financial intermediary to reduce objective risks of loan default. The moral hazard problem can be tackled through developing capacity in the effective use of the monitoring systems discussed above. Perhaps the most compelling reason for such an IFI capacity building programme is the scale of demand for such a credit framework is estimated in the millions in India alone.

More effective transfer mechanisms are required for compensating the poor for restricted access to natural resources generating global values. This includes making GEF procedures more effective as discussed above, but also considering the interests and incentives for the poor to manage these resources when designing certification and other schemes.

**Box 7: SAPPROS - Creating Sustainable Livelihoods in Rural Nepal**

Support Activities for Poor Producers in Nepal (SAPPROS) is an example of a new kind of indigenous Southern NGO which takes a rigorous approach to fostering sustainable livelihoods, starting with education and training. Since its foundation in 1991, 5,000 women and 1,500 men have received management training and another 2,500 people been made literate. The most able of these are recruited as catalysts, and under their guidance, and that of SAPPROS’ technical experts, 100 km of trail roads and 13 suspension bridges, 140 drinking water supply and 170 micro-irrigation systems have been constructed, 2,600 ha of community forests have been planted, over 100 PV electrification systems, 50 biogas plants and 5 micro-hydro plants have been installed, and 670 credit and savings groups established. The new infrastructure is managed and operated by 350 user groups from, and funded by, the communities concerned. Average incomes in the 15,000 beneficiary households have risen by over Rs.5,000. SAPPROS installs the water services at 20% of the cost of comparable Government schemes.

Much of SAPPROS’ funding comes from bilateral aid programmes, but some of its water service projects have been funded in partnership with the World Bank’s Rural Water Supply Fund Development Board Programme. While grant funding is always likely to play an important role at least in the initial stages of such programmes, SAPPROS has added to the now extensive evidence that, given the right institutional framework, even the poorest of the poor can make productive and sustainable use of loans.

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18 Spanger-Siegfried, E. & T. Banuuri op cit.
3.2 ENERGY

3.2.1 Current situation

The current situation in financing energy is not sustainable:

- One third of the world’s population does not have access to electricity.

- No chance of climate stability if developing country energy demand is met through fossil fuels.

- IFIs are focused on financing large-scale fossil fuel power generation rather than renewables.

One third of the world’s population still does not have access to electricity, despite the historic record that electrification catalyses both agricultural and industrial productivity gains, and can stem the flow of population from rural to urban centres. Moreover, developing country energy use is generally inefficient and detrimental to human and social development. Millions spend hours each day collecting subsistence energy at great opportunity cost to productive income generation and education.

The bulk of this energy deficit is not being filled by renewables or efficiency projects. Yet if developing countries meet their growing demand for energy with fossil fuels there is no chance of climate stability. This is not the only option even with no further progress with existing alternative energy technologies. In fact, renewables may be the most competitive off-grid option as the marginal cost of extending transmission lines into rural areas from a centralised grid is often higher than for stand-alone renewable energy systems. In addition, there is evidence of willingness to pay for alternative energy supplies. Large sums are already paid per unit of energy for instance to provide lighting from inferior grade candles or dry-cell batteries.

Box 8: IFC innovative funds for small-scale renewable energy ventures

The IFC has responded to the demand, for small-scale financing of renewable energy venture in developing countries, with three innovative funds: the PV Market Transformation Initiative (PVMTI), the Renewable Energy and Energy Efficiency Fund (REEEF) and the Solar Development Group:

- PVMTI aims to accelerate the commercialisation and financial viability of PV-based energy services in India, Kenya and Morocco. Operational since 1998, and using $25 million of concessional finance from the GEF, it provides finance (debt, equity or guarantees) and business advice to local PV businesses. Total project investment is planned to rise to $90-120 million.

- REEEF targets renewable and energy efficiency projects, generally <50MW and small scale PV operations. Planning to draw on GEF co-financing the Fund expects to invest $150-210 million.

