European Bank
for Reconstruction and Development

MEMORANDUM

To:	Directors and Alternate Directors	Ref:	CS/AU/19-20 (Addendum 1)
From:	Secretary General	Date:	5 June 2019
Copy:	President / Executive Committee		

Subject: **Climate Initiatives Special Study Presentation to Audit Committee – Managements Comments**

Attached for information is a document on the above.

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EvD Special Study on Climate Initiatives
Management Comments

Executive Summary

- Management would like to thank EvD for this important Special Study on Climate Initiatives (CIs).
- The Study reflects significant work by both the Evaluation Department and by Management and staff active in this area. This has been driven by the broad scope of this report covering a sequence of initiatives over a long period of time.
- Management welcomes the overall finding of the evaluation which is that 'the Bank has had considerable success amongst its MDB comparators and with respect to meeting financing targets' and agrees that there is 'both significant opportunity and pressing need to strengthen existing approaches and processes.'
- Overall Management agrees with the recommendations for further strengthening and enhancing the impact and contribution of the Bank's initiatives to national and global climate change mitigation and adaptation objectives. These are also aligned with the ongoing Management work together with other MDBs, in particular, to clearly align objectives of climate related components of GET with the Paris Agreement, using selective programmatic approaches in line with low carbon pathways and taking account of NDCs.
- Within these enhanced objectives that will become more important over time in the Bank's country strategies and operations, Management also: 1) agrees to further intensify private sector mobilization, including through funded and unfunded instruments to strengthen project risk profiles, fully recognising the key role of the private sector to achieve climate action at scale with the magnitude of investments required; 2) agrees to increase capacity to use LCY finance in line with its overall approach to Local Currency and Capital Market Development; and 3) agrees to strengthen the Management Information System recognising that improvements in ex-post monitoring and verification capacity would require significant additional resources and budget.
- Management also agrees to further strengthen institutional arrangements for concessional climate funds. However, Management believes that the suggestion to shift responsibility for climate fund management is not warranted to achieve the intended goal. Strengthening institutional arrangements should not focus on any individual team but continue to rely on the current cross-matrix approach.
- Management notes that the study findings about past performance and effectiveness do not accurately reflect the achievements of the Bank under past climate initiatives in line with its objectives and metrics of results in scaling-up green finance and delivering positive climate mitigation and adaptation impact in anticipation of, and in response to, the evolving global climate finance challenges and climate change agenda.
- Management is of the opinion that the assessment should be done relative to the objectives and results metrics set at the time instead of using only GHG emissions reduction to assess effectiveness of activities and allocation of concessional finance or resource allocation to assess the extent and role of policy engagement. Objectives/performance metrics of the Bank's initiatives were related to the scaling-up of green financing volume, the mainstreaming of sustainability objectives into the Bank's operations, donor funds mobilisation, the build-up of policy dialogue and collaboration with other MDBs. Bank initiatives also clearly articulated intentions to seek to magnify the demonstration effect of projects and use project-focused approach, leveraging individual projects to achieve broader transformation towards a low-carbon economy. The maximisation of GHG emissions reduction outcomes of investments and TC/Non-TC was not directly targeted by the past initiatives; neither has the Bank committed to the tracking of ex-post physical outcomes.

Management provided extensive comments to the draft study and some important points have already been reflected by EvD in the final version of the study.

Management comments to the recommendations and key findings of the study are presented below:

Management Comments on Recommendations

Recommendation 1: *Strengthen and clarify the broader strategic context and objectives of the climate related components of GET. The objective should be clear alignment with the Paris Agreement, using selective programmatic approaches in line with low carbon pathways and taking account of NDCs.*

Management agrees with this recommendation. Reflecting the increased evidence of climate change impacts and urgency to address mitigation and adaptation at scale, alignment with the Paris Agreement is expected to become an increased factor in the strategy and operations of MDBs. As a result, the role of low carbon pathways will emerge as a core implementation tool for this alignment addressing a number of issues and comments raised in the Report. The link to NDCs, which was not a consideration at the time of launching GET as it was approved before the Paris Agreement, will become more important over time in the Bank's country strategies and work has already started on NDC capacity building, supported by a targeted TC programme.

