# Covid-19 and Adaptation Finance: Risks, Opportunities and Recommendations for Governments and Development Finance Institutions

## 1. Context

The Covid-19 pandemic, as well as taking a huge toll on human lives and health, represents the greatest shock to the global economy in almost 100 years. “The Great Lockdown” has led to major reductions in both production and consumption, with the IMF’s global growth forecasts for 2020 being cut to -4.9%, an 8% fall from 2019. Some countries are already seeing record unemployment and the ILO estimate that working hour reductions will take place equivalent to 305 million jobs, with 1.6 billion informal economy workers suffering damage to their earning capacity.

The fiscal and monetary measures being taken by governments to support workers, firms and strained health systems are also unmatched in recent times. Governments have announced fiscal stimulus response packages worth $8bn, with a further $6trillion of liquidity injections expected from central banks. The IMF has made $1trillion in lending available to service country requests for emergency financing, and Development Finance Institutions (DFIs) have announced substantial lending packages, for example with the World Bank pledging up to $160bn over the coming year.

While necessary, this fiscal stimulus foreshadows a subsequent public debt crisis, as seen in the wake of the 2008/9 financial crisis, which may compound future growth challenges, particularly for the poorest and most vulnerable countries, where access to financial markets will be weakened, and country risk premiums likely to see increases.

This context presents challenges and opportunities for the agenda to increase financing for climate change adaptation, and specifically the long-term objective of mainstreaming physical climate risks into economic and financial decision-making. This note assesses these, and proposes three action areas for Governments and DFIs to support the delivery of adaptation objectives through the crisis and recovery.

## 2. Challenges for financing climate resilience

**Potential lack of availability of public finance for adaptation**. The rapid and large-scale financing for Covid-19 response made available by DFIs and the IMF will do much to support developing countries in responding to the crisis. These funds will not be enough, however, forcing countries to make domestic prioritizations decisions that are likely to favor short-term health and economic recovery priorities. Sluggish bond markets reduce countries’ ability to raise capital for resilience-related investment, with vulnerable nations such as Jamaica going into the 2020 hurricane season without the buffer offered by a planned public catastrophe bond issuance. Vulnerable and indebted countries may see further restrictions in fiscal space from Covid-19 related borrowing and associated increases in their cost of capital. Ethiopia’s cost of servicing debt, for example, already outstrips its spending on health, a situation that the health crisis may worsen.

**Depressed growth and private investment**. Reduced risk appetite among private investors may limit new private flows going towards resilience solutions in developing and emerging markets. This will make it harder to finance and test the new technologies, products and services needed to transition towards more resilient economic growth pathways. An extended recession may further compound this reduction in private capital flows for projects with uncertain or longer-term benefit streams. In developing country contexts, the availability of private capital will be further diminished by the projected 20% fall in global remittances caused by the health crisis. This will be particularly impactful in Africa, where remittances account for over half of private capital flows and around 3% of GDP, and where remittances are projected to fall 23% in 2020.

**Potential de-prioritization of long-term resilience objectives**. In the absence of decisive action from regulators, the imperative to invest quickly to address the economic crisis may lead to the by-passing of regulations and standards targeted at longer term sustainable development objectives. Examples of this are already emerging. While UK financial regulators are playing a leading role in the drive to assess and disclosing climate risks in the financial system, it has been forced to postpone planned climate stress testing, in order to help banks play their part in supporting the economy through the Covid-19 recovery. The immediacy of the current health crisis therefore risks accentuating of the “tragedy of the horizon”, which has to date plagued efforts to date on adaptation.

## 3. Opportunities for climate resilience finance

**Unprecedented fiscal stimulus:** While in the short-term the focus of this stimulus is likely to be on urgent needs in health, social care, and blanket support for SMEs and individuals, there are opportunities to secure resilience co-benefits from both immediate interventions and those targeted at longer-term recovery. There is evidence that large scale public programs related to watershed management, soil conservation, and ecosystem-based adaptation, can provide mass employment opportunities. For example, it has been estimated that 39.7 FTEs are generated per $1m spent on conservation and ecosystem restoration projects, a rate that far outstrips traditional energy projects and even large scale water and transport infrastructure. Agricultural investment delivers between 21.7 and 22.8 FTEs per $1m invested, again performing better than almost all other sectors. Beyond job creation, as illustrated by the GCA’s flagship report, investment in adaptation delivers economic and social benefits of between 2 and 10 times the costs, highlighting the broader value of a resilient recovery package.

Green stimulus packages have been linked with enhanced economic recoveries in the past, as seen in the Republic of Korea after the 2008-9 financial crisis, where 80% of stimulus was in line with environmental objectives, and growth rebounded far faster than other OECD countries. In the US, bailouts for GM and Chrysler in the US were linked to requirements around increased energy efficiency, leading to competitiveness gains for the US motor industry. This same drive is building momentum in the current Covid-19 crisis, through a drive to “build back better”.

