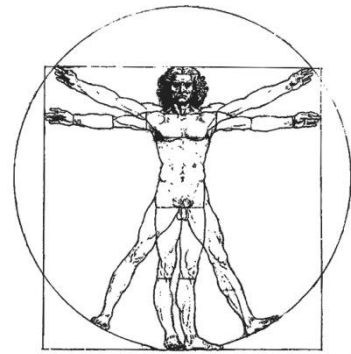


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policy brief

The Reformed Financial Mechanism of the UNFCCC

Post Copenhagen Architecture and Governance

April 2010

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The Analytic Framework

TWO KEY PURPOSES FOR AN INTERNATIONAL REGIME: DISTRIBUTIVE JUSTICE AND THEMATIC BALANCE

While there is general consensus that the existing institutional arrangements for financing climate change activities in developing countries are not fit for purpose, there is less agreement on what that ‘purpose’ is meant to be. According to the table compiled by the UNFCCC Secretariat at the end of the third 2009 Bonn session,¹ there is a common understanding that the financial system is to provide *financial resources to further enhance the full, effective and sustained implementation of the UNFCCC and fulfilment of the Bali action plan*, and that there is a *need to provide scaled-up, new, additional, predictable and sustainable financial resources, which would be derived from multiple sources*, in compliance with the *principle of equity and common but differentiated responsibilities*. ‘Equity’ appears in the Secretariat text only under *Principles to guide generation of resources*. Yet it stands to reason that distributive justice is an issue not only in the context of shouldering the burden of contributions, but also in sharing the revenue.

DISTRIBUTIVE JUSTICE: Official Development Assistance (ODA) traditionally neither involves obligations to pay, nor entitlements to receive. The issue of *distributive justice* – of contributing and/or receiving a ‘fair share’ – strictly speaking *does not apply*: if ‘donors’ think they pay over the odds, then they are free to pay less, and if ‘recipients’ feel hard done by, then that is not a matter of injustice but bad luck.

In contrast, payments for climate change activities – particularly in the case of adaptation and response to climate impacts – are a matter of *restitution*. Hence there are both obligations to pay and entitlements to receive, which implies that equity, in the sense of either *shouldering a fair share of the payment burden*, or *receiving a fair share of the revenue*, is an issue. The fact that the focus of the debate has so far almost exclusively been on the former (e.g. the Mexican and Swiss proposals) does not mean that the question of how to distribute climate finance equitably can be ignored. On the contrary, it has to be seen as one of the key challenges for any climate finance regime.

THEMATIC BALANCE: Climate finance involves a number of different themes (mitigation, adaptation, technology transfer, etc.), and the issue of ‘thematic balance’ relates to whether *each of these themes receives an appropriate share of the revenue*. Given the nature of climate finance, the decision on how achieve this balance must involve not only contributors but also recipients.