- The Solar Development Group was formed by the IFC, GEF, the World Bank, and some US foundations with a $30 million for profit fund and $20 million for charitable funding. It aims to accelerate for-profit distribution, retailing and financing of environmentally sound and reliable energy to rural areas in developing countries, through education, awareness training and ultimately investment in local PV companies.
IFIs, including ECAs, are presently financing a substantially greater proportion of fossil fuel power generation to renewables projects than many think is consistent with sustainable development. For instance, the US ECAs (OPIC and Ex-Im) are financing projects with CO₂ emissions equivalent to three-quarters of annual US emissions. The World Bank has started to take significant steps to tackle this issue. In 1997 the ratio of fossil fuel projects to renewables plus energy efficiency projects was 100:1. Today this ratio is down to around 16:1.

3.2.2 Change required
Several major changes in energy lending policies are required:

- The adoption of strategic goals for providing access to electricity.
- A reorientation of finance towards small-scale, off-grid, renewable energy projects.
- Financial and capacity-building support for local financial intermediaries.

The changes recommended by the G8 Renewables Taskforce include the adoption of a strategic goal to provide access to electricity for 1 billion people during the next decade, and to reorient finance towards small-scale, off-grid renewable energy projects. IFIs, particularly ECAs, need to continue the transition apparent with World Bank lending policies.

Similar changes are required to promote the financing of sustainable energy as for sustainable livelihoods. Namely the promotion of local financial intermediaries to fill the gap between large-scale project finance and micro-credit, and provide management and technical advice. These small-scale financial intermediaries have significant comparative advantages of local knowledge, sector-specific experience and can give the technical and business advice that will reduce transactions cost and risk to a commercially viable level. Their disadvantages are that they have poor leverage on policy-makers to level regulatory and tariff playing fields, they are capacity constrained and find it hard to pay market rates for high quality staff.

3.2.3 Barriers to change
A number of barriers to reorienting IFIs finance towards renewable energy projects were identified:

- The small scale of renewable energy projects.
- Lack of capacity in financial intermediaries.
- Higher transactions costs.
- Greater risks.

The small scale of renewable energy projects make them difficult to finance for the reasons already discussed, that IFIs have a comparative advantage in financing large and risky projects and their internal incentive structures favour large projects. In financial intermediaries, loan officers may misperceive risks because of the transactions costs in acquiring the necessary information about unfamiliar technologies and borrowers. GEF, for example, has limited capacity to finance renewables both in terms of funds available and expertise in shaping the energy investment choices of developing countries. Transaction costs are much higher.
than with traditional thermal power projects partly because renewable energy projects are more site-specific and dependent on the predictability of weather patterns. Renewables may also face higher costs for transmission to a centralised grid, due to the intermittent nature of supply or the distance from grid in rural areas. Moreover, risks are higher. Widespread deregulation of the power supply industry and project development by independent power producers with no power purchase guarantee means renewables often have to sell on the spot market, with the associated uncertainty of price. Renewables also face uncontrollable resource (sun, wind) risks although insurance and capital market products may be available to offset these, at a cost.

**Box 9: Asian Development Bank and the India Renewable Energy Development Agency**

A good example of how IFIs can support small-scale financial intermediaries is provided by the India Renewable Energy Development Agency. IREDA was set up, by the Indian Ministry of Non-Conventional Energy Sources and the Asian Development Bank, to provide small-scale loans and business assistance to Indian developers of micro-hydro projects, residential solar PV systems, biomass fuels and wind farms. Funds are also raised by issuing bonds on local capital markets, and credit lines have recently been extended to IREDA by the World Bank and the German Development Bank, KfW. Support is given of up to 85% of project finance requirements and 90% of equipment financing at rates comparable to commercial institutions. Debt does not begin to be repaid until three years into the loan. IREDA’s investments have been profitable since start up in 1987. A typical project was the initiation of a credit system for low-income households to purchase solar PV systems for applications such as household appliances, water pumping, residential lighting and community health clinics.

