Dialogue on

Establishing a Blended Finance Mechanism Involving Climate Funds in Bangladesh: Opportunities and Challenges

Presented by

Dr Wasel Bin Shadat

Senior Visiting Fellow

Centre for Policy Dialogue

Dhaka: 2 October, 2021

Acknowledgement

This scoping study was conducted by the Centre for Policy Dialogue (CPD) as part of the Climate Induced Migration (CIM) Issue Based Project (IBP) of the Promoting Knowledge for Accountable Systems (PROKAS) Programme.

The research team consisted of *Dr Fahmida Khatun*, Executive Director, *Dr Wasel Bin Shadat, Senior Visiting Fellow*, and *Mr Foqoruddin Al Kabir, Programme Associate, CPD.*

The research team gratefully acknowledges the valuable support received from a number of officials of various organisations and register its sincere thanks to them. However, views expressed in this presentation are of the research team only.

Outline

- Overview of the Study
- From Village to City Slum: An Anatomy of Bangladesh's Climate Displacement Problem
- The Intervention, Rationale and a Theory of Change
- Blended Finance: Characteristics, Opportunities and Challenges
- A generic Blended Finance framework for Bangladesh with an illustration
- Sum up

Overview of the Study

Overview of the Study

- Climate change and natural disaster – a major threat to BD's growth and development endeavor.
- Climate displacement leading to urban slum migration has emerged as a major development challenge for Bangladesh.
- Growth of urbanization and urban slums and subsequent impact on the quality of life have become a major policy concern. Hon'ble PM's brainchild "My Village, My City" project reflects the policy prioritization.
  - Dhaka's position stood at 8th in 2021 among the top ten of the least liveable cities in the world (The Global Livability Index, 2021).
- Insufficient decent livelihood opportunities is identified as a dominant, underlying and structural problem for climate displacement.
- This study proposes a high-impact intervention, with rationale and a theory of change focusing on SME growth through improved access to finance from formal banking and non-banking channels.
- Blended Finance (BF), involving the green climate fund, can be used to address the finance gap.

Contribution of the Study

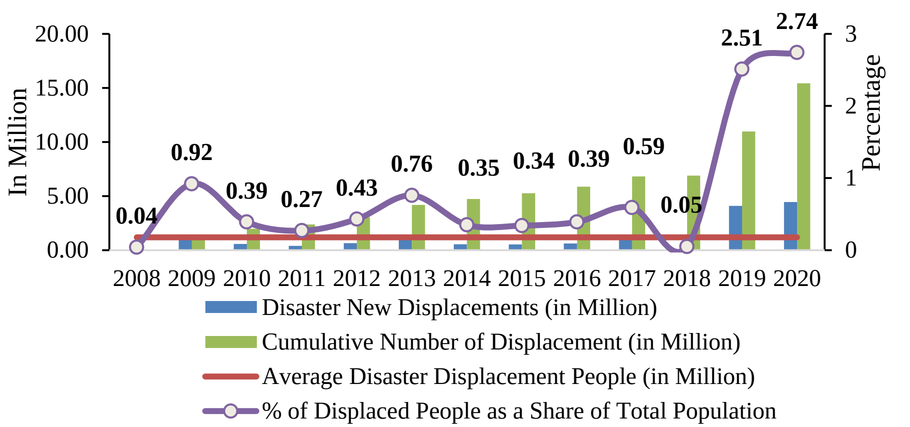
- An anatomy of the climate displacement problem, drivers and consequences (development challenges)
- Designing an intervention (Employment-oriented SME growth through providing improved access to finance) to tackle the problem, with rationale and a theory of change.
- Analyzing BF mechanism: Characteristics, Applications, Potentials and Challenges.
- Developing a generic BF framework for Bangladesh with an illustration to the SME financing context.

Natural Disasters in Bangladesh: Increasing Risks and Vulnerability

- Disasters, and in particular, cyclones and floods, cause significant economic losses in Bangladesh, particularly in the disaster-prone coastal, flood-plain and haor areas (Shadat, 2021; Shahid, 2012).
- Natural disasters damage household (HH) assets, reduce HH overall wealth including future productive capacity and affects household consumption behaviour. As a result, HH's livelihood security is compromised that leads to internal migration (Shadat, 2021, Petrova, 2021 and Kabir et al., 2018).
- During 2008-2020, on average, each year natural disasters internally displaced 1.2 million people in Bangladesh (Internal Displacement Monitoring Centre, 2020).
- The proportion of internally displaced people due to natural calamities in Bangladesh is the highest in South Asia.