THREE DESCRIPTIVE DIMENSIONS

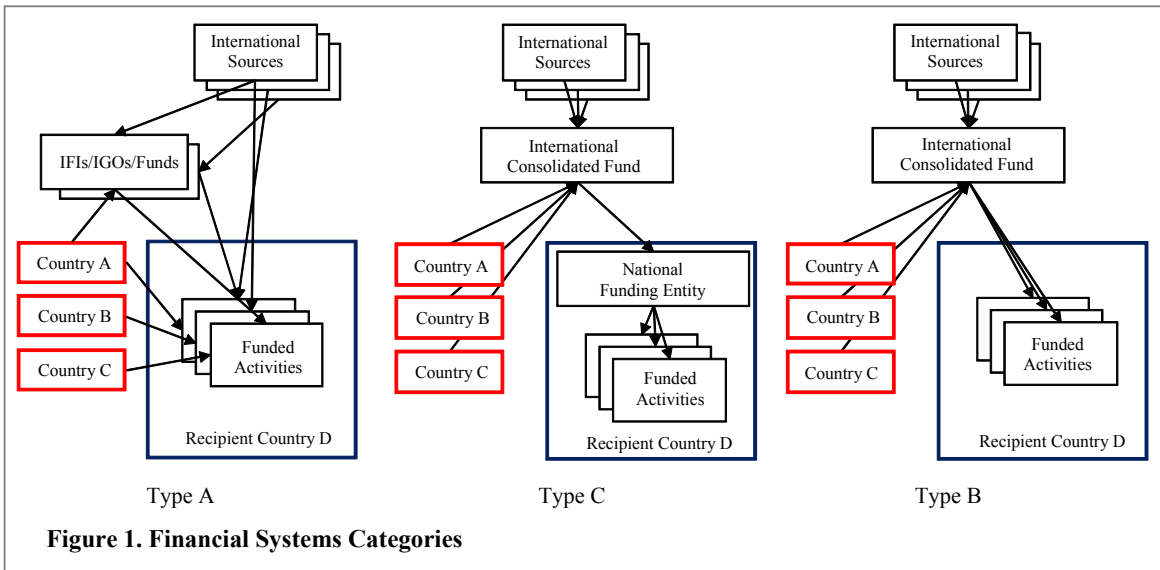
To discuss the different proposals in a coherent and comparable manner, it is useful to introduce three descriptive dimensions as categorizing tools, the distinctions between them being (i) *fragmented* or *consolidated*, (ii) *centralized* or *decentralized*, and (iii) *devolved* or *retained*.

The distinction between ‘fragmented’ and ‘consolidated’ refers to funding flows, and in particular, the degree to which funding sources are channelled into intermediate collective ‘pots’, to be disbursed as lump sums to recipients or directly used to fund their activities. The other two categorizations are about decision making, that is, whether or not funding decisions are taken by a central body, and whether they are devolved to the recipients or not.

All three of these dimensions are a matter of *degrees*, that is to say, financial systems can be more or less centralized/decentralized, etc. They are also *independent* in that they could occur in all combinations. Indeed, even though the concepts of ‘consolidation’ and ‘centralization’ are often used interchangeably, they are clearly distinct, in that one could have a completely fragmented system that is nonetheless completely centralized, say through a ‘coordinating’ body with powers to decide who has to pay whom.

Figure 1 contains graphical representations of three specific combinations which have actually been put forward. Type A represents the current *fragmented, decentralized and retained* system of climate change finance, meant to be enhanced through ‘high level coordination’ as put forward by the Climate

Registry proposal (described below). Type B corresponds to the *consolidated, centralized and retained* system put forward in the original G77+China submission,² while Type C represents the *consolidated, decentralized, and devolved* system of the Reformed Financial Mechanism (described below), the AWG-LCA language introduced by India, and the UK Compact model.



The Reformed Financial Mechanism – Mark I

At the heart of the original RFM proposal³ (RFM1) is the idea of *consolidation* at the international and national level and *decentralized* funding decisions *through devolution* to the recipient countries.

KEY INSTITUTIONAL FEATURES

Internationally, the institutional structure of RFM1 is constituted by an *Executive Board*, which together with a small number of *administrative units* (Thematic Assessment and Secretarial Units) provides the *operating entity* of the RFM1 (see Fig. 2). Other functions, such as internal and external audits and evaluations, as well as that of trustee for the consolidated RFM fund, are to be outsourced.

Nationally, funding is to be consolidated in *Designated Funding Entities* (DFEs), with transparent governance and representation from all key national and sub-national government agencies as well as civil society. There are already a number of such climate change national funds and mechanisms (e.g., in Bangladesh, Indonesia, Brazil/Amazon) which could serve as templates for the envisaged DFEs. Under the RFM, *funding decisions* – i.e., decisions on (country) *priorities*, and *approvals of projects and programmes* are taken in-country by the DFEs.

