4TH INTERNATIONAL CONFERENCE ON Small Island Developing States 2024

# Making Climate Finance Work for SIDS: Building on the Outcomes of UNFCCC COP28

*Background Note[1] for the Interactive Dialogue 3,*
*4th International Conference on Small Island Developing States*
*"Charting the Course Toward Resilient Prosperity"*

## 1. Introduction

The 2021 UN High-Level Climate Action Champions study and related Net-Zero Roadmap estimated the need for financing for net-zero by 2050 at USD 125 trillion.[2] In 2023, the Energy Transition Commission (ETC) reviewed estimates to USD 3.5 trillion per year, or a total of USD 105 trillion needed to reach net-zero by mid-century. The largest investment is in decarbonizing electricity, the sector needing to scale-up investments from USD 600 billion annually to USD 2.2 trillion by 2030. According to the IMF, of the USD 630 billion a year in climate finance across the world, only a fraction is going to developing countries.[3]

For small island developing States (SIDS), the world's missing the net-zero target by mid-century is an inconceivable scenario as their low-lying lands will be claimed by rising seas and increasing erosion and seawater submersion will infiltrate groundwater and destroy soils, vegetation and infrastructure.[4] The world cannot meet the goals of the Paris Agreement and avoid a climate catastrophe without a rapid alignment and scaling-up of development and climate finance. Yet the majority of SIDS face significant challenges accessing and absorbing sufficient levels of affordable climate finance. The most concerning barrier relates to access to concessional finance, for which many middle-income SIDS are ineligible due to their GNI per capita. The proposed Multidimensional Vulnerability Index is currently being negotiated as a complement to the GNI per capita to better link development and climate financing to actual needs.[5] The second most challenging barrier is the current financial architecture including the climate finance system, which is fragmented, complex, burdensome, slow and expensive. Coupled with SIDS' increasingly high debt burden, limited

[1] This Paper was prepared under the leadership of UNOPS and the Resident Coordinator's Office for Barbados and the OECS. Contributions were received from IOM, MCOs Fiji & Micronesia, UNDP, FAO, UNIDO, UNDRR, UNESCO, UNFCCC and DCO.
[2] https://climatechampions.unfccc.int/whats-the-cost-of-net-zero-2/ and https://www.gfanzero.com/netzerofinancing/
[3] https://www.imf.org/en/News/Articles/2023/02/28/sp022823-scaling-up-climate-finance-for-emerging-markets-and-developing-economies
[4] https://www.theguardian.com/books/2022/aug/14/nomad-century-how-to-survive-the-climate-upheaval-by-gaia-vince-review-a-world-without-borders
[5] See final_mvi_report_1.pdf (un.org). A/RES/78/232 and the ABAS 2024-2034 call on the international community and the United Nations to make use of the MVI including in climate financing and report back at the 79th UNGA in September 2024.

economic growth options, low productive capacities and heavily constrained governance systems due to insufficient human resources to run large-scale programmes, it is clear that reforming international financing is a critical necessity.

In order to achieve sustainable development and thrive in a world increasingly ravaged by climate change impacts, SIDS have identified access to predictable and concessional financing and scaled-up climate finance as prerequisites for their continued progress towards resilient prosperity. Reforming climate finance is a global priority and steps are being taken to progress this reform at COP29 later this year drawing on the Biennial Transparency reporting using the Enhanced Transparency Framework due by 31 December 2024 and the New Collective Quantified Goal (NCQG) on Climate Finance framework. The NCQG will cover all forms of climate finance including mitigation, adaptation and loss and damage.

In anticipation of the COP29 discussions, and considering the need to address the shortcomings of the current climate finance architecture and for action to achieve resilient prosperity over the next decade, this background paper will: i) reflect the SIDS' call to the international community to scale-up climate finance in line with the UNFCCC and the Paris Agreement principles of common but differentiated responsibilities and respective capabilities; ii) outline the existing challenges that prevent the timely and efficient access to and utilization of climate finance in SIDS; and iii) propose potential solutions and opportunities to ensure SIDS can secure a climate resilient future.