### 3.2.4 Recommendations

- A higher priority should be given to renewables financing by IFIs.
- IFIs should develop innovative financing mechanisms to direct funds towards SMEs.
- Build capacity in local financial intermediaries.
- Use leverage with government to promote good practice in regulatory design.

If they are to enhance the sustainability of their energy lending, the World Bank, GEF, EIB, multilateral development banks and ECAs will have to give renewables a higher priority. Internal incentive structures favouring large-scale projects will have to be addressed. One aspect of this will be to develop a transparent methodology to calculate the carbon content of IFI loan portfolios. ECAs could be given targets for financing renewables in developing countries. Many IFIs should consider leveraging their funds through local financial intermediaries that may well be able to better manage the risks and enterprise development needs associated with small-scale renewable ventures. Box 9 describes an Asian Development Bank-funded example of this.

A key role for IFIs will be to continue to support and develop innovative financing mechanisms for directing funds to SMEs. The IFC’s Africa and Mekong Projects Development Facilities are well placed to fund these projects, as are the specialist venture capital funds shown in Box 8.

22 See http://www.ireda.nic.in/ for further information.
IFI’s role in promoting sustainability in selected areas

IFI’s need to build capacity in the small-scale financial intermediaries if the developing world is to access and effectively utilise the non-concessionary funds available. A good example of a GEF-funded initiative of this sort is described in Box 10.

Good regulatory design could also be encouraged by IFIs, using their experience and influence with national government. The lessons from mistakes made in energy reform in California and elsewhere include the importance of pricing to ensure efficient allocation, and that reformed regulation may often be more appropriate than privatisation.

Box 10: GEF-funded Renewable Energy and Energy Efficiency Advisory Service

This service is a good example of the sort of capacity building in local financial intermediaries that IFIs can support. It is implemented by UNEP, using just under $1 million of GEF funds, with the aim of helping bank loan officers and other financiers in the due diligence process when evaluating renewables and energy efficiency projects in developing and transition economies. It is not meant to cover all aspects of project evaluation, instead focusing on incremental risk issues relating to new technologies that abate Greenhouse Gases when used instead of traditional energy supply options. The Service’s long-term objective is to help financial institutions develop the capacity to appraise these projects themselves.

3.3 WATER

3.3.1 Current situation

The current water situation is characterised by:

- A growing shortage of fresh water and sanitation.
- IFI lending to this sector is marginal and likely to remain so.
- IFIs have leveraged this contribution by demonstration projects and building capacity.

There is a clear and growing shortage of fresh water and sanitation in many parts of the world today. Currently six billion people depend on the world’s finite supply of freshwater to drink, grow food, dispose of waste, bathe, etc. One billion people have only unsafe water to drink and 2 billion lack sanitation. In a generation’s time it will be eight billion people that will depend on that same finite supply of freshwater for all purposes. Water is also a contested resource with all the problems of conflict that brings, as millions live in areas where water is very scarce.

In tackling this sustainability issue, as with energy, IFIs start from a position where their influence in terms of volume of lending is very small and this is unlikely to change. Their lending is around $2 billion as compared with total investment in water, sanitation and wastewater treatment in developing countries of $30 billion each year. This looks even more marginal when compared with the $80-90 billion a year estimated by the Global Water Partnership as required to reach coverage targets agreed at the Hague in 2000. A s

23 See http://www.uneptie.org/energy/act/re/IAF/index.htm for more details

24 This section draws on the papers and contributions of Jens Mathiesen (EBRD), Prof. Tony Allan (SOAS), James Winpenny (Moselle Economic Consultancy), Ravi Narayanan (WaterAid) and comments from other workshop participants.

with energy and poverty reduction, IFIs must look to opportunities to build capacity and leverage their influence on private finance and policy to have an impact on sustainable water financing.