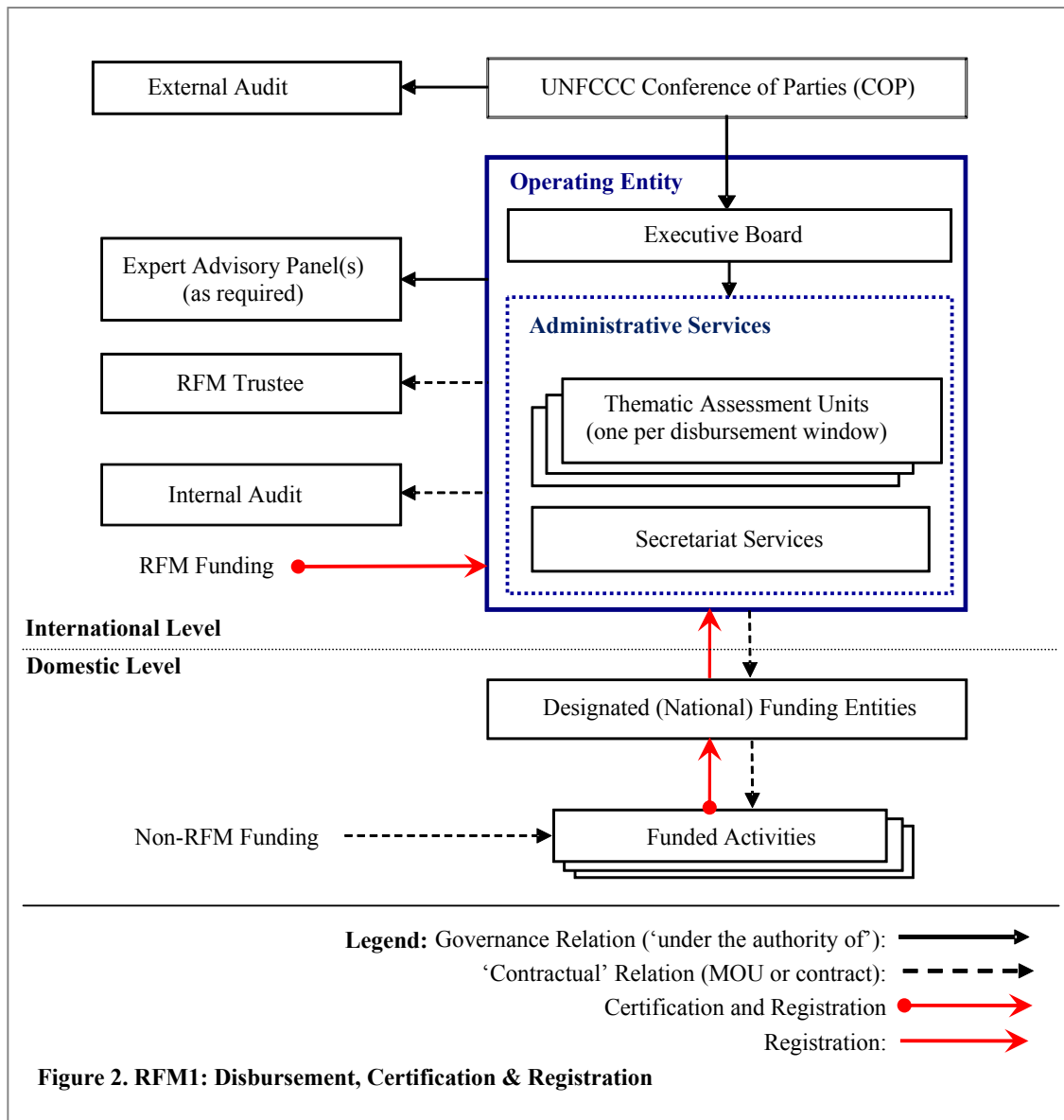
The RFM1 Operating Entity, in turn, does *not* fund in this sense, but *disburses* (‘channels’) revenue to the DFEs to enable their funding activities. The key point is that the RFM proposes a *genuine devolution of funding decisions*, and not just some half-way measure, as in the case of the NAPA process, where such entities were merely given the right to make plans, but not to decide what is to be funded.