**A wake up call for financial resilience:** The economic fallout of the Covid-19 crisis represents a disruptive moment economic planning worldwide, with leading figures such as the UNSG Antonio Guterres calling for governments and financial institutions to take a fundamental new approach to risk management in the financial system. With such a clear example of the economic costs of unpreparedness, there is an opportunity to shine a spotlight on the looming threat of physical climate risks and their resulting financial impacts.
Previous financial crises highlight evidence that a crash can lead to a step change in how governments manage climate risks. The creation of the Capital Markets Union (CMU) in the EU following the 2008-9 financial crisis, tasked with enhancing the resilience of the financial system, lent significant momentum to the region’s sustainable finance agenda, ultimately resulting in the development of the EU’s plan of action on sustainable finance and European Green Deal.

## 4. Securing a climate resilient economic recovery

In the context of these challenges and opportunities, the following three steps can help Governments and DFIs to ensure that the economic crisis delivers on as far as possible the climate resilience agenda.

A. Accelerate the mainstreaming of climate risk into public policy and spending

Finance ministries should ensure that fiscal interventions avoid harm to, and where possible benefit, the resilience of people, communities and businesses to climate shocks. New public spending on infrastructure, for example, should respect resilient building standards, protected areas legislation, and best practice in water management, to avert the compound threat of health and climate-related disasters. Investments in key sectors such as agriculture public works programs related to ecosystem restoration can provide (and preserve) much needed short-term employment, and reach those who lack access to formal benefits such as unemployment insurance.

Governments should source investment-ready adaptation interventions from Nationally Determined Contributions (NDCs), National Adaptation Plans (NAPs) and sectoral climate strategies, building these into plans for broader economic recovery and development. New Zealand are setting a strong example, with a Covid-19 $1.1bn public recovery package that is set to create 11,000 environmental jobs, including measures such as ecosystem restoration and other resilience measures, helping to secure water availability and stabilize river banks.

DFIs through the Paris Alignment agenda should continue to expand and implement mainstreaming measures such as climate-risk screening at the project level, to avoid promoting maladaptive practices, working with governments to ensure Covid-19 support delivers co-benefits for climate resilience where possible. For example, the World Banks recently announced $1.9bn of Covid-19 recovery support, which include new and rehabilitated treatment centers in India, Ethiopia, Mongolia and Cambodia, represent an opportunity for mainstreaming, through incorporating resilience to risks such as extreme heat or flooding into the construction of those facilities.

The IMF's continued progress on integrating climate risk into its Article IV consultations is greatly welcomed, including by scaling up its Climate Change Policy Assessments, and supporting countries factor macroeconomic climate risks into debt sustainability planning. It should continue to explore how its country lending can be complemented by policy and program support to promote climate resilience co-benefits.

B. Enhance private sector disclosure of physical climate risks

The Covid-19 crisis has placed a spotlight on financial stability in the face of exogenous shocks. In responding, Governments should take advantage of this by also promoting the transparency of businesses' exposure to physical climate-risks, in line with the recommendations of the Task Force for Climate Related Financial Disclosures (TCFD). One option to hasten the uptake of these recommendations would be to make public support for Financial Institutions (FIs) and businesses contingent upon the introduction of climate-risk assessment and disclosure. Canada is leading the way, with bailouts for large companies (over $300m) being made contingent upon climate disclosures.

The role of financial regulators is crucial in this respect. Following the example set by some such as the European Central Bank, which is proposing that all banks disclose data on their climate-related risks and exposures as a matter of course. The Network for Greening the Financial System (NGFS), a leading group of central banks, has also recently launched best practice guidance for supervisors and regulators to manage climate risk across the financial sector. In the light of Covid-19, governments should carefully consider regulating to formally require these risk-reporting measures, to further bring to light hidden risks across the economy.

C. Drive innovation in the design and application of debt instruments, such as Resilience-related Bonds, to raise finance for both health and climate crisis management

As a means to help fund covid-19 recovery, some developing countries and DFIs have turned to the bond markets, for example, with Indonesia launching a $4.3bn dollar-denominated pandemic bond, and the African Development Bank releasing a $3bn social bond. While pandemic bonds have been used by some countries, similar insurance-based models have faced criticism due to complex triggers and slow pay-outs. Resilience bonds, as first trailed by the EBRD last year, which raise finance for measures that improve the resilience of assets or systems to climate shocks, represent an alternative opportunity, and if designed well could offer dual benefits for climate and health.

In approaching this issue, countries will need to thoroughly consider debt sustainability and local financial market conditions, recognizing that for many countries, additional debt may not be an advisable strategy. DFIs can play an intermediary role in structuring these instruments, to give confidence to investors and help improve the terms of the debt for recipient countries.

In summary, in tackling the Covid-19 crisis, this commentary argues that the immediate response should not replace the essential systemic objective of integrating physical climate risks into fiscal and financial decision-making. Alongside its partners, the GCA is driving a number of initiatives to support both the public and private sectors in achieving this goal.

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