3.3.2 Change required
To improve the sustainability of their lending to this sector IFIs must:

- Ensure that projects are responding to demand.
- Treat water as an economic good to ensure efficient use and allocation.

Historically water supply and sanitation programmes were supply driven, centrally planned according to available technologies and desired standards. It is now recognised that projects have far more chance of succeeding if costs and service levels are driven by local conditions and user demands. IFIs need to ensure that their focus on large-scale projects does not bias them towards a supply-driven approach.

Moreover, water has also been viewed primarily as a social good, which is so but it is also an economic good with value and costs associated with its provision. If provided free then use of this scarce resource can be excessive and misallocated. Water as an economic good implies that pricing is required for efficient use and allocation between users, full cost recovery over an appropriate time period, and consideration given to whether cross-subsidies should be phased out (if equity can be achieved without it being at the expense of efficiency).

The experience in some developing countries, unlike the transition economies, has been that the near absence of capable civil society groups and a feeble local private sector means that the withdrawal of government from direct provision of water has not worked. Pricing rather than private ownership is the key to efficient use and allocation and this can be brought about by appropriate regulation as well as privatisation.

3.3.3 Barriers to change
Barriers facing IFIs efforts to implement these changes include:

- Poor ability and willingness to pay outside the urban centres in peri-urban and rural regions.
- Contested supplies where watershed covers several countries.

Pricing policies, with full cost recovery and the removal of subsidies, attractive though these are to resource efficiency and to private finance, may not be feasible in peri-urban and rural areas. Outside the urban centres ability and willingness to pay may be considerably lower and will require either a flexible pricing policy or a system of transfer payments to ensure the affordability and acceptability of the water project.

Throughout human history, water resources have been a source of conflict and the same is true today where large populations live in areas of scarce water supply and watersheds cover several countries. Trans-boundary water resource conflicts have become very significant in recent years but there are some encouraging examples of countries discussing these issues with increased transparency. One of these is the Nile Basin initiative that established an arrangement between Burundi, Democratic Republic of Congo, Egypt, Ethiopia, Kenya, Rwanda, Sudan, Tanzania and Uganda. It is particularly important in these circumstances.
for IFIs to fully apply the principle of participation. A model of the sort of multi-stakeholder approach that is required to overcome this barrier is the World Commission on Dams, which is described in Box 11.

### 3.3.4 Recommendations

These include:

- Building capacity through shaping ‘water wisdom’.
- Demonstration projects.
- Leveraging private finance.

Despite their marginal significance in terms of lending volumes to the water sector, IFIs can exert considerable influence on the sustainability of water projects through capacity building and using their influence and research resources to spread knowledge of best practice.

Best practice examples through carrying out model projects are another key channel of influence on sustainability by IFIs. There are a number of examples of good practice in privatisation: Sofia (EBRD); Bucharest (IFC, EU); Manila (ADB, then IFC). Also good practice can be pointed to in the reform of public institutions: Riga and St Petersburg (World Bank and EBRD).

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**Box 11: The World Commission on Dams**

The World Commission on Dams was an initiative of the World Bank and the World Conservation Union which worked from 1997-2000, with the objective of assessing the effectiveness of large dams and alternatives, but also the complex social and environmental consequences for poor people. The Commission comprised twelve individuals of international standing, each representing different interests in the dams debate. This multi-stakeholder process achieved a remarkable consensus, reflected in the World Commission on Dams report (November 2000) which sets out a very constructive protocol for future planning of dams.