In the Climate Registry model, *eligibility for funding* depends on *certification of national strategic plans* by the international thematic Boards. This is decidedly *not* the case for country disbursements under the RFM; not only because this would unnecessarily duplicate work already undertaken at the national level, but also because it is very unlikely that any country – developing or developed! – would actually agree to having nationally approved plans or strategies submitted to such a procedure. This would touch at the very core of national sovereignty.

GOVERNANCE: The RFM1 Executive Board is *accountable to* and *under the authority and guidance of the COP*. Being ‘under the authority’ in this context simply means that the *COP (s)elects the EB members* (i.e., has the authority to ‘hire and fire’).

Following standard domestic practice, there is to be a well defined *separation of powers* between the COP and the EB, in the sense that the COP delegates certain operational powers to the EB. Apart from the right to select the EB members, other powers retained by the COP are: (i) the power of setting *RFM revenue levels* (ii) approving *thematic disbursement criteria* (iii) approving *certification criteria* (see below) and (iii) approving overall *revenue allocation to themes*.

The tasks to be delegated to the EB are: (i) operational management of the disbursement entity, (ii) oversight over any other operating entity of the RFM, (iii) preparation of *proposals for thematic disbursement criteria*, and regular *thematic budgets*, both for approval by the COP



CERTIFICATION AND REGISTRATION: As mentioned above, the COP is to approve criteria on what payments *are to count against compliance* with financial commitments under the UNFCCC. These criteria will be operationalized in a system of certification and registration under the RFM. As

illustrated in Figure 2, contribution to the RFM consolidated fund will be certified and registered by the RFM secretariat. Other payments – if permitted by the certification criteria – will be *certified and registered in-country by the Designated Funding Entities*. The key here is that, in order to avoid double counting and pledge non-deliverance, payments are to be counted (certified and registered) *at the recipient end*.

BUDGETING AND DISBURSEMENT:⁴ ‘Disbursement,’ as used here, is not to be confused with ‘funding’. The latter, as emphasized above, refers to the traditional activities involved in the selection and approval of projects, programmes and other ‘on the ground’ activities. ‘Disbursement,’ by contrast, is taken to refer to the allocation of funds to the Designated Funding Entities by the RFM on the basis of theme-specific disbursement criteria, and the amount of revenue allocated for the relevant budget period to the respective themes. Disbursement criteria will vary from theme to theme. For example:

- *Mitigation disbursements* could be on made on a performance basis, with a flat up-front country component: x million + y million for the MRV reduction in the previous period.
- *Adaptation disbursements* should be carried out through a very simple disbursement formula, e.g., a flat country component + a component proportional to the number of poor inhabitants.

The Budgeting Process will involve the *preparation of an overall budget* – based on general needs assessments carried out by the different thematic assessment units – to be presented to COP. This information provides the COP with the means to decide on the overall revenue level, as well as the theme allocations. Once these decisions are taken, the EB takes over and carries out the disbursements as prescribed in the relevant criteria, within the constraints given by the COP budget decisions.

Calls for Coordination and the Climate Registry Proposal

As mentioned earlier, the current debate on climate change finance is characterized by a divide not only on ‘who is to pay how much’ and ‘who receives for what purpose’, but also on how these flows are to be managed, i.e., on the issue of *institutional arrangements*. There is a broad recognition that the current system is not fit to manage the required financial transfers, but opinion on how this is to be remedied roughly divides into two camps:⁵

The ‘Coordination Camp’: At one end of the spectrum, there are those (mostly from developed countries) who believe that what is needed is *enhanced coordination* through *existing institutions* (possibly reformed to become *fit for purpose*). This side rejects both the need for new institutions and for consolidating funding streams.

The ‘Consolidation Camp’: At the other end of the spectrum, there are those (mainly from developing countries) who believe that coordination through existing institutions will not remedy current shortcomings, and instead call for reform of the *consolidation of funding* under the UNFCCC financial mechanism, to be managed by a *new operating entity*.