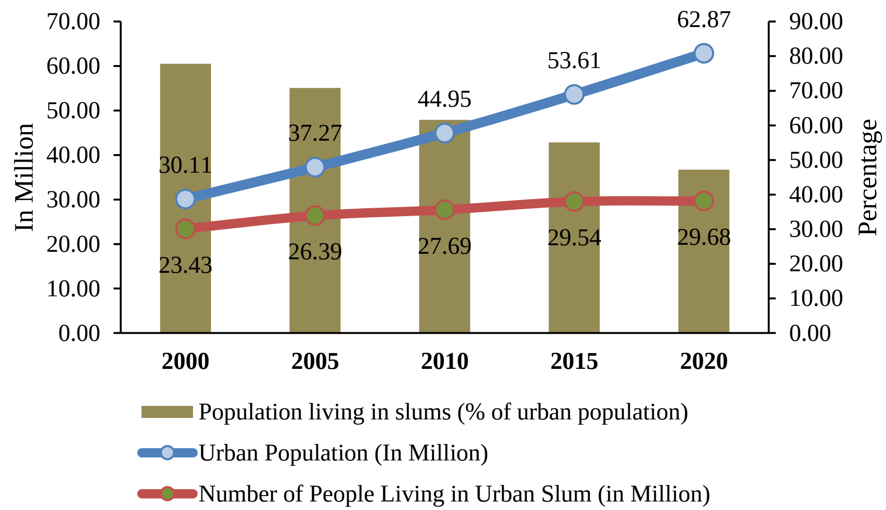
Alarming Rise in Disaster Driven Internal Displacement

The Overview of Disaster Displacement in Bangladesh (2008-2020)



Source: Internal Displacement Monitoring Centre (2020).

Trend of Urbanisation in Bangladesh



Source: World Development Indicator (2020).

- Alarming jump in figures in 2019 (4.1 million or 2.5% of total population) and in 2020 (4.4 million or 2.7% of total population).
- The number of urban population has significantly increased from 56.61 million in 2015 to 62.87 million in 2020.

From Village to City Slum: An Anatomy of Bangladesh's Climate Displacement Problem

Drivers, Consequences, and Development Challenges

- The coastal and cyclone prone areas of south-east and south-west, and Brahmaputra-Jamuna flood plain areas are severely hit by disasters.
- Spatial distribution shows that slums in Dhaka, Chittagong, and Rajshahi as the major destinations
  - Mostly driven by the centralised and urban-centric growth culture and lack of employment and income generating opportunities in the local/nearby city centres.
  - Belief and knowledge (obtained from networks who have already migrated to cities) about the employment opportunities for the unskilled/low-skilled displaced people.
- **This alarming trend puts tremendous pressure on the already overcrowded, unsafe and unhealthy city slums with limited or no access to basic services such as water, sanitation, electricity, and transportation, lead to critical environmental consequences.**

Drivers, Consequences, and Development Challenges *(Continued)*

- Achieving at least seven Sustainable Development Goals (SDGs) are directly threatened by the observed upward trend of internal migration to big cities. These are: SDG 1 (No poverty), SDG 2 (Zero hunger), SDG 3 (Good health and well-being), SDG 6 (Clean water and sanitation), SDG 8 (Decent work and economic growth), SDG 11 (Sustainable cities and communities), SDG 12 (responsible production and consumption), SDG 13 (Climate action) and SDG 15 (Life and land).
- A number of economic, environmental, social, and political drivers can potentially contribute to the climate induced migration to big cities.
- **This study argues that *household's compromised livelihood security and scarcity of decent income generating activities in local areas are* underlying and structural causes for internal migration.**

