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# Governing the Post-2012 Financial Mechanism: Engagement, Effectiveness, Efficiency and Expertise

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## KEY MESSAGES:

- Proposals for governing a post-2012 financial mechanism should be evaluated along four criteria: engagement, effectiveness, efficiency and expertise.
- A regional registry system should be established to help administer the matching of "nationally appropriate mitigation actions (NAMAs) supported by technology, financing and capacity-building, in a measurable, reportable and verifiable (MRV) manner" as defined in the Bali Action Plan (BAP).
- The regional registry could partner with regional development banks such as the Asian Development Bank (ADB) and make use of existing technical networks to facilitate the matching of climate actions and finance.
- The operational entity of the financial mechanism under the Conference of Parties (COP) to the United Nations Framework Convention on Climate Change (UNFCCC) should oversee and monitor financial flows from regional registries and recommend reforms on issues such as interregional funding imbalances.

### *Introduction*

How the future climate regime's financial mechanism will be governed is one of the most important and contentious issues in negotiations over the post-2012 climate regime. Governance—the question of how funding will be managed, allocated and distributed—is integral to the performance of the new regime's financial mechanism. Yet developed and developing countries are sharply divided over this question. Failure to resolve their disagreement could stall climate negotiations and undermine prospects for a mutually beneficial outcome at Copenhagen.

This briefing note offers a way to move beyond the current impasse. The briefing proposes four criteria to assess governance structures for a post-2012 financing mechanism: engagement, efficiency, effectiveness and expertise. The briefing suggests that using these criteria could lead to a more balanced appraisal of the relative strengths and weaknesses of different governance proposals. Based upon such an assessment, the briefing calls for a mixed proposal with a regional registry to help match financing needs of developing countries with financial resources from developed countries. The briefing contends that this mixed proposal will perform better on the engagement, effectiveness, efficiency and expertise criteria than governance proposals supported by developed and developing countries.

The briefing note is divided into three sections. The first section reviews the positions of developed and developing countries on the financial mechanism's governance structure. The second section evaluates different governance proposals along the four aforementioned criteria. The third section outlines

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how a mixed proposal anchored by a regional registry system could perform comparably better than structures preferred by either developed and developing countries.

The briefing note is based on the Institute for Global Environmental Strategies (IGES) fifth round of consultations on the future climate regime held in Beijing, China and New Delhi, India during September and October of 2009. It is meant for climate negotiators, policymakers, academics and representatives from the private and non-governmental sector who are familiar with the current climate negotiations.

## *How Should Finance be Governed?: Outlining Competing Positions*

The way that decisions over the future climate regime's financial mechanism are made could have lasting implications on the global climate and national budgets. It is therefore not surprising that developed and developing countries have contrasting views on how new inflows of funding should be managed. To a certain extent, these different views have been addressed in the Bali Action Plan (BAP). In particular, Article 1(b)(ii) of the BAP calls for "nationally appropriate mitigation actions (NAMAs) by developing country in the context of sustainable development, supported and enabled by technology, financing and capacity-building, in a measurable, reportable and verifiable (MRV) manner."

This passage from the BAP was seen as an important step forward when it was agreed upon at the 13th Conference of the Parties (COP) in Bali, Indonesia in 2007. By suggesting that developing countries would get more funding, technological and capacity building for taking a broader range of actions, it effectively exchanged scaled up actions from developing countries for scaled up support from developed countries. But just as it helped to remove one barrier to negotiations it created another set of obstacles. Namely, it left open to discussion how decisions over new and larger-scale flows of finance would be governed. This, in turn, has led to differing perspectives on the structure of the future climate regime's funding mechanism. A simplified overview of these differing perspectives follows.