In his recent Statement⁶ to the United Nations Summit on Climate Change, the Japanese Prime Minister Yukio Hatoyama called for establishing *an international system ... under the auspices of the UN climate change regime. This system should facilitate one-stop provision of information on and matching of available bilateral and multilateral financing, while securing transparency and effective utilization of assistance*.

Japan, in other words, is firmly in the ‘Coordination Camp’. Is there room for a mutually acceptable compromise between these two world views? Before we can address this question, it is important to clarify what types of institutional arrangements are associated with the two camps. Given that the original idea of a Reformed Financial Mechanism (RFM1) clearly falls in the consolidation camp, what is needed for the present purposes is a somewhat clearer idea of how a coordination approach is meant to work. Probably the best worked out proposal of how such a ‘one-stop information exchange and matchmaking’ system would operate is the *Climate Registry Model* proposed in Reed *et al.*, (2009).⁷

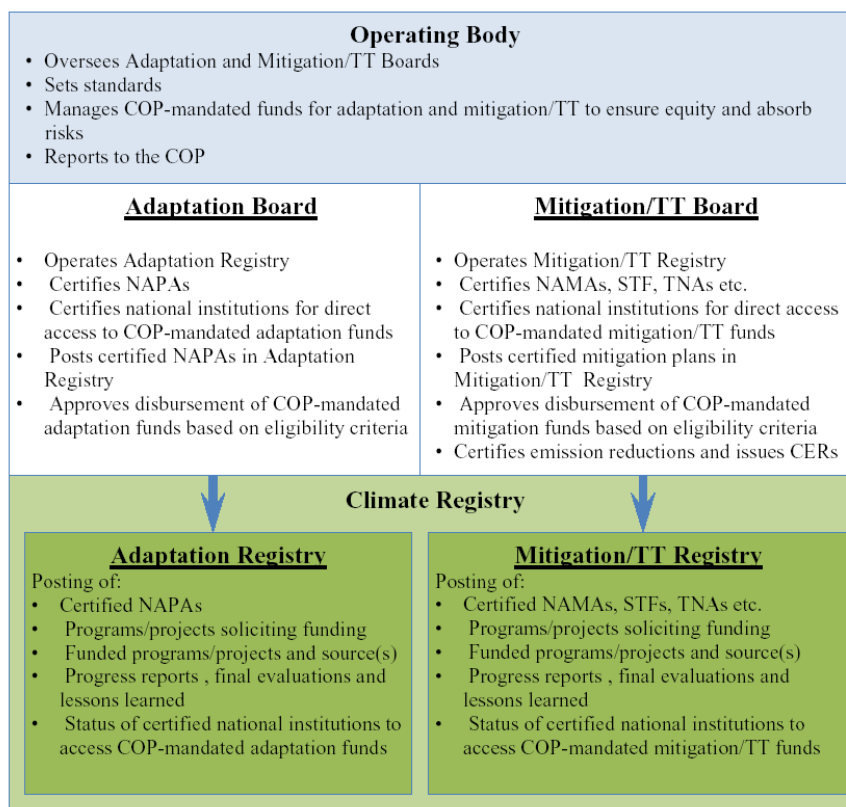


Table 1. The Climate Registry Model

Source: Reed *et al.*, 2009

In that model, an *Adaptation Board* and a *Mitigation/Technology Transfer (TT) Board* are to operate an *Adaptation Registry* and a *Mitigation/TT Registry*, respectively. An *Operating Body*, in turn, is meant (i) to oversee these two Boards, (ii) to set standards, (iii) to manage COP-mandated funds and (iv), to report to the COP (Table 1).

To avoid creation of new institutions, Parties could consider using the recently created Adaptation Fund Board to serve as the Adaptation Board. In equal measure, Parties could consider reforming the Clean Development Mechanism Executive Board or reforming the GEF to become the Mitigation/TT Board.