Finally, there is scope to leverage private finance. This is certainly true in the urban centres of transition economies, but much more difficult in rural areas of the developing world. Capacity building will be required where civil society and governance are undeveloped and where the private sector is weak. This includes support for a transparent regulatory system (tariff rules, shareholder remuneration, tendering of water contracts, independent regulator) which private finance will require. The support through funding and capacity building of local small-scale financial intermediaries such as micro-credit institutions is a further channel of influence on private finance for the IFIs.
3.4 CLEANER PRODUCTION

3.4.1 Current situation
There are a number of features that characterise cleaner production financing:

- Cleaner production is a goal and not a thing to be financed.
- The SMEs are the key sector for the IFIs to influence.
- Cleaner production good practice varies widely by industry and sector.

Cleaner production arises from sound and proactive environmental management rather than from technology per se. As a matter of course, good management will identify cleaner production technologies when they make business sense, and will manage existing technologies to reduce resource use and waste within the limits of cost-effectiveness.

Unfortunately management of this kind is still comparatively rare, especially in the small and medium enterprise (SME) sector, in which the great majority of new investment in industrial productive capacity will take place over the next few decades.

The practice of cleaner production will vary by industry, by sector, sometimes even by company. There is no way that IFIs could become expert in different cleaner production processes and technologies in order to give direct advice to enterprises. Fortunately they do not need to. Over the last decade there has been a substantial growth in organisations that can give advice about cleaner production, which may be called Cleaner Production Centres, Green Business Links, Cleaner Production Technical Assistance Organisations (CP-TAOs) or a variety of other names.

3.4.2 Changes required
The key change required to enhance IFIs influence in this area is:

- To raise awareness about the private and social benefits that arise from cleaner production.

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Box 12: World Bank’s Global Water Partnership initiative

There is an important role for IFIs to act as ‘knowledge’ banks, promoting strategies and policy that bring about sustainable resource use. One good example of this is the Global Water Partnership, set up in 1996 by The World Bank, along with the UNDP, Donors and NGOs. The GWP promotes sustainable water use by supporting integrated water resources management, influencing the policies of governments, aid agencies and other stakeholders, sharing information and experience and developing innovative and effective solutions to unsustainable water use. It has programmes covering water and sanitation, irrigation and drainage, both of which it intends to have a catalytic effect on investment in sustainable water use.

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26 See http://www.gwpforum.org/ for more details.
27 This section draws on the papers and contributions of Mike Kelly (KPMG), Burton Hamner (Consultant), Mark King (EBRD) and comments from other workshop participants.
The most important change that is necessary for production to become cleaner is for businesses, especially SMEs, to put in place the institutional capacity and systems that will enable them to progress towards best practice in terms of their use of environmental resources and generation and management of wastes. This capacity has, at minimum, five elements: total cost accounting, an environmental management system, special concern for toxics reduction and resource efficiency, an awareness of life-cycle impacts of products and processes, and active contacts with cleaner production experts. There is now substantial experience which confirms that, at worst, the net cost of such capacity is small, and at best it can lead to major cost savings and improvements in competitiveness.

At present businesses either do not know about, or do not give a high enough priority to, the private and social benefits that can arise from cleaner production. IFIs have an important role to play both in raising the awareness of businesses in this respect, and making it clear to them that access to IFI resources is dependent on businesses having or building the necessary management capacity to take these issues seriously.

3.4.3 Barriers to change

The most important barrier to an enhanced role for IFIs in promoting cleaner production is:

- A lack of understanding and commitment to cleaner production principles.

The most important barrier to change, in both businesses and IFIs, is a general lack of understanding of and commitment to cleaner production core principles. Many businesses do not feel that cleaner production is of importance to their consumers, their business performance or their investors, including IFIs. Sometimes they are right in their suspicion that cleaner production is actually very challenging in business terms, because policy failures to internalise externalities can mean that cleaner production operates at a competitive disadvantage to dirtier alternatives. IFIs too, even when they are aware of cleaner production, can find that cleaner production presents challenges (longer lead times, smaller project sizes, less experienced sponsors, newer technologies, less established markets and a higher ratio of capital to operating costs) which can make them less attractive than the relatively dirty alternative.