Recommendation 2: *Intensify Private Mobilization - Strengthen creditworthiness of project designs to private partners by strengthening the focus on project designs that derive acceptable risk return profiles for private sector financiers by making innovative use of unfunded and funded instruments to strengthen project risk profiles and target mobilization in total, rather than ABI.*

Management agrees that the private sector is essential to achieve climate action at scale with the magnitude of investments required and that further attention needs to be given to enhance mobilisation. It should be noted that a fundamental element of mobilisation of the private sector is first and foremost to work with the private sector. It is relevant to note in this context that over the period 2014 to 2018, 61% of EBRD climate finance was in the private sector.

Furthermore, Management acknowledges that concessional finance and structured finance instruments can indeed play a role in strengthening the private finance mobilisation of projects. The EU in particular has a number of emerging risk instruments for this purpose. Management agrees to pursue the use of funded and unfunded instruments in cases when these can contribute to strengthening project risk profiles and targeting mobilisation. The structure of these instruments, as always, will be in line with the Bank's guidelines on the use of concessionality and the underlying structure will reflect specific market and project-specific conditions.

Recommendation 3: *Strengthen Institutional Arrangements for Concessional Climate Funds. Provide E2C2 with a mandate to manage the portfolio of concessional climate funds, with an overarching objective to mitigate climate change effects by reducing GHG emissions in its COOs and reducing vulnerability to CC; maximize potential for private co-finance to achieve this objective; and regularly report to the Board on the achievement of physical climate change objectives.*

Overall, Management agrees with the recommendation to strengthen institutional arrangements for concessional climate funds. However, Management believes that the suggestion to shift responsibility for climate fund management is not warranted and will not achieve the intended goal. Strengthening institutional arrangements should not focus on any individual team but continue to rely on the current cross-matrix approach which remains broadly valid.

Institutional strengthening can be achieved within the existing division of labour (which has enabled the Bank to "compete effectively for the external/concessional resources critical for CI delivery," as acknowledged in the Report) whereby pipeline development and structuring is driven by Banking teams and E2C2, fundraising and packaging of investments for donor consideration by E2C2, DCF and Banking, and fund management, administration and reporting by DCF.

EBRD mobilises resources via well-established calls for proposals, which have been established by donors for a range of development partners. In this process, EBRD and the donor agree ex-ante on reaching programme/project specific outcomes and targets, by measuring tailor-made indicators. Recommendation 3 incorrectly assumes that EBRD can pool concessional funding from a variety of donors and allocate it at its own discretion, based on internally defined metrics.

Moreover, Management does not believe that the proposal contained in the Report would be welcomed by donors who expect an arm's length relationship to exist between the manager of funds and the users of funds in the Bank who may at times have different priorities, objectives and policies in terms of the provision of grant funding.

Management agrees, however, that the approach, guidelines and procedures for the assessment, allocation and prioritisation of funds based on a common set of climate change mitigation and adaptation objectives could be reviewed. In this context, Management is currently undertaking a Bank-wide, full-scale internal review to assess the best ways of managing its donor relations and funds.

The detailed and ambitious recommendations in section 4.2 are in line with the current work on Paris Agreement alignment and related country planning and low carbon pathways considerations. As part of this approach, E2C2 will continue to work across the matrix organisation to support the Bank to pursue the 'overarching objective' regarding climate change mentioned in the EvD report.

At the same time, Management believes that the allocation of climate finance and investment should not be driven by the objective of maximising GHG emissions savings per unit of investment. There are many investments that will not maximise GHG emissions but are essential to the low-carbon transition, e.g. energy efficiency in buildings, SMEs, as well as the upgrade of municipal and transport infrastructure. Furthermore, an excessive focus on maximising GHG emissions reduction would not be consistent with the rising importance of climate change adaptation.