*The [overall] function of the Climate Registry is to expedite, through the public pooling and sharing of information, the **matching of needs** of country governments and the **availability** of financial resources and products offered by financing institutions. ...the Climate Registry serves as an international **bulletin board** that lists developing country programs and projects.*

Countries are meant to provide their national objectives, needs and financing requests, framed at national level and through national adaptation, mitigation and technology transfer plans such as NAMAs, NAPAs, Technology Needs Assessments (TNAs) and Low Carbon Action Plans (LCAP). In addition:

- The statements of national strategic plans to address climate change must be *certified* to be in compliance with standards set by the COP or its designated body *so that these plans become eligible for financing*. The intention behind this requirement is to provide *assurances to investors that MRV, fiduciary and transparency standards are embedded in investment packages*.
- The plans then enter into the public registry domain where all interested parties, public or private, can enter into discussion or negotiation with the hosting country regarding the terms of financing.

- Through this *pooling and posting of information process*, the Climate Registry serves as an *international bulletin board* that lists developing country programmes and projects as integral parts of national climate strategies.
- Once alignment between a developing country's needs and contributing country/private investor financial resources has been established, the Registry will also function as a monitoring tool which displays the progress of the implementation of the agreement between the country and a funding source.
- One of the key problems for this sort of information exchange and matchmaking regime is delivery on the above-mentioned *distributive justice* and *thematic balance* issues. Short of equipping the Operating Body with the power to order who has to pay for what, it is unlikely that this sort of system can deliver on these key requirements. Indeed, the Climate Registry model itself acknowledges as much by giving the Operating Body the function to manage *the COP-mandated funds ... to ensure equity in the access of all developing countries to financial resources to support adaptation and mitigation programs. This is a critical function because, without an equalizing distributional mechanism, past experience has demonstrated that financial resources will flow to the largest, most sophisticated developing countries.*

The Reformed Financial Mechanism – Mark II

In the run-up to (and since) Copenhagen, the Reformed Financial Mechanism proposal has been adapted not only to take into account what happened in the finance negotiations under the AWG-LCA, but also to accommodate certain specialist needs that were not sufficiently reflected in the original proposal – such as the need for continued international funding with consolidated funds in addition to the core disbursement function. This has led to the following second generation (Mark II) proposal for a Reformed Financial Mechanism ('RFM2')

THE COPENHAGEN DRAFT LCA DECISION ON FINANCEⁱ

The *Copenhagen Accord* – henceforth, 'the Accord' – was drafted by a group of *Friends of the Chair* consisting of around two dozen heads of state and government and other heads of delegations convened by the Prime Minister of the host country during the high-level segment concluding the Copenhagen conference. The Accord was tabled for adoption by the COP in the early hours of the last day. Ultimately, the COP did not adopt the Accord but merely noted its existence.

The Accord consists of 12 paragraphs concerning mitigation, finance, technology transfer and adaptation, with a clear focus on mitigation and finance. The issue of finance is treated in a number of places in the Accord. The key language, however, is to be found in three consecutive paragraphs, creating a *Copenhagen Green Climate Fund*, a *High-level Panel* on potential sources of revenue, and '*collective*' commitments to provide fast-start funding of (on average) \$10 billion annually for 2010-12, and a 2020 target of \$100 billion annually.

The lack of any concrete proposals on levels of finance has been a major impediment in the recent climate change negotiations, in this case under the AWG-LCA. Regardless of whether the figures are deemed adequate, the fact that they have now been tabled should help to unblock the negotiations, provided that they are followed up with an acceptable concrete scheme of how these funds are to be raised.

This could be facilitated by the envisaged High-level Panel, but unfortunately it could equally be

ⁱ For more on the Copenhagen Accord, and on its role in the future negotiations, see Benito Müller, *Copenhagen 2009: Failure or final wake-up call for our leaders?* Oxford Institute for Energy Studies, February 2010.

undermined by it, if the procedural lessons from Copenhagen are not learned. There is, however, a grave danger that the Panel could be (mis-) used as an alternative negotiating forum, undermining the AWG-LCA finance negotiations instead of providing useful input for them.