The Intervention, Rationale and a Theory of Change

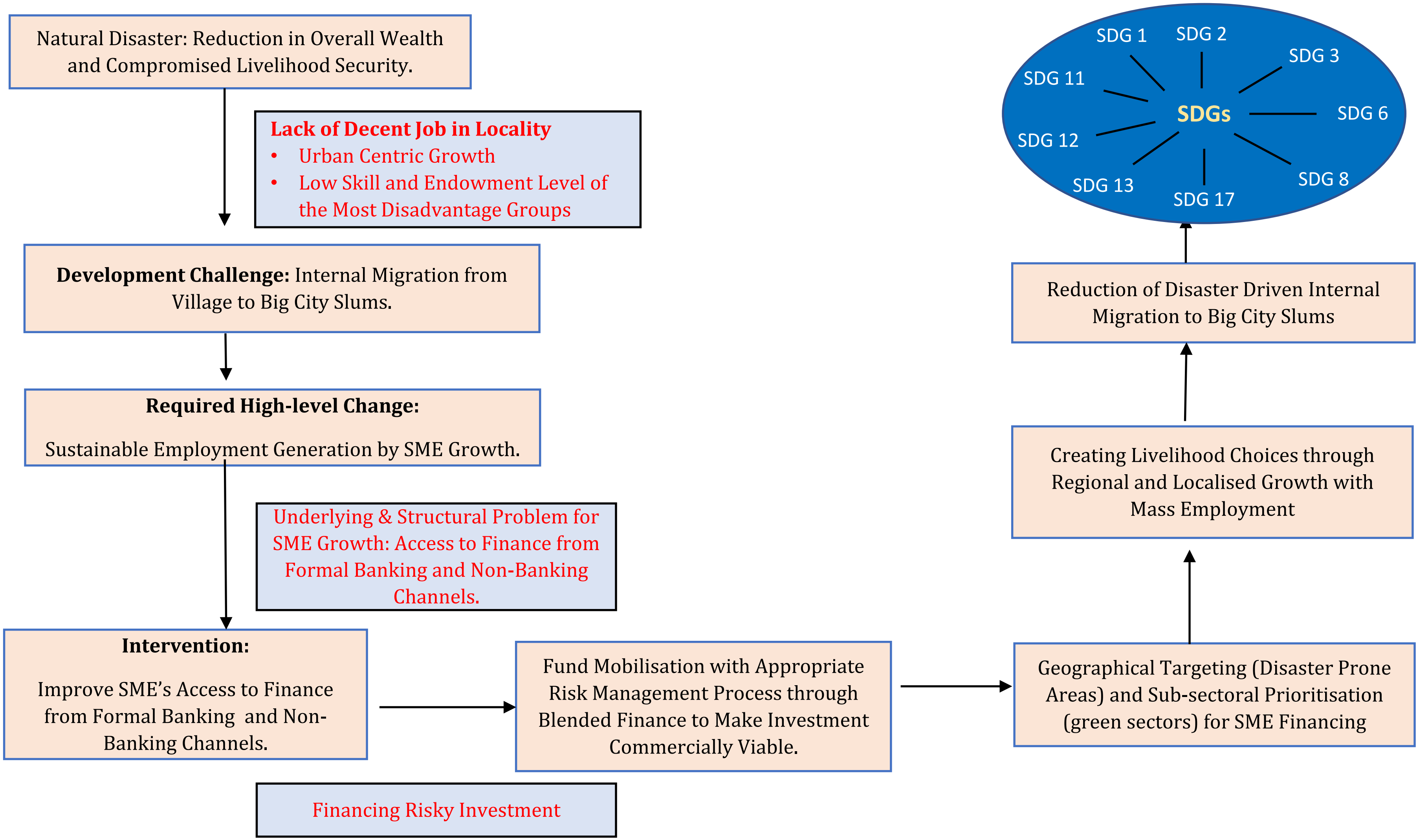
SMEs in Bangladesh: Importance and Challenges

- SMEs in Bangladesh contributes 25 per cent of the GDP and 45 per cent of manufacturing value addition and 90 per cent of total industrial units (Ministry of Planning, 2019 and ADB, 2015).
- SME is a labour intensive sector: accommodates about 25 per cent of the total labour forces and 80 per cent of industrial employment (Ministry of Planning, 2019).
- A number of studies reveal that the high cost of capital and access to financing from formal banking channel is the major obstacle to SME growth in Bangladesh (Hassani-Mahmooei & Parris, 2012; Cattaneo et al., 2019; Rahman & Majumder, 2020).
- The allocation, implementation and disbursement processes of GoB's COVID stimulus package for CMSMEs has once again demonstrated the extent and gravity of SME's challenges in accessing finance from the formal channels; it has highlighted both demand and supply side constraints.