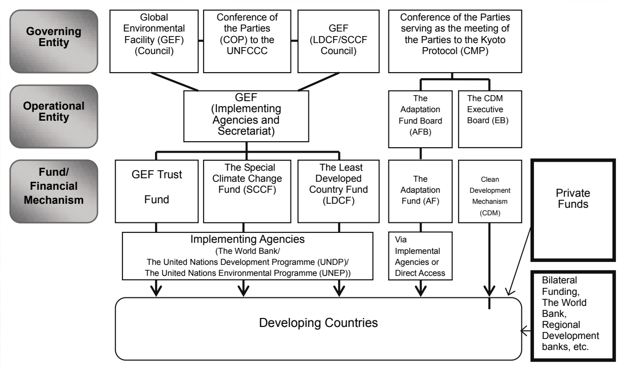
## *The Developed Country View: Building upon the Status Quo*

The basic position of developed countries on a new governance structure can be summarised as building upon the status quo. Countries such as the United States, the Czech Republic (for the European Union) and Japan support utilising and strengthening existing financial institutions and mechanisms to fund climate change actions in developing countries.[1] While acknowledging room for improvement in the current system, most developed countries advocate refining that system and relying on familiar set actors and arrangements to handle what will be billions of dollars in new financing.[2] These familiar set of actor and arrangements include the Global Environmental Facility (GEF), the World Bank, regional developmental banks, bilateral financial contributions, the carbon market and private funds.

Diagram 2 illustrates the governance structure many developed countries prefer. As suggested by the diagram, the structure would consist of a three-tiered hierarchy of functionary bodies. In this hierarchy, three governance entities would oversee the GEF as the main operational entity that would, in turn, administer finance through several existing funds such as the GEF Trust Fund, the Special Climate Change Fund (SCCF) or the Least Developed Country Fund (LDCF). There would also be a set of governing and operational entities overseeing the future climate regime's Clean Development Mechanism (CDM) and Adaptation Fund (AF) under the COP serving as the meeting of the Parties to the Kyoto Protocol (CMP). Below the three tiers, institutions such as the World Bank or United Nations Development Programme (UNDP) would implement funded projects and programs, while implementing agencies or countries themselves would continue to manage resources flowing through a new CDM and AF.

[1] *Please refer to submissions by the Czech Republic (EU), Japan and the United States. FCCC/AWGLCA/2009/MISC.4 (Part I)*
[2] *UNFCCC, Investment and Financial Flows to Address Climate Change, Bonn: UNFCCC, 2007.*

**Diagram 1. The Developed Country View**



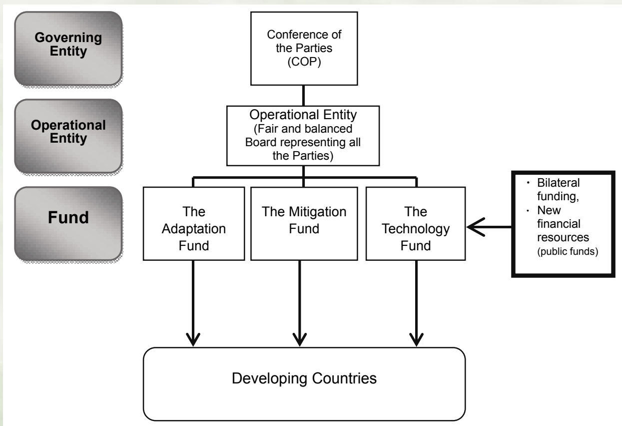

The option in diagram 2 has several noteworthy features. First, it would enable developed countries to control the distribution of funding, most of which would be procured through market mechanisms and public finance. Second, it would focus on strengthening existing institutions to facilitate and expedite the administration, management and distribution of those funds. Third, it would allow developed country donors to require recipients, namely developing countries, to meet standards to receive funding and ensure the efficient and effective use of these funds. Fourth, it would make decisions over the allocation and distribution of funding roughly comparable to the level of those contributions, mirroring the governance of the World Bank and other international financial institutions.

## The Developing Country View: Building a New System

Not surprisingly, developing countries have a different view on how the new funding mechanism should be governed. Countries such as India and China have argued that the current financial system is not only insufficient but inequitable.[3] From their perspective, donor countries exert too much influence on which sectors are prioritised and which projects are financed. As such, they call for ensuring that developing countries can actively participate in the decision making process that determines the allocation of funds. They also assert that the core source of the financing required in article 4, paragraph 3 of the UNFCCC should be public contributions and procurements from developed countries while private funds and the carbon market should be complementary and additional to the required funding.