## 2. Key challenges

Evidence shows that over the course of four years (2016-2020), SIDS have paid in debt service 18 times more than what they received as climate finance (USD 26 billion versus USD 1.5 billion for climate adaptation).[6] Their debt-to-GDP ratios are generally deteriorating due, in part, to the cost of debt servicing exceeding SIDS' GDP growth rates. Poor credit ratings and close to distress levels of indebtedness are making difficult any additional borrowing to cover climate adaptation needs. More frequent extreme weather events and the associated economic losses will only worsen SIDS' fiscal outlook moving forward.

SIDS are uniquely vulnerable due to fragile natural environments, high exposure to sea level rise and tropical storm activity, and geographic isolation, heavy reliance on food imports, global food price spikes, and excessive exchange rate volatility. This has led to high levels of food insecurity and malnutrition, low economic growth and lack of progress on human development. Dominica, for example, experienced losses of up to 226 percent when Hurricane Maria hit the island in 2017

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https://www.eurodad.org/small_island_developing_states_sids_have_spent_18_times_more_in_debt_repayments_than_they_receive_in_climate_finance_says_new_research#:~:text=The%20latest%20statistics%20reveal%20that%2C%20while%20all%20SIDS,more%20than%20US%2426.6%20billion%20to%20their%20external%20creditors.

whereas Kiribati, on which no part of its land mass rises more than two metres above the ocean, is urgently attempting to slow coastal erosion through land reclamation. Reliance on Official Development Assistance (ODA) among SIDS remains high with the Pacific SIDS' ODA to GDP ratio ranging from 15 percent in Fiji to over 80 percent in Tuvalu. Due to a deteriorating global context defined by conflicts and adverse impacts of climate change and the pandemic, from 2020 to 2023, ODA to SIDS declined by 22 percent. However, high -income SIDS are largely ineligible for concessional finance, even when highly exposed to multiple natural, economic and social risks.

Several challenges affecting resilience prospects in SIDS require expeditious action for which adequate financing is key. The climate finance landscape is becoming increasingly complex leaving climate vulnerable countries struggling to access funding at scale. Climate project sizes are getting smaller with many projects falling below the minimum threshold requirements of multilateral banks and thus requiring bundling. Lack of sectoral and costing data as well as project preparation capacity (e.g., feasibility assessments) have also hindered access to climate finance. Large high impact greenfield projects, particularly for critical infrastructures, receive little climate finance, and when secured that finance usually takes the form of loans. In fact, loans are much more prevalent for delivering climate projects than grants, thus increasing the debt burden. Over two-thirds of official climate finance is provided as loans – a proportion significantly higher than the 52 percent average for all official flows to developing countries.[7]

The current climate finance architecture also poses issues for improving public financial management in many SIDS. Little climate finance is provided directly to government budgets and most climate interventions are delivered via project-based modalities posing the risk of fragmentation and bypassing country systems. Further, committed climate finance is not being disbursed to recipients at the same rate as other types of development finance leading to project delays or cancellations. SIDS experience higher transaction costs in relation to total project costs compared to non-SIDS countries due largely to small project size and limited local expertise. Country ownership is essential for optimizing development effectiveness. In this regard, direct access project modalities have been put forward as a promising avenue for increasing country ownership but there remains significant scope to scale up their impacts. Equally important is the integration of climate and development strategies and their alignment with national budgets including comprehensive Integrated National Financing Frameworks which remain a work in progress in many SIDS.