3.4.4 Recommendations

- Pressure on governments to internalise the costs of relatively dirty production.
- Cleaner production criteria should be fully integrated into IFI lending decision-making.
- IFIs should mobilise private sector financing of firms developing cleaner production.

The most important recommendation is that governments should take steps to ensure that cleaner production is not put at a competitive disadvantage by a failure to internalise the costs of relatively dirty production. This may be encouraged through disclosure strategies such as the publication of equity indices composed of companies with good cleaner production performance. They also need to make clear to IFI managements that they expect IFIs to be major promoters of cleaner production and to lever and catalyse private finance into cleaner production as well. They should recognise that this may have resource implications, at least until the necessary practices and procedures have bedded down, in terms of higher transaction costs, and will require longer-term financing at reasonable rates.

Once IFIs have the necessary policy mandate they can in turn make clear to potential borrowers that they expect a high level of environmental management. In loan discussions they can ask pointed questions which will reveal the extent to which prospective borrowers
are taking these issues seriously. They can insist that business plans are formulated in terms of environmental best practice, as well as best practice in other business areas. They can also encourage potential borrowers to transmit a concern for cleaner production up their supply chain.

IFIs also need to spread a greater concern for cleaner production to the rest of the investment community. They should be prepared to offer basic training in cleaner production investment appraisal to financial intermediaries, and other investment institutions, where necessary. The publication of cleaner production equity indices, described above, and the assembling of pools of investible SMEs by technical assistance organisations, are information instruments that can leverage private finance into companies developing cleaner production.

Finally, IFIs can open special financial windows for lending to promote cleaner production (while being careful not to subsidise essentially competitive technologies and so crowd out private investment). Gradually as better practice gets established through these windows, it can be mainstreamed through the IFIs normal loan portfolio, while the special windows change their criteria and expectations to remain at the cutting edge. The special windows or initiatives of the Danish Export Credit Agency (see Box 13) and the IFC (see Box 14) could operate in this way.

**Box 13: Eksport Kredit Fonden (EKF), Denmark**

Denmark’s export credit agency, EKF, has had environmental procedures, applying to contracts above USD 15 million, in place since February 2001. A new initiative is to offer soft loans for investments in environmental projects, including cleaner production, in Central and Eastern European countries. The loans, to credit-worthy clients only, are intended to finance a wide range of environmental investments, including alternative energy, wastewater, waste management, air purification and district heating. The loans come with a subsidy of 25% of the financed amount, an export credit guarantee free of charge and a flat interest rate. Projects are put out to international tender, which is administered by EKF. There is a simplified tender process which must, however, be accompanied by an environmental assessment of the proposed project.

**Box 14: Proposed New Facilities from the International Finance Corporation (IFC)**

IFC recognises that cleaner production investments have challenges for both borrowers and investors. To help meet these it is proposing to set up three new facilities:

**Corporate Citizenship Project Assistance Facility:** this would allow IFC and project sponsors to engage actively in public good and activities specifically geared to development that are not strictly part of any particular project.

**Financial Institutions Support Facility:** this would aim to strengthen the capacity of key financial sector plays in environmental and social management.

**Environment Opportunities Facility:** this would provide project preparation support and seed financing for projects addressing local environmental issues. Such projects would produce goods and services that reduce pollution or improve the use of scarce resources such as water and energy.

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28 Enhancing institutional capabilities for sustainable development, an presentation from Eksport Kredit Fonden (EKF), Erhversministeriet.

29 Harnessing the Role of the Private Sector to Deliver Sustainable Development, A presentation by Glen Armstrong, senior Advisor, sustainable development, International Finance Corporation. www.ifc.org
Unlike their private sector counterparts, IFIs are driven primarily by policy rather than private financial returns. When the Bretton Woods institutions were set up one of their roles was to take on large and risky industry and infrastructure projects. The strong message from the workshop was that the need for this financing from the IFIs has changed. It has changed both with the increasing volume of private financial flows into these projects and with the realisation that large scale infrastructure projects are not the best vehicles for delivering sustainable livelihoods and sustainable development more generally.