The governance structure in diagram 3 illustrates several of the key features of the funding mechanism developing countries prefer. First, developing countries have proposed a centralised structure, led by the COP to the UNFCCC, as the key decision making node. Second, the financial resources would be directly allocated for adaptation, mitigation and technology transfer needs under COP control and managed by newly established operational entity under the authority and guidance of COP.[4] In sharp contrast to the developed country view, members of this new entity would be chiefly from developing countries and would oversee the entity on a one vote per country system, paralleling the governance of the Adaptation Fund Board (AFB). Finally, there would be an institution that enables direct access to the funds without intervention from implementing organisations, again similar to the Adaptation Fund (AF).

**Diagram 2. The Developing Country View**




[3] *Please refer to submissions by China and India. FCCC/AWGLCA/2009/MISC.4 (Part I)*

[4] *The proposed individual funds include the following: the Convention Adaptation Fund; Mitigation Fund under the Convention; REDD Fund; The Multilateral Climate Technology Fund; A Multi-Window Mechanism to Address Loss and Damage, including an Insurance Fund ; The Global Fund to Support a Feed-in Tariff Programme; The Capacity-Building Fund; the Venture Capital Fund, and other funds. Please refer to Non-Paper No. 54 (Contact Group on Enhanced Action on the Provision of Financial Resources and Investment). Also refer to submissions by China and India. FCCC/AWGLCA/2009/MISC.4 (Part I).*

### *Four Criteria: Engagement, Efficiency, Effectiveness, and Expertise*

As suggested by the previous section, developed a post-2012 and developing country views on the governance of financial mechanism differ dramatically. In general, developed countries prefer relying on the existing set of institutions because they would enable them to exert continued influence over expedited decisions. Developing countries prefer a new set of institutional arrangements that will enable them to determine how funding would be managed. While these differing views may appear irreconcilable, this briefing suggests a way forward. The way forward begins by suggesting that that rather than continue to debate different views, what is a needed is set of principle-based criteria to evaluate these views' relative strengths and weaknesses.[5] The briefing suggests four such criteria.

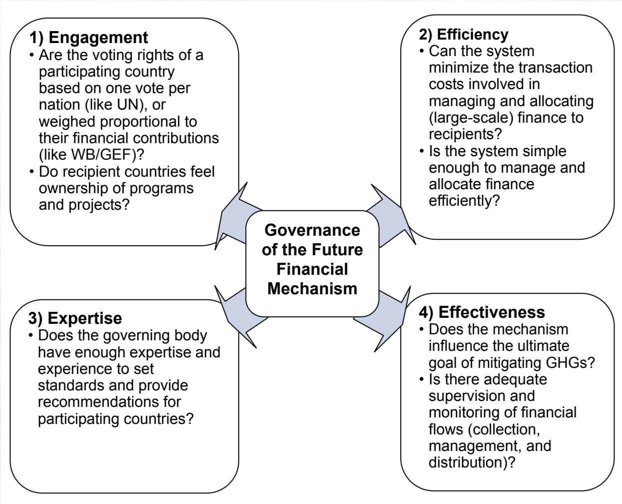
1. **Engagement-**This criterion focuses on ensuring that countries using financing are more involved in the process determining the allocation and distribution of that financing. Often the sticking point with this criterion is whether each country has equal influence over funding decisions (one country one vote) or whether influence is proportional to the levels of funding provided. This criterion also involves enhancing ownership of funded projects and programs during implementation.

2. **Efficiency-**This criterion involves minimizing the transaction costs associated with allocating and administering financing. The main issue is ensuring that funds move quickly enough to meet the needs of recipients without sacrificing the monitoring needed to enhance the effectiveness of those funds.

3. **Effectiveness-**This criterion refers to the impact that financing has on the ultimate goal of mitigating GHGs. Enhancing effectiveness often requires not only adequate provisions of financing but sufficient supervision, transparency and monitoring of those resources.

4. **Expertise-**This criterion relates to whether there is technical knowledge or practical experiences to guide funding decisions. The technical background and experience could be used to set standards and provide recommendations for financing actions from participating countries.

**Diagram 3. Criteria for Evaluating the Governance Structure of a Post-2012 Financial Mechanism**




As illustrated in Table 1 and 2, these four criteria can be used to evaluate the strengths and weaknesses of the proposals presented in the previous section. They can also be used to demonstrate how different criteria relate to each other.

