Beyond loans: instruments to ensure the poor access climate and development finance

While there is wide-ranging debate about how to mobilise financial resources for developing countries, much more policy attention must be focused on how to get these resources into the hands of poor people who need them most. We highlight concessional loans, risk-sharing instruments, grants and social protection schemes as ways to enable low-income groups to limit risks arising from climate change, access affordable energy and develop sustainable businesses. Governments will need to deploy such tools to ensure their poorest citizens can access the large sums of finance that are set to flow from international agreements on climate change and sustainable development. With this finance, poor people can be one of the most effective groups delivering on the SDGs. A range of instruments may be deployed in combination or sequentially according to their effectiveness at reaching different low-income groups. In some cases this may require aligning incentives to develop a menu of options.

Major international processes to agree universal Sustainable Development Goals (SDGs) and implement the UN Framework Convention on Climate Change (UNFCCC) are highlighting an urgent need for finance to flow to low-income groups. It is these groups, after all, who will bear the main costs of adapting to climate change and who have the greatest need for financial security.

Low-income households and businesses are already spending their own scarce resources to tackle poverty and climate change. But they need finance to improve their resilience to climate-related shocks, access services such as health and education and invest in income-generating activities that improve productivity and add value. There has been much focus on how to mobilise financial resources for developing countries, but the real question is how to get these resources into the hands of poor people who need it most?

To date, donors and international financial institutions have made little progress in this regard. International development finance has largely failed to reach the most vulnerable people.1 As we enter a new era of sustainable development, with universal goals for countries to achieve by 2030, it is essential to reassess how best to deliver finance. Among other things, this calls for attention to appropriate financial instruments that target the poor. Whether it is a mother working to send her child to school or a farmer breeding drought-resistant crops, the aim of national and international public development...
Finance and climate finance should be to support poor men and women to reduce the growing adaptation costs that they face.

Mainstream financial institutions have long emphasised traditional instruments, such as high interest loans. But high transaction costs, low profit margins and limited credit worthiness tend to exclude lower income groups. This market failure has exacerbated the failure of public finance to reach the poorest people. Our experience points to four alternative instruments with a proven track record in helping low-income groups to access affordable finance, manage risks and escape poverty. To varying degrees, all four incorporate an element of ‘grant’ finance, which is essential if the poorest and most vulnerable people are to benefit.

Grants

Banks and donor-funded projects often assume that what low-income populations need most is access to lending and commercial credit. However, low-income groups struggle to access flexible, long-term finance that meets their needs. This is especially important as mainstream financial institutions often neglect pro-poor markets because of high transaction costs and perceived risks to investments.

Grants can be an important alternative source of finance for activities that do not generate profits but which are essential in early stages of developing pro-poor markets. Flexible grant funding is needed to cover initial stages of feasibility research, product development, or technical assistance for capacity building to help new players enter a market.

Grants can also be used to subsidise high interest loans, reduce upfront costs for end users or create market incentives for small and medium enterprises. Three types of grants are commonly used in both development and climate finance:

- Direct grants in the form of subsidies
- Technical assistance grants providing expertise at no cost
- Grants bundled with loans to reduce the cost of borrowing.

IIED is testing a grant-based approach in Mozambique (see Box 1).

In Bangladesh, a state-owned financial intermediary called the Infrastructure Development Company Limited (IDCOL) provides a grant to reduce the cost to households buying solar home systems. A common subsidy for all income segments provides a higher proportion of subsidies for poorer households, which tend to need smaller systems. IDCOL also provided grants to develop the capacity of partner organisations that install and service the solar power systems. Grants are disbursed upon delivery of certain outputs. This shifts the purchasing power to the poor and performance risk to private investors.

In Nepal, the Alternative Energy Promotion Centre (AEPC) has also developed a targeted subsidy model to enable the most vulnerable households to adopt renewable energy technologies. Forty per cent of its National Rural Renewable Energy Programme’s US$170 million budget is being disbursed as grants. Depending on the circumstances, grants cover between 30 and 50 per cent of the cost of buying and installing renewable energy technology, with the remainder coming from concessional loans. These grants are delivered in accordance with Nepal’s Subsidy Policy for Renewable Energy.

Box 1. Grant funding to enable low-income groups to participate in REDD+

In central Mozambique, IIED is testing ways to implement REDD+, which will compensate land users who conserve, manage sustainably or enhance forest stocks. To enable local farmers and small-scale entrepreneurs to participate in REDD+ activities, the initiative includes an £900,000 investment package.