The common thread running through the debate (on poverty reduction, sustainable energy and water, and cleaner production) is that sustainable development in developing economies depends on financing small and medium-scale projects and enterprises, through leveraging private finance including the support of local financial intermediaries, and by capacity building to enable these institutions and their SME clients to access and utilise non-concessionary finance.

The comparative advantages IFIs can bring to bear on financing the key small-scale projects and enterprises include their: knowledge and capacity-building capabilities; role in setting out an incentive-based framework to direct private finance; ability to leverage private financial flows through innovative risk and cost sharing.

In order to significantly improve the contribution IFIs make to financing sustainable development the following recommendations need to be considered:

- IFIs need to reorient their financing away from large-scale industrial and infrastructure projects towards small-scale projects and enterprises by:
  - Changing volume-based internal incentives for IFI lending towards a more results-based incentive framework, including sustainable development targets.
  - Setting an incentive-based framework to direct private financial flows by overcoming disincentives, improving markets and creating missing markets such as the World Bank’s Prototype Carbon Fund, encouraging sound regulation and providing information.
  - Leveraging private financial flows through local financial intermediaries such as the ADB-funded India Renewable Energy Development Agency, and through innovative financing mechanisms such as the IADB-supported Eco-Enterprises venture capital fund.
  - Building capacity with local institutions, including financial intermediaries such as the GEF-funded Energy Efficiency Advisory Service, and carry out demonstration projects.
  - Promoting good governance to ensure continuing monitoring and enforcement of project objectives, through local government and civil society participation as with the World Bank-supported World Commission on Dams.
The success of the Montreal Protocol Multilateral Fund points to a need for new single-issue IFIs to be set up:
- To finance sustainable energy and water.
- To support micro-credit and mini-enterprise lending for sustainable livelihoods.
- To provide competition for established IFI financing in these areas.

As a necessary complement to IFI financing there is a need for a substantial improvement in international transfer mechanisms to help pay for global sustainability benefits generated in the South.
# List of participants

<table>
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<td>ECGD UK</td>
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<tr>
<td>Stephen O. Anderson</td>
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<td>John Ashton</td>
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<td>Duncan Brack</td>
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<td>Daryl Brown</td>
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<td>Fanny Calder</td>
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<td>Jake Werksman</td>
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<td>Alex Wilks</td>
<td>Bretton Woods Project</td>
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<td>James Winpenny</td>
<td>Moselle Economic Consultancy, Luxembourg</td>
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<td>Daphne Wysham</td>
<td>Institute of Policy Studies, US</td>
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<td>Zoe Young</td>
<td>Hull University/Conscious Cinema</td>
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# GLOSSARY