The Intervention

- **Facilitating improved access to finance for SMEs through credit from formal financing (banking and non-banking) channels, using a blended finance mechanism with a contribution from the green climate fund (GCF).**
- **The fund will prioritise regions and sub-sectors in disaster prone areas to promote employment generating green growth.**

A Simplified Theory of Change



Blended Finance: Characteristics, Opportunities and Challenges

Blended Finance (BF): An Evolving Concept

- A new and evolving concept with massive implications for development finance.
- OECD/WEF(2015): "*the strategic use of development finance and philanthropic funds to mobilise private capital flows to emerging and frontier markets*".
- Blended finance can be used to mitigate existing and emerging risks and threats in achieving SDG targets by attracting required investments and has tremendous potentials to finance the sizeable SDG investment gap in developing countries.
  - **Estimated SDG financing gap: annually $2.5 trillion globally (UNCTAD), $1.5 trillion for Asia-Pacific (UN-ESCAP), $145 billion for Bangladesh (Planning Commission)**
- The inbuilt de-risking measures enables to attract private capital flow to finance interventions with unfavourable risk-return investment profile, which would not be possible in the absence of such mechanism.

Blended Finance (BF): Key Characteristics

1. A combination of public and private finance which includes official development assistance (ODA) as well.
2. Development finance and philanthropic funds are strategically used to mobilise private capital flow.
3. Types of finances may include combinations of concessional, non-concessional, syndicated loan, credit line
4. Risk management using financial engineering and other policy tools and supports to de-risk the investment and creating a favourable risk-return environment. Innovation and learning from experiences are two essential components in managing risk successfully.
5. Prudent investor-friendly, yet accountable, regulatory framework to ensure the governance of the fund.
6. A flexible framework allowing stakeholder's participatory consultation, reflection and revision as much as possible.

Some Applications of Blended Finance

- The Islamic Development Bank (IsDB) and development cooperation partners launched a USD 2.5 billion Lives and Livelihoods Fund (LLF) in IsDB member countries in 2016 for poverty reduction, is an example of syndicated financing.
- Livelihoods and Food Security Trust Fund (LIFT) and Yoma Bank in Myanmar started an agribusiness finance programme with a total budget of USD 18.07 million in 2015.
- Blended finance will have more than USD 360 billion investment in clean energy by 2030 in Sub-Saharan Africa and South and East Asia (with strong institutions, sufficient investment and climate friendly policy settings).
- Unlocking Forest Financing (UFF) in three sub-nations of Africa, agriculture, energy, and transport are the priority sectors that attract blended finance.

Operationalising Blended Finance: Challenges

Challenges are categorized under five sets:

1. Establishing a prudent, investor and development friendly regulatory and institutional framework to ensure the governance and accountability of the mobilized fund. In the absence of a transparent and effective monitoring and evaluation process, potential investors become less interested in financing development interventions due to increased investment risks and asymmetric information.
2. Identification, prioritisation, and selection of development problem and intervention to address the problem; with a credible estimate of finance gap to implement the intervention.
3. Fund mobilisation issues, such as, identification of and reaching out to potential donors, private investors and public institutions, socializing the development impact with the commercial viability of the intervention to motivate them, and negotiation on the size and type of contributions to the mobilised fund.

Operationalising Blended Finance: Challenges (Continued)