Recommendation 4: *Increase capacity to use LCY finance – direct resources to Treasury to improve foreign access to local capital markets; country strategies should assess EBRD's ability to provide LCY finance and the main constraints; LCY should feature specifically in country strategies and Bank Scorecards.*

Management agrees on the importance of minimising currency mismatch risks and the increasing capacity to use LCY finance. Management believes that while this is especially relevant for "Green" projects, as these typically support clients with local currency income (renewable energy, water, waste, transportation), it is an issue that goes beyond CIs. Management considers, however, that much more than increasing treasury resources is needed to improve foreign access to local capital markets. This includes assessing the existing regulatory environment and EBRD's ability to provide LCY finance and develop sustainable green instruments at the domestic level, such as Green Bonds, as well as identifying constraints and helping create jurisdictions and regulation that are supportive of climate initiatives. This is in line with the Bank's overall approach to Local Currency and Capital Market Development that was covered in the EvD recent study on local capital market development and the management follow-up to that study.

Management notes that the level of activities in local currency (and capital market) development is already in the institution scorecard, as part of the indicators under the Composite Performance Assessment of "Resilient" transition quality, as well as teams scorecards.

Recommendation 5: *Strengthen Management Information System – The Technical Cooperation Reporting System (TCRS) or some equivalent urgently needs to be made operational to capture project level TC data. CI databases need to be integrated and ex ante and ex post data collected at the country and project level on variables such as COO vulnerability and carbon budgets, baselines and targets for net and gross emissions, expected lifetime emissions savings, scoring for improvements in resilience, sources of co-finance, and unit costs of outputs and outcomes.*

Management agrees with the need for a strong management information system for capturing project level data given the weaknesses with current systems. Management believes that it is important to improve the Bank's data management and data systems across the board, in a consistent manner and for all areas. Work is underway to strengthen the TCRS system, while awaiting more far-reaching changes related to the introduction of the new IT data system that is being developed (Monarch). The capabilities to collect, integrate and analyse project- and country-level data beyond the current practice will need to be assessed and a business case for additional MIS investments will need to be made. The work on MIS will need to be linked with the work on the development of the methodologies for Paris Alignment.

Management also agrees that it is important to collect the necessary ex-ante and ex-post data but emphasises that improvements in ex-post monitoring and verifications capacity would require significant additional resources and budget (a precise monitoring and tracking of actual GHG emissions reductions can require in certain cases expensive studies, for example in the case of public transport investments).

Finally, it must be noted that at present the quality of data made available at national level is poor and significant gaps exist although it is expected to improve over time as national capacity and systems to collect and monitor data relevant to climate, energy and environmental data improve.

Recommendation 6: Management should submit a report to the Board within no more than 12 months providing a detailed discussion of implementation of these recommendations, including explicitly identifying resources, responsibilities and timelines.

Management takes note of this recommendation and will update the Board in the context of the strategic developments in the climate and environmental activity of the Bank being considered for the next SCF period and taking into account and/or responding to the recommendations set out in the EVD report.

Management Comments on key findings

1. Evolution and Focus of Initiatives

Management notes that EvD has introduced the term Climate Initiatives (“CI”) as an umbrella covering the full sequence of initiatives in the environmental operations area. This is a broad scope which contrasts with the narrow focus placed in the assessment on GHG savings. This leads to a judgment that environmentally-relevant activities with limited or no direct impact on GHG reduction dilute the Bank’s focus.

The point here is that initiatives have changed to address an evolving agenda driven both by shareholders (for example increased attention to climate change adaptation), by its countries of operations (for example energy security and economic competitiveness), and by its private sector clients (for example resource efficiency). Each strategic development stage clearly defined a precise set of priority interventions reflecting both their relevance in terms of addressing the issues faced by COOs on green economy and the comparative advantage of the Bank. These priorities set out in the Bank’s strategies are relevant to a broader environmental agenda than a single focus on GHG emissions reduction.