This grant provides finance for training, equipment and technical assistance that enables farmers to adopt sustainable agriculture and allows small businesses to invest in sustainable timber, charcoal and honey production.

IIED and implementing partners are using the grant to mobilise additional funding from international donors, impact investors and national microfinance providers. We conclude that grants should be used to establish revolving funds or other mechanisms of flexible financing that are accessible to small-scale entrepreneurs and local people. This flexibility is important to ensure long-term impacts and the sustainability of enterprises.
Grants are, however, more appropriate in some circumstances than others. They work well for projects that may not generate revenue, but they are not ideal for promoting growth. Grants may also increase government expenditure over investments or provide false market signals if investment is on the rise.

Even the poor may not need grants or subsidies in the long run. Subsidies should be phased out once markets are developed. Both IDCOL and AEPC have gradually phased out subsidies for all but the lowest-income households. IDCOL also phased out its institutional development grants once its partners had the required capacity.

When pro-poor markets are well established the very poorest people will continue to need financial support. It will be important therefore to develop pro-poor subsidies for the most marginalised sections of the society to ensure long term development benefits.

**Box 2. Making concessions: experiences from Bangladesh and Ethiopia**

The Development Bank of Ethiopia offers concessional loans to microfinance providers with a six per cent interest rate. A ten-year repayment period creates an incentive for the microfinance providers to lend onward to low-income borrowers over shorter periods and revolve the repaid funds as new loans.

The Central Bank of Bangladesh and Bangladesh’s Infrastructure Development Company Limited (IDCOL) offer loans to commercial banks or microfinance providers at interest rates of five per cent and six to nine per cent, respectively. The borrowers lend this to households or investors and charge nine per cent or 12–15 per cent interest, respectively.

Both the Development Bank of Ethiopia and IDCOL absorb the risk of lending to microfinance providers, requiring no collateral from them.

**Box 3. Social protection schemes are starting to address climate and environment objectives**

**Brazil.** The national Bolsa Verde programme provides cash payments to low-income families who adopt practices that conserve trees, fish and other natural resources. The scheme targets people in extreme poverty, particularly forest-dependent communities in the Amazon region. The Bolsa Verde programme distributes more than US$40 million dollars each year among more than 69,000 families. The quarterly payment of 300 reais is nearly double the average quarterly income.

**Ethiopia.** The Productive Safety Net Project provides seven million people who are chronically food insecure with a predictable transfer of cash or food in return for labour on schemes that benefit vulnerable communities. These work schemes include tree planting, water harvesting and construction of health centres. The project enables vulnerable people to resist shocks, accumulate assets and feed themselves. The project aims to encourage households to engage in production and investment. It promotes market development by increasing household purchasing power.

**India.** Each year, the Mahatma Gandhi National Rural Employment Guarantee Scheme provides tens of millions of people with 100 days of paid manual work. The scheme creates a legal right to employment. Anyone who applies and is not given work within 15 days is entitled to an unemployment allowance. Since 2006, when the scheme began, it has distributed about US$25 billion. Participants work on projects that benefit their local communities, such as creating infrastructure for water harvesting, drought relief and flood control.
Social protection and safety nets

Concessionary loans and even microcredit are beyond the reach of the very poorest people, who cannot provide upfront capital and have a poor track record of repayment. Targeted social protection instruments and safety nets may provide an alternative way for climate and development finance to reach this segment of society. Recognising this, the SDGs call for all countries to implement social protection systems to help eradicate poverty.

Such schemes are already underway in Africa, Asia and Latin America (see Box 3). Often they have originated the aim of reducing poverty. Some are now evolving to also incorporate climate resilience and ecosystem management.

Conclusions

Experiences around the world show that it is possible to choose or develop pro-poor financial instruments. A range of instruments may be deployed in combination or sequentially based on their effectiveness in reaching and targeting poor families with different income levels. In some contexts, they can be complementary but in other contexts they are best used separately. Grants, loans, guarantees and social protection schemes all carry different incentives. Combined with the right set of financial intermediaries, planning and budgeting systems, such instruments can ensure that vulnerable women and men benefit from climate and development finance. This will be critical to efforts to achieve the sustainable development goals and address the threats climate change poses.

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