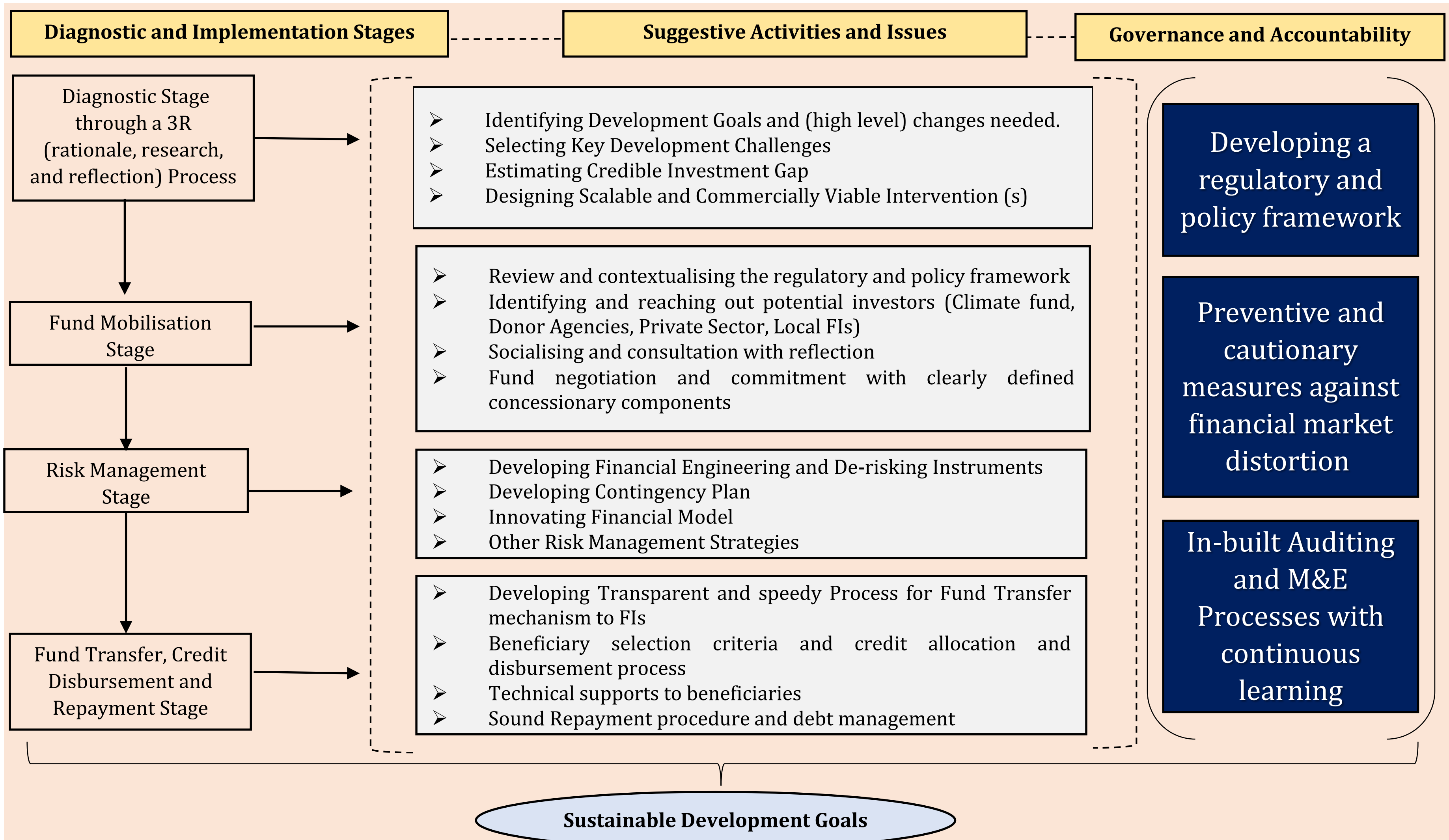
4. Efficient and transparent application of innovative financial modelling and engineering tools to manage financial risks and appropriate policy support to mitigate political and environmental risks that are associated with the choice of the intervention. Debt management and debt servicing should be carefully be monitored. The dearth of required technical skills is a major hinderance to address this challenge.
5. Developing of a sustainable, transparent and speedy fund transfer (to financial institutes and beneficiaries) and repayment framework.

A Generic Blended Finance Framework for Bangladesh with an Illustration

A Generic Blended Finance Framework for Bangladesh with an Illustration

- There is no universally applicable and practiced blended finance framework.
- In case of Bangladesh, the key issue is the absence of a generic model to operationalize blended finance.
- This study outlines a generic, sustainable, transparent, and accountable blended finance framework that would cover both key operational and regulatory issues.
- **This locally contextualized generic framework does not cover all relevant issues at this stage in a holistic way; rather the model is developed as a prototype to initiate discussions among policymakers, academics and other stakeholders and will be fine tuned with expert opinions.**
- The framework has four key diagnostic and implementation stages, each involving certain key activities, and a governance and M&E mechanism to oversee and administer these stages under a sound policy framework.
- Activities grouped under these four stages are neither strictly sequential nor mutually exclusive.

A Generic Framework



Source: Authors' Own Illustration

Governance and Accountability

- To initiate BF operation in Bangladesh, regulatory reforms and innovations are required with capacity building and strengthening domestic institutes.
- Successful implementation of BF interventions crucially depends on the existence of a proper regulatory framework covering governance and accountability issues.
  - An in-built reliable, dynamic and responsive auditing, M&E, and learning mechanism is an integral part to ensure accountability and detect risks and warning signs. This will help to trigger appropriate responses and contingency plan to offset risks promptly.
  - Adaptation of anti-distortionary measures to maintain local financial market stability.
  - Transparency and accountability in fund transfer, credit allocation, credit disbursement and repayment frameworks are essential.
- Bangladesh Bank and other relevant government authorities, in collaboration with broader stakeholders will finalise the regulatory framework.