2. Objectives and Incentives: Annual Business Investment (ABI) vs. GHG emission reduction

The study concludes that the financing target creates incentives for / contributes to resource allocation to drive EBRD lending rather than maximising GHG emissions reduction. Management notes that from the start in 2006, SEI responded to the request of shareholders to scale-up EBRD *climate finance* contributing to closing the funding gap for climate change mitigation and adaptation. The focus on climate finance targets was further intensified following the Copenhagen COP with the formulation of the $100 billion climate finance goal set for 2020. Within this frame, the MDBs have been under an increasing pressure to contribute to the fulfilment of this goal. The focus on financing targets is therefore entirely in line with the context within which the sequence of climate-relevant initiatives was developed and the EvD report acknowledges that the Bank has been very successful in reaching these financing objectives.

While maximisation of GHG emissions savings / minimisation of GHG emissions have accordingly not been the core goal, individual investments need to meet required standard and energy/GHG emissions saving thresholds (and other applicable eligibility criteria) to be counted as climate finance. Furthermore, as mentioned above, Management acknowledges the recommendation that the objectives and results framework may need to be revisited in the future to further enhance the impact and contribution of the Bank’s initiatives to national and global climate change mitigation and adaptation objectives. Recommendation 1 highlights this point while an ex-post monitoring system will be an important factor to optimise impact.

3. Performance and Effectiveness

Management welcomes the findings that climate finance targets were met consistently. It is noted that the study concludes that apart from ABI targets “elsewhere results are mixed” and that the positive results related to ABI “exist alongside some areas of concern and underperformance” related to declining GHG savings outcomes, misaligned incentives, the lack of ex-post monitoring and a coherent basis for allocating resources to areas where effectiveness and impact are likely to be greatest.

Management notes these conclusions and agrees that these areas of concern should be considered with a view of enhancing the positive impact of Bank’s initiatives going forward. However, Management is of the opinion that the assessment should be done relative to the objectives set at the time. The maximisation of GHG emissions reductions outcomes of investments and TC/Non-TC was not among

Board-approved targets/metrics of the past initiatives; neither has the Bank committed to the tracking of ex-post physical outcomes.

Objectives/performance metrics of the Bank's initiatives were related to the scale-up of green financing volume, the mainstreaming of sustainability objectives into the Bank's operations, donor funds mobilisation, the build-up of policy dialogue and collaboration with other MDBs. Bank initiatives also clearly articulated intentions to seek to magnify the demonstration effect of projects and use project-focused approach, leveraging individual projects to achieve broader transformation towards a low-carbon economy. Each of the initiatives has also set-out intentions to innovate and develop new products, approaches and areas of focus. It is Management's opinion that the Bank has been highly successful in developing an effective business model (combining Bank's funding with TC and capacity building, policy dialogue and selective concessional funding) and delivering against these objectives/performance metrics, while the evaluation did not make a judgement beyond assessing the achievement of respective ABI targets and physical impact.

4. Concessional Funds / TC

Firstly, Management notes the heavy focus of the study on the issues of concessional finance and would like to emphasise that the majority of GET operations do not require support in the form of investment grants or concessional finance (the total value of Non-TC was 5% of GET ABI in 2016 and 3% in 2017 as noted in the Study). The Bank's competence and comparative advantage are particularly strong in the private sector, with very limited non-TC requirements compared to the public sector.

Secondly, the study uses GHG emission reduction/EUR of investments metric to assess the effectiveness and guide the allocation of TC/Non-TC. The study also states that concessional funds are being allocated on the basis of lending volumes. Management notes that in allocating grant funding the Bank is guided by internal policies on the use of subsidies, which should be targeted at addressing market barriers and failures. While having a relatively smaller GHG reduction potential, SMEs and small projects face relatively higher barriers to investment due to the inherent lack of capacity and expertise, higher risks and transaction costs; barriers to investments in challenging areas such as public infrastructure and buildings are also significant.

In contrast, industrial energy efficiency projects can generally be financed without any grant incentives. Accordingly, the low share of concessional finance to industry reflects the fact that in most cases there should be no subsidies for this finance. It does not reflect as the study asserts a misallocation based on differential GHG emissions reduction potential.