Where climate finance is directed to also requires some improvement if climate resilience is to be achieved for SIDS. Climate-related development finance to SIDS exhibits a distinct pattern, with over 62 percent channeled into adaptation, 15 percent to mitigation and 23 percent funding cross-cutting actions addressing climate change.[8] Continued fossil fuel dependence and subsidies limit SIDS' ability to invest in climate mitigation and adaptation. Little to no affordable risk mitigation instruments such as small-scale guarantees and insurance products, innovative climate financing instruments and matchmaking with venture capital and institutional funds are also impeding climate

[7] https://www.cgdev.org/publication/climate-finance-effectiveness-six-challenging-trends
[8] https://openknowledge.fao.org/items/38454cc7-d014-4d20-b4a1-56f535d008e0

progress in SIDS. There is also a dearth of climate finance directed to support SIDS' cleantech innovation and entrepreneurship, local manufacturing and servicing of adapted sustainable energy, and resource efficient and climate adaptation solutions, all of which leads to low local value addition. This scarcity of financial risk mitigation instruments also applies to emerging technologies of high relevance to SIDS such as ocean energy technologies. For example, the future of the ocean thermal energy conversation (OTEC) projects endorsed by COP28 remains unclear.

Aside from limited capacities in SIDS and the increasing inadequacy of the climate finance system, the lack of robust data collection systems and infrastructure, limited historical data, and weak monitoring systems lead to information gaps relating to the impacts of climate hazards and disasters. This makes it difficult to accurately quantify losses and damages over time, and impedes the flow of climate finance to critical needs.

**Climate Funds and Access for SIDS**

Compared to other funding sources for climate adaptation in SIDS, the Green Climate Fund (globally, the single largest source of climate finance) has been reported as a less effective mechanism for SIDS to access climate finance than for other developing countries. The project approval process for the GCF, for example, is still perceived to be much tougher and more prolonged than for other funds, including the Adaptation Fund and the Global Environment Facility, and the apparent ad hoc nature of funding approvals makes predictable climate programming unnecessarily challenging for SIDS. The complexity and administrative burden of applications also impose high transaction costs on SIDS, which is not overcome by Readiness Support, although of great importance.

There is no doubt that direct access accreditation enables full ownership of the GCF application process. However, challenges persist due to: i) the disproportionately high burden of meeting GCF fiduciary standards relative to SIDS size or project value; and ii) lengthy processing times (in the past as much as 3 years), which is often incompatible with the availability of expertise.

In response to these challenges, the Fund has made some incremental improvements, including *inter alia* the introduction of a project-specific assessment approach to accreditation and a revised approach to the climate rationale which clearly takes into account country context, the different capabilities of accredited entities, and traditional, local and indigenous knowledge. The end result(s) of these changes is yet to be seen.

At the same time to take advantage of these changes, SIDS will also need to strengthen their capacity to ensure the appropriate technical rigor in the project design phase. SIDS face challenges with *inter alia* lack of adequate data, the development of an appropriate rationale that is distinct from general development challenges and to demonstrate bankability of their projects. Unfortunately, advice from the independent Technical Advisory Panel is not always helpful in this regard. Further challenges also arise from a lack of transparency over what qualifies for grant financing and an increasing push towards coupled loans.

Regional approaches contributing to economies of scale, building coherence and equal progress are a missing link of the GCF's support. The absence of regional envelopes hinders country cooperation on common issues and solutions. Building on the outcomes of COP28, GCF has launched several further initiatives to streamline the proposal development and approval process. The initial results are promising but more must still be done to lower barriers for SIDS to access climate finance.

**Financing Loss and Damage**

Estimated costs of losses and damages range from USD$1.1 - $2.7 trillion annually until 2050 under the net-zero scenario. As the Early Warning for All Initiative shows, SIDS come third after Africa and the LDCs in terms of deaths and missing persons attributed to disasters per 100,000 people, while experiencing disaster displacement sometimes in the millions.[9] Only 25 percent of SIDS reported to have in place effective early warning systems with comprehensive coverage while 14 percent have limited capacities and 61 percent are lacking any recent assessment.[10] Given the challenges described above, the new Loss and Damage Fund is an opportunity to learn from past shortcomings, adopting Direct Benefit Transfer (DBT) based on risk thresholds and a trigger-based mechanism for timely and targeted support without undue delay. The Loss and Damage Fund will also need to consider specific SIDS' characteristics (small economies, high doing-business cost, vulnerability, geography) and cultural / non-economic loss and damages to be effective. Further, components of this funding must be institutionalized through national government mechanisms to meet specific needs, including the enhancement of monitoring, tracking and reporting capacities to adequately assess vulnerable populations, resilience deficits, and the cost of disasters in SIDS.