Another potential problem with the finance text of the Accord is the fact that, according to the US delegation,ⁱ the **Copenhagen Green Climate Fund** (CGCF) was *inspired by ideas that had been put forward this year by Mexico*. It is well known that the key element of the Mexican proposal for a Green Fund is a very controversial burden-sharing scheme involving contributions from all Parties (except LDCs).

The proposal of a CGCF raises further important questions. Is it meant to manage the fast-start money? Given the experience of the time it has taken to set up the World Bank Clean Investment Funds (CIFs) and the Kyoto Protocol Adaptation Fund, this would be very curious indeed. If, however, it is intended to manage the mentioned *significant portion* of the medium term funding,⁸ the question that arises is: how does it relate to the **Climate Fund/Facility** that is to be established according to the draft AWG-LCA finance decision?⁹

THE CONTINUED NEED FOR INTERNATIONAL FUNDING

As originally conceived, the RFM was purely a disbursement mechanism. While the bulk of the RFM2 transactions is (ultimately) still meant to be carried out through ‘money-in-money-out’ disbursements to Designated Funding Units, it has to be acknowledged that there will still be a need for international funding in the more traditional sense, such as currently developed under the Adaptation Fund.

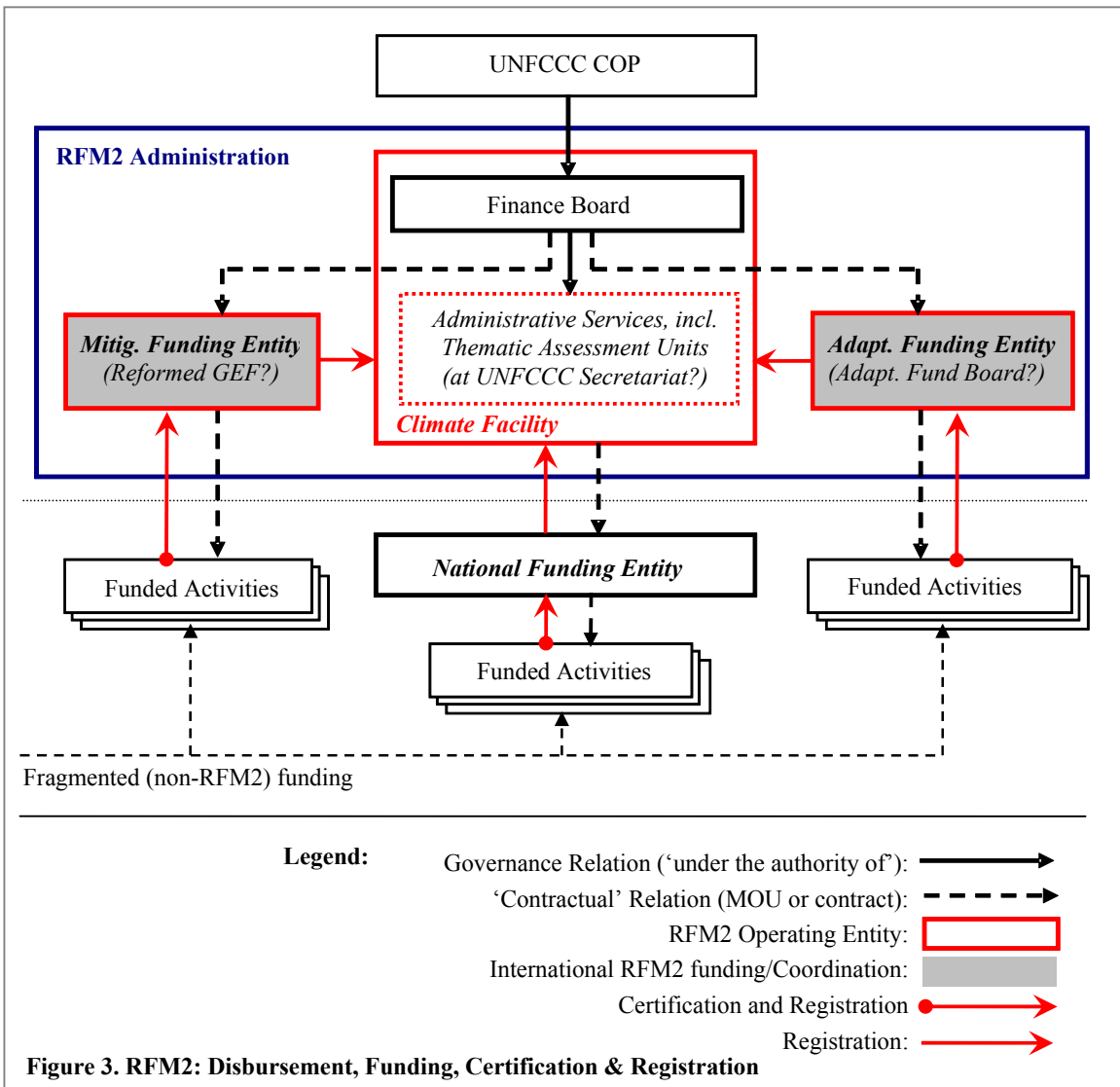
- For one, ***not all funding purposes lend themselves naturally to be devolved*** to the country level. While mitigation and adaptation *per se* would seem to be prime candidates for such devolutions, funding decisions for certain types of capacity building and technology transfer activities may be better kept at the international level.
- Even with respect to the prime candidates, it will be necessary to retain a more traditional international funding capacity for quite some time: it will take time before all countries will be able to participate in the devolved disbursement regime.