Diagnostic Stage

- To fund high impact projects with limited financial resources, a rigorous 3R (Rationale, Research, and Reflection) process will be used:
  - To identify key challenges and obstacles in achieving development goals and targets
  - To design/select scalable, and commercially viable intervention(s), with a sound theory of change, and having a large developmental impact.
- A credible estimation of the financing gap between demand and supply of resources (Ojo & Ayanwale, 2019; Veiga & McCahery, 2019; Lopez-de-Silanes et al., 2018). The estimation of finance requirement should be based on updated data and preferably under alternative scenarios.
- Participatory consultation processs with larger stakeholders is required to validate the intervention and to establish ownership of the mechanism.

Fund Mobilisation Stage

- Successful mobilisation of the fund depends on identifying and engaging potential financing partners and stakeholders. At the onset of fund mobilization stage, the regulatory framework needs to be established (if there is none in place) or reviewed for possible reforms and/or contextualization to ensure the transparency and accountability of fund mobilisation and utilisation.
- The rationales of the interventions and its possible impact need to be introduced and socialised with a particular reference to commercial viability and sustainability of the proposed interventions (Schmalz et al., 2018 and Clark et al., 2018). All interested financiers should negotiate and commit to contribute at this stage.

Risk Management Stage

- Financial risk will be managed by identifying, analysing and mitigating the uncertainty associated with the projects.
- Developing de-risking mechanism using innovative financial engineering and modeling tools (for example, equity, partial risk financing, partial shared risk coverage, and supplementary non-exclusive guarantees).
- Different combination of de-risking (i.e., debt-equity mix, equity and partial risk management) instruments can be applied innovatively to incentivise and motivate the private sector investors to invest in challenging projects.
- Determination of the interest rates which may be charged at various stages of fund flow.

Fund Transfer, Credit Allocation, Credit Disbursement and Repayment

- The fund should be transferred to the financial institutes to allocate and disburse to selected projects/beneficiaries with a sustainable repayment system in place. Thus, this stage comprises of three important components:
  - i) A fund transfer mechanism to ensure a speedy yet transparent flow of mobilised fund to the financial institutions.
  - ii) A guideline for the financial institutions to allocate and disburse credit among the selected recipients along with technical support and training, where required. An effective targeting of the beneficiary projects and assessment of credit worthiness is of paramount importance. For some interventions, socialization and sensitization campaign may be required to create interest and demand among the targeted beneficiaries.
  - iii) A framework of repayment procedure (i.e., frequency and size of repayment instalments, defaulter penalty/fees and mitigating measures etc.) should be in place to monitor and manage debt burden within an acceptable limit.

An Illustration of the BF framework with SME Intervention: Some Key Issues

- A credible and updated estimation of SME's demand for credit, and thereby of resource gap, is crucial.
  - IFC (2011) projected SME financing gap be $1.8 bln. Institute for Inclusive Finance and Development (2016) estimated a gap of $1.07 bln (underestimated as SME growth was not considered).
- GCF can play a significant role to mobilise the fund. Some examples of other potential financing sources are: Bangladesh Climate Change Trust Fund, Bank Disaster Management and Corporate Social Responsibility Fund.
- To attract private capital flow, efficient risk management using innovative financial and non-financial instruments is a pre-requite. Need to develop and strengthen institutional expertise and skills.
- A balance between development outcome and return from investment is important. Investor's CSR options should be explored.
- Determination of concessional lending rate for beneficiaries.

An Illustration of the BF framework with SME Intervention: Some Key Issues (cont.)

- Beneficiary selection with geographical and green sub-sectoral targeting of SMEs.
- Women entrepreneurs should be prioritised. A certain proportion of disbursed credit may be reserved for eligible women entrepreneurs.
- Deciding the role of local financial institutes: intermediary only? Investor?
- Minimising operational and transaction costs of financial institutes.
- Training and technical support to beneficiaries to develop demand side capacity such as managerial capacity, transparent accounting, banking support, business idea generation and expansion etc.
- Easy and user-friendly application procedure with required support.
- Quick and transparent approval, credit allocation and credit disbursement to beneficiaries.

SUM UP

- To tackle substantial development challenges posed by climate displacement to urban slums, an intervention (SME's improved access to finance), with a theory of change, is proposed.
- In view of the sizeable SDG financing gap and shrinking fiscal space due to the pandemic, the BF involving climate fund could be extremely useful to finance the intervention.
- A generic, flexible and dynamic BF framework is proposed to initiate policy discussions and debates, emphasizing the governance (transparency and accountability) issues. This can be synchronised with the overall financial sector reform.
- A number of key issues and concerns has been raised in the context of proposed SME intervention and BF framework.