## 3. Potential Solutions and Opportunities: New Pathways for Action

To address the profound socioeconomic ramifications of climate change in SIDS, a nuanced, multifaceted response is needed. A strategic approach[11] focusing on innovative fiscal sustainability mechanisms, including state-contingent clauses and debt-for-climate swaps and future-proof insurance products is needed to create a more resilient financial framework, enabling SIDS to invest in climate adaptation and mitigation without exacerbating their debt burden.

Several solutions have been identified for SIDS to build resilience in the next decade, including:

i. Establishment of a **Financing Compact for SIDS** focused on acknowledging the multifaceted nature of vulnerability. The Compact will include debt relief and reprofiling, state-contingent debt instruments and resource-backed loans[12] through a Debt Sustainability and Investment

[9] https://wmo.int/site/early-warnings-all/early-warnings-all-dashboard
[10] ibid
[11] ibid
[12] https://resourcegovernance.org/publications/resource-backed-loans-pitfalls-and-potential

Support Service (DSISS)[13]. The Compact would be supported by adequate resources under existing financing mechanisms[14] and complemented by increased private financing, international carbon markets and access to SIDS-specific funding through the UN system. The Compact will be key to supporting SIDS to secure dedicated financing mechanisms for the SDGs, climate action, and the ABAS 2024-2034.

ii. **Enhanced governance capacities**, including through mainstreaming technical assistance in climate funds[15] and establishing and supporting project formulation and management through a **Centre of Excellence** for SIDS as outlined in A/RES/78/232. Strengthened capacities would also be targeted in the areas of planning, costing, developing and managing resilient infrastructure, through tools such as UNOPS' National Infrastructure System Modeling[16],; Sustainable Infrastructure Financing Tool and Infrastructure Asset Management[17], and the FAO Global Roadmap for achieving SDG2 without breaching the 1.5 C° threshold[18].

iii. Establish a **dedicated platform for climate finance**, bringing in IFIs, bilateral donors, governments and private sector to ensure a comprehensive and coordinated climate finance model for SIDS. Modelled on the Bangladesh initiative[19], a Climate and Development Platform for SIDS (SIDS - CDP) would help scale-up climate finance and crowd-in private financing for mitigation and adaptation including through impact investment funds, blue and green bonds, carbon credits, and guarantees.

iv. Commitment to equitable disbursement by the **Loss and Damage Fund,** adopting vulnerability metrics, such as the MVI, for resource allocation; support provided to SIDS to comprehensively monitor loss and damage at national and sub-national levels, including use of tools currently under development like the hazardous event and disaster tracking system being developed by UNDRR, WMO and UNDP; the efforts of the Santiago Network advanced to catalyze technical assistance at local, national and regional level. These measures would help ensure that SIDS can fully benefit from the Fund.

v. Improvement of financing for **climate mobility**, ranging from essential needs and costs stemming from disaster displacement preparedness and response, management of planned relocation, developing labor migration pathways, and support for staying in place through adequate investment in adaptation and economic opportunities. Leading initiatives in these areas include the newly established Pacific Regional Framework for Climate Mobility by the