Some of the key advantages and disadvantages can be seen when comparing the different criteria against the developing country view. Placing an operating body under COP, for instance, would not only enhance ownership and increase engagement with stakeholders, but potentially lead to more voluntary participation from developing countries that would increase effectiveness. At the same time, centralizing control in COP and instituting a one-country, one-vote system would create a more bureaucratic and complex structure. The increased transaction costs from this more complex system could lower

[5] *It is important to note that these criteria are not exhaustive list of the standards one might use to evaluate different proposals. For instance, equity and transparency, which are currently incorporated in the engagement and effectiveness criteria respectively, could be standalone criteria. For the sake of providing a relatively simple yet objective basis for evaluation, the four criteria were chosen.*

efficiency. When coupled with the limited influence of developed countries, it may also reduce willingness to support the new financing mechanism and potentially hurt effectiveness. The developing country view does not directly address the fourth criteria, the need for expertise, except by implicitly including greater local involvement in funding decisions.

The developed country view can also be evaluated along similar criteria. Building upon the status quo would increase developed country confidence in the mechanism, which would likely bring greater finance from developed country donors. It may also enhance effectiveness because working through existing arrangements would reduce time and costs needed to arrive at allocation decisions. It would not, however, strengthen engagement or ownership, which may add to developing countries' concerns over equity, curtail their willingness to participate in the funding mechanism and possibly hurt effectiveness. Finally, the developing country view does not address the expertise criteria directly, except by implicitly relying on the experiences of existing institutions and development agencies for implementing projects and programs.

**Table 1. Evaluating Developed and Developing Country Views**

| | Developed Country View | Developing Country View |
|---|---|---|
| **Engagement** | · Limited participation by developing countries | · More equitable system will enhance participation of developing countries in decision making process<br>· Donor countries may find decision rules unacceptable and may cause conflict between developed and developing countries |
| **Efficiency** | · Relying on existing institutions could reduce transaction costs<br>· But possible fragmentation and cooperation between funds/financial flows | · Enabling coordination and balance between funds/financial flow<br>· Enabling to manage large-scale public fund<br>· Possibility of system's expansion and complexity<br>· Capacity building of developing countries is required for direct access to the funds to avoid insufficiency and corruption |
| **Expertise** | · Existing institutions have policy expertise and experience | · Further capacity building to enhance expertise may be necessary |
| **Effectiveness** | · Greater willingness to provide funds from developed countries<br>· Possible to monitor funds individually<br>· But possible limited interest from developing countries | · System likely to become larger and more complicated (due to more involvement of diverse stakeholders in decision making) |

Table 1 compares the developed and developing country views along these four criteria to clarify their importance to different countries. As suggested in table 1, developing countries place the emphasis on engagement, which could enhance effectiveness by increasing stakeholder involvement in allocation decisions. In comparison, developed countries place the emphasis on efficiency, which could enhance effectiveness by ensuring that funds are delivered to stakeholders in a timely manner. Neither set of countries emphasizes expertise, which could also enhance effectiveness by ensuring that funding for particular policy or project is warranted on a more objective basis.

While both the developed and developing country views have their strengths and weaknesses, neither is flawless. More specifically, the developing country proposal focuses on engagement at the expense of efficiency. The developed country proposal focuses on efficiency at the expense of engagement. In light of these imperfections, the briefing proposes a mixed approach that would arguably perform better in balancing developing countries' emphasis on engagement and developed countries' emphasis on efficiency while addressing both sets of countries desire for increased effectiveness. The mixed proposal would also directly address the need for technical expertise.

## *The Architecture of a Mixed Proposal*

The core of this mixed proposal is a registry system initially proposed by South Africa and Korea at COP 14 in Poznan, Poland in 2008.[6] The registry system would enable developing countries to pledge their climate actions to an operational entity under the future climate regime and then receive matching financial support for those actions. The mechanism would be designed to help match financing from developed countries with needs of the developing countries. Similar to the previous section, the concept of a registry can also be evaluated along the four criteria.