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Definition</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asia Development Bank</td>
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<tr>
<td>CP</td>
<td>Cleaner Production</td>
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<tr>
<td>CP-TAO</td>
<td>Cleaner Production Technical Assistance Organisation</td>
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<tr>
<td>Concessional finance</td>
<td>Grants or loans extended at below-market interest rates</td>
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<tr>
<td>Counterfactuals</td>
<td>A scenario or simulation of an historic event with different underlying assumptions</td>
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<tr>
<td>DEFRA</td>
<td>Department of Environment Food and Rural Affairs</td>
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<td>DiFD</td>
<td>Department for International Development</td>
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<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<tr>
<td>ECA</td>
<td>Export Credit agency</td>
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<td>ECGD</td>
<td>Export Credit Guarantee Department</td>
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<tr>
<td>EIB</td>
<td>European Investment Bank</td>
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<tr>
<td>EKF</td>
<td>Eksport Kredit Fonden (Danish ECA)</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>Ex-Im</td>
<td>Export-Import Bank (US ECA)</td>
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<tr>
<td>External costs</td>
<td>Unpriced economic, environmental and social impacts resulting from an economic activity</td>
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<tr>
<td>Financial intermediaries</td>
<td>Institutions such as banks that act as an intermediary between savers and borrowers</td>
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<tr>
<td>GEF</td>
<td>Global Environment Fund</td>
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<td>GWP</td>
<td>Global Water Partnership</td>
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<tr>
<td>Genuine Savings</td>
<td>A World Bank indicator designed to measure the value of the net change in the whole range of assets that are important for development: produced assets, natural resources, environmental quality, human resources, and foreign assets</td>
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<tr>
<td>Global public goods</td>
<td>A good, such as climate functions and biodiversity, with benefits that accrue to the world generally and which is ‘non-rivalrous’ and ‘non-excludable’</td>
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<tr>
<td>Global values</td>
<td>Values or benefits, such as from the reduction of greenhouse gases, which accrue to the world generally</td>
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<td>IADB</td>
<td>Inter-America Development Bank</td>
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<tr>
<td>Acronym</td>
<td>Description</td>
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<td>IFI</td>
<td>International Financial Institutions broadly defined to include the World Bank group and the multilateral development banks, bilateral development banks, export credit agencies and institutions such as the UNEP, GEF and the Montreal Protocol Fund.</td>
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<tr>
<td>IIED</td>
<td>International Institute for Sustainable Development</td>
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<td>IREDA</td>
<td>India Renewable Energy Development Agency</td>
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<tr>
<td>Incremental costs</td>
<td>A controversial term with differing interpretations under the various 1992 Rio agreements. Its economic interpretation is simple in concept being the additional cost arising from choosing an action that differs from the action that would otherwise have taken place (the baseline).</td>
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<tr>
<td>Internalisation</td>
<td>The full inclusion of external environmental, social and other impacts with financial information when taking decisions on an economic activity.</td>
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<td>Moral hazard</td>
<td>In the case of banking, the incentive to make 'excessively' risky loans as a result of 'excessive' insurance or public sector backing in the event of loan default or run on deposits.</td>
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<tr>
<td>Market credit</td>
<td>Unsubsidised loans, debt and equity finance.</td>
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<tr>
<td>Non-efficiency objectives</td>
<td>Such as equity or sustainability.</td>
</tr>
<tr>
<td>Non-concessional finance</td>
<td>Unsubsidised loans, debt and equity finance.</td>
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<tr>
<td>NGO</td>
<td>Non-Governmental Organisation</td>
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<tr>
<td>OPIC</td>
<td>Overseas Private Investment Corporation, a US EPA</td>
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<td>PCF</td>
<td>Prototype Carbon Fund</td>
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<tr>
<td>PV</td>
<td>Photo-voltaic</td>
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<tr>
<td>PVMTI</td>
<td>Photo-voltaic Market Transformation Initiative</td>
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<tr>
<td>Private equity</td>
<td>The investment of funds in a share of a company that is unlisted on a stock market.</td>
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<tr>
<td>REEEEF</td>
<td>Renewable Energy and Energy Efficiency Fund</td>
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<td>RING</td>
<td>Regional and International Networking Group</td>
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<tr>
<td>SAPPROS</td>
<td>Support Activities for Poor Producers in Nepal</td>
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<tr>
<td>SME</td>
<td>Small and Medium size Enterprises</td>
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<tr>
<td>SOAS</td>
<td>School of Oriental and African Studies</td>
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<tr>
<td>UNDP</td>
<td>United Nations Development Programme</td>
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<tr>
<td>UNED</td>
<td>United Nations Environment Programme</td>
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<td>USEPA</td>
<td>United States Environment Protection Agency</td>
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<tr>
<td>WB</td>
<td>World Bank</td>
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<tr>
<td>WSSD</td>
<td>World Summit on Sustainable Development</td>
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<td>WWF</td>
<td>World Wide Fund for Nature</td>
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