[13] The DSISS, as outlined in the ABAS 2024-2034 Outcome Document, is supported by the establishment of a Strategic Advisory Group (SAG) co-chaired by Antigua and Barbuda and the Maldives and includes representation of all SIDS and key development partners. The SAG works on the design of the DSSS and will launch it at SIDS4.
[14] Such as GCF, GEF, LDC Fund, and the Loss and Damage Fund
[15] OECD lists 99 climate finds which do not offer technical assistance: https://qdd.oecd.org/subject.aspx?subject=climatefundinventory
[16] https://www.nismod.ac.uk/home/
[17] https://unosd.un.org/sites/unosd.un.org/files/11._mr._gustavo_goy_garcia.pdf
[18] https://www.fao.org/agrifood-economics/publications/detail/en/c/1675931/
[19] https://www.imf.org/en/News/Articles/2023/12/03/bangladesh-launch-climate-development-platform-to-leverage-adaptation-and-mitigation-investments

Pacific Island Forum, and the Eastern Caribbean States Ministerial Declaration on Migration, Environment and Climate Change. Both take a novel approach to climate mobility by incorporating measures to mitigate non-economic losses and protecting overall well-being and citizen security.

vi. Ensure that climate finance integrates **gender considerations** in the design and operationalization of dedicated climate financing mechanisms. Programming guidelines and structures, operational processes, and monitoring and evaluation must call for explicit gender criteria in performance objectives and results measurement frameworks.

vii. Emphasize a "**budget support approach"** to climate financing to accompany larger scale funding from GCF and other sources. This approach will place countries in the driver's seat for programming climate finance, working through national budgetary systems to mobilize private financing through innovative instruments; support climate policy interventions to build absorption capacities; mitigate challenges such as transport costs, logistics, and limited economies of scale. Such an approach will support the financial ecosystem to ensure a conducive legal and policy framework for innovative finance, as well as capacity-building measures for both public and private institutions to design and successfully implement innovative finance. The approach also targets the reduction of ODA to GDP ratio by directing development finance to productive sectors of SIDS' economies and matching concessional finance with affordable risk mitigation instruments, such as small-scale guarantees and insurance products, matchmaking with venture capital and institutional funds.

## 4. Recommendations

1. Support the proposed **Financing Compact for SIDS** including the Debt Sustainability and Investment Support Service (DSISS) to address debt sustainability and tap into innovative financing mechanisms to meet climate adaptation and mitigation needs.

2. Support the establishment of a **Climate and Development Platform for SIDS (SIDS - CDP)** following the model of Bangladesh to specifically address the scaling-up of climate finance and crowd-in private financing.

3. Advocate for an **increase in dedicated SIDS-specific financing** under the existing climate finance mechanisms including through the SIDS-CDP and ensure dedicated financing instruments score high in OECD Rio Markers. This could be as a complement to 2 above.

4. **New instruments** including the Loss and Damage Fund be operationalized expeditiously and funding arrangements to specifically consider SIDS needs.

5. **Strengthen data for evidence-based climate investment** in SIDS using localized data and risk analytics to support trigger-based funding mechanisms.

6. Ensure **stronger linkages between national budgets and climate finance** through integrating national sustainable development strategies with adaptation plans and disaster risk reduction strategies.

7. **Explore underutilized modalities for climate finance** including international carbon markets, debt-for-climate swaps, and private financial products such as green and blue bonds.

## 5. Questions for Interactive Dialogue 3

- The UNFCCC Parties reached a historic agreement in December 2023 at COP28 on the Loss and Damage Fund as well as the Global Goal on Adaptation and the Newly Quantified Goal on Adaptation to be set by 2025 starting from a floor of 100 billion to reach 500 billion for mitigation, adaptation and loss and damage. What actions are required to keep the momentum going and move forward with the operationalisation process of those agreements?
- How can the UN better support SIDS to identify climate finance needs for national adaptation plans, especially in the area of data.
- What changes in the current climate finance system should be proposed to enable SIDS to access affordable resources at scale?
- If the proposed Climate and Development Platform for SIDS were to be operationalized, what should be its key elements to make it effective as a means for mobilizing financing for climate-resilient development?
- What changes are needed to make development funds already supporting SIDS, such as the Joint SDG Fund, be complementary to the various climate funds?