Evaluating this proposal reveals several distinct advantages over previous proposals. These advantages include the following:

- First, a registry will enable developing countries to identify actions and demonstrate their funding

[6] *For an earlier view on the pledge and review of actions under a registry see Bradley, R. and K. A. Baumert, (eds.) Growing in the Greenhouse: Protecting the Climate by Putting Development First, Washington D.C.: World Resources Institute, 2005.*

needs and thereby enhance their engagement in the process.

- Second, a registry can support coordination and harmonization between funds and financial flows, thereby lowering the transaction costs involved in managing and allocating financial flows from the UNFCCC and other multilateral and bilateral contributions.

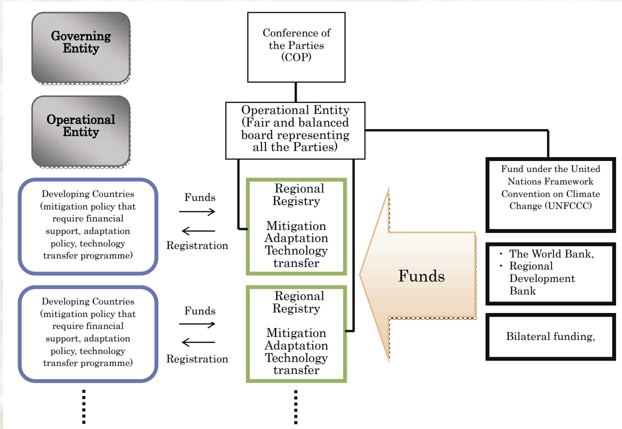
- Third, if the registry supports the disclosure of implementation and metrics to measure, report and verify (MRV) mitigation actions, it could improve effectiveness.

Building a single registry system under the current UNFCCC, however, may create other issues. One is that placing the matching in a single institution would raise the transaction costs of managing increasingly diverse information as well as significant new inflows of finance. Moreover, even though a registry would allow developing countries to pledge their actions, it would not necessarily give them influence over which actions actually receive funding. Last but not least, a registry by itself does not incorporate technical expertise.

To address these outstanding issues, the briefing recommends a mixed proposal with two additional elements. The most important addition is regionalizing the registry. Under a regional registry, developing countries would pledge climate change actions to decentralized set of entities located in four of the five United Nations regional grouping with developing country membership. The regional registry would then work with regional development institutions such as the Asian Development Bank (ADB) to match actions with funding. The system will be able to make effective use of existing networks and monitoring protocols, enhancing ownership and effectiveness. It would also draw directly upon the regional expertise of these institutions and thereby provide greater technical guidance.

Another additional element would be the creation of operational board under the Conference of the Parties (COP) that would have fair and balanced membership of developed and developing countries. The board would have broad oversight powers, for example, ensuring that there is adequate balance between regional financial allocations and guarding against the regional inequity issues that have arisen with the current CDM. It would also assuage some of the concerns from developing countries that they lack input into the use of funds. Diagram 4 presents a schematic of the governance of the mixed proposal. Table 3 summarizes its advantages and remaining challenges along the four key criteria.

**Diagram 4. A Mixed Proposal**




As suggested by Table 3, there are several advantages associated with the mixed proposal. These include the following:

- First, the mixed proposal would perform comparatively better in terms of engagement because developing countries would be able to identify actions for funding and become more involved in financial oversight.

- Second, the mixed proposal would be comparatively more efficient because it would enable the management of large scale of funds on a regional basis.

- Third, the mixed proposal would be better designed to incorporate expertise by relying on the technical competency and experience of regional development banks.

- Fourth, the mixed proposal would allow for greater monitoring and transparency that could enhance effectiveness. Finally, by building confidence between developed and developing countries, increased participation from both parties would also strengthen effectiveness.