Based on the above, Management believes that the Bank has been applying TC/Non-TC across various areas and sectors in an effective manner. Management does agree with the EvD's assessment regarding the importance of renewables (as demonstrated by projects supported in Jordan, Egypt, Kazakhstan), and the Bank will continue to seek ways to use targeted support to alleviate specific barriers and underpin the development of the sector further.

5. Policy

The Study states that the Bank is not allocating sufficient attention towards "upstream" policy work, particularly to support the preparation of national climate change mitigation and adaptation commitments and strategies.

This finding is based on a comparison of the share of TC allocated to policy work relative to project preparation (see section 3.6.1 (iv)). Management considers that this is not a relevant basis for assessment considering the significant difference in average cost between policy and project preparation work.

Management does agree that the Bank needs to work on systemic "upstream" policy activities and believes that it has been doing this consistently since the end of SEI Phase 1. It is relevant to note in this context that the first policy staff hired within the Banking Department was in the E2C2 team as far back as 2008. Since then, the Bank has developed an active and diversified climate policy work programme. In the period from 2009 to 2017, the Bank completed over 330 policy activities including national energy efficiency and renewable energy action plans, renewable energy laws, energy performance standards for appliances and legislation for public sector energy performance contracting.

While the Bank's climate initiatives and project-based operational approach have not been linked to national climate strategies as they have either not existed or been at a nascent stage of development, the Bank has pursued policy engagement that has been successful in removing barriers, setting standards, opening markets and catalysing private sector action. The strengthening of NDCs and alignment to the Paris Agreement will provide a stronger base for alignment between Bank activity and country climate priorities.

6. International Climate Action

Management would like to highlight that the Bank has actively contributed over the period covered by the CI evaluation to the international work to address the climate change debate by participating in a broad range of fora including, for example, the G20, the One Planet Summit, UN Climate Summits, the EU High Level Expert Group on Sustainable Finance, the Network for Greening the Financial System (observer in the NGFS which currently includes 34 central banks), the NDC Partnership and the MDB Working Group on Paris Alignment. The Bank's contribution is particularly appreciated in relation to its expertise related to private climate finance, energy efficiency, renewable energy, cities climate finance and the integration of policy work and investment.

Over the course of time, this work has allowed the Bank to contribute in a practical manner to international climate policy and finance development, while staying at the forefront of the climate agenda and of MDB best practices on climate action (including in terms of relevant internal procedures and guidelines related to climate finance accounting, monitoring and reporting).

7. Data

The report states that large and problematic data gaps exist, particularly on concessional funding. Management acknowledges that significant data gaps exist and both systems for and approaches to data collection, monitoring and reporting need to be improved. As reflected in relation to Recommendation 5, Management agrees on the value of ex-post data highlighting the additional costs which will have to be incurred.

At the same time, it must be noted that the Bank's current procedures and systems only collect and integrate data that the Bank is required to monitor internally (based on approved strategies, guidelines, performance metrics) and disclose externally (reporting to donors, disclosures in the Annual Environmental Report and Joint MDB Report, etc.). Data availability/collection, as well as monitoring and reporting practices have been in line with respective commitments and obligations vis-à-vis EBRD donors.

Equally, the Bank's practices for the accounting, monitoring and reporting of climate finance and associated physical impacts have been conforming to MDB guidelines – which are primarily based on ex-ante estimates – as well as other applicable standards (including Green Bond Principles in respect of the portfolio financed by the Bank's Environmental Sustainability Bond Programme). The Bank regularly monitors the use of financing proceeds ensuring that green projects are implemented; as well as tracks projects' performance against the underlying Transition Impact benchmarks (such as expected GHG emissions savings and other physical impact indicators as applicable). Finally, the Bank has already started strengthening its MRV unit and approach, going beyond the requirements of the adopted MRV procedures. For example, since 2016 the Bank has been validating GHG emissions from a sample of CI projects with the highest CO_2 emissions and/or emission reduction potential.