**Table 3. Advantages and challenges of the mixed proposal**

| | Advantages | Challenges |
|---|---|---|
| **Engagement** | · Developing countries can identify actions for funding<br>· Establishment of a fairer system because developing countries are more involved in oversight | · Possibility of the sharpening of conflicting opinions in oversight decisions |
| **Efficiency** | · Potential to coordinate and harmonise between each of the funds and financial flows<br>· Can manage large-scale public funds in each region<br>· To balance inter-regional financial distributions and allocations, monitoring and recommendation by operating entity under the COP | · Increased operational costs and mandates (regulations, compliance supervision, etc.)<br>· Capacity building to avoid waste and corruption is required for direct access to the funds by developing countries |
| **Expertise** | · Integration of expertise by networking with regional development banks<br>· Integration of experience by Incorporating the needs of developing countries | · Possible trade-off between existing multilateral- and bilateral-cooperation<br>· Need to enhance developing countries technical expertise to directly access funds |
| **Effectiveness** | · Securing transparency through registration and reporting<br>· Intensive monitoring can be conducted<br>· Greater participation from both developed and developing countries in the financial mechanism | · Increased participation and funding will require more robust institutional design |

While the mixed proposal has several advantages, some challenges remain. These include the possibility of sharpening conflict between developed and developing countries involving oversight decisions. They also include the need to enhance the technical expertise to access funds. Finally, these involve the need for a more robust institutional design to handle the increased participation and funding. Some of these remaining challenges will involve integrating the financing mechanism with other elements of the future climate regime, while others will require more research and consideration moving forward.

In addition to evaluating this proposal along the four criteria, the mixed proposal can also be assessed in terms of its advantages and challenges for key stakeholders. For instance, as suggested in table 4, the mixed proposal would allow developed countries to share information on financial and technical assistance with other countries, which could avoid duplicating development assistance. It is nonetheless important to point out that developed countries might quickly lose interest in a mixed proposal if it is having a limited impact on intended goals. In that eventuality, developed countries might also be inclined to transfer resources to bilateral aid to achieve other diplomatic goals and objectives. It is therefore imperative that the mixed proposal clearly demonstrates results.

The mixed proposal can also be evaluated from the perspective of developing countries. The mixed proposal would give developing countries greater standing in the international community by providing them greater voice in decision making processes and strengthening their authority over the funds. However, it should also be understood that these privileges entail greater responsibilities. In addition to obligations to report on the status of implementation of domestic actions supported by developed countries under a measureable, reportable and verifiable (MRV) framework, developing countries could also lose credibility if funds were not used for the original purposes due to, for instance, corruption.

**Table 4. Advantages and disadvantages for each actor in the mixed proposal**

| | Advantages | Challenges |
|---|---|---|
| **Developed countries** | · Avoidance of duplicate assistance | · Limited impact on recipient countries (can induce bypassed-actions if focused on bilateral diplomatic relations) |
| **Developing countries** | · Strengthen influence on decision making<br>· Disclosure of ownership over the fund use | · Board: Complicated decision making by different stakeholders<br>· Compliance with greater responsibility (e.g. obligation of reporting on registry such as implementation status of measures selected for support) |
| **Developmental Banks** | · Reduction of cost of identifying new projects | · Difference of mandate between organisations with COP<br>· Limitation of impact on recipient countries |

Finally, the mixed proposal can be evaluated from the perspective of development banks. A significant advantage of the mixed proposal is that it would reduce the costs of finding new projects because actions would be reported to the aforementioned regional registries. However, for multilateral institutions that already have sufficient financial resources, the lost influence on recipient countries may possibly exceed the benefits of the reduced project identification costs. The banks' incentives should therefore be carefully taken into account.

## Conclusion

This briefing note has argued that mixed proposal anchored by a regional registry can help developed and developing countries break the current deadlock over the governance of the financial mechanism. Both developed and developing countries stances may, however, change over time. There may also emerge differing views between different sets of developed or developing countries. To make the governance of the new financial mechanism adaptable, there is a need for set of procedures for adjusting the governance of the financing mechanism to changing conditions. One way of doing this would involve a regularly scheduled evaluation of the financial mechanism using the four criteria outlined previously.

Indeed, developing countries under the post-2012 climate regime have a critical role in reducing GHGs. More attention to the financial mechanism as well as the governance system is required to promote and strengthen their roles. In conclusion, the establishment of an innovative financing method that provides for greater engagement, efficiency, effectiveness and expertise is much needed. This issue briefing has offered a vision of how such a mechanism might be structured. It has also outlined a set of principle-based criteria that would be used to evaluate proposals for governance for not just the financial mechanism but other important and contentious institutional structures in the future climate regime.

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