WHAT’S NEW UNDER MARK II?

In a first instance, the institutional arrangements under the RFM2 proposal have been assimilated to the arrangements put forward under the LCA Draft Decision (see Figure 3). Thus, the original Executive Board has been renamed the **Finance Board**, while the disbursement operating entity has become the **Climate Facility**. However, there remains an important difference with the ideas in the LCA Draft Decision. In the RFM2 model, there is no additional Board for the Climate Facility. Because of the limited function of that Facility – principally the disbursement of funds to designated national funding entities – there is simply no need for such an additional layer of bureaucracy. The Finance Board should be perfectly capable of supervising the operations involved in these disbursements. Note, incidentally, that it is precisely because of this special nature that the disbursement entity is called ‘Climate Facility’, as opposed to the alternative ‘Climate Fund’ (as is also envisaged in the LCA Draft).

ⁱ 19 December 2009, COP resumed 9th Meeting, 06:25.

Furthermore, in light of the continued need for international funding (as opposed to disbursement), The RFM2 also envisages *further operating entities* which, in contrast to the Climate Facility, are to be involved in the international funding of activities. The exact number of these additional operating entities will depend on a number of factors. From a purely organizational perspective, it would probably be best to use just one such funding entity. However, as there are two ‘existing entities’ that currently have the status of being *an operating entity* under the current international climate change regime – the *Adaptation Fund Board* (AFB) under the authority of the COP/MOP, and the *Global Environment Facility* (GEF) under the guidance of the COP – it might therefore make political sense to retain them under an Extended Reformed Financial Mechanism (RFM2) as *Adaptation Funding Entity* and *Mitigation Funding Entity*, respectively.¹⁰



CONSOLIDATION AND COORDINATION: THE GRAND RFM2 COMPROMISE?

Guidance, Authority and Oversight: In the case of the AFB this may not be too controversial, but a great deal of resistance to having the GEF involved in any capacity (even when ‘reformed’) is likely to come from developing countries, which – as the Adaptation Fund negotiations have clearly shown – have been less than happy about the manner in which the GEF has operated, particularly in its implementation of COP guidance. However, part of the problem with the GEF and COP guidance seems to be systemic in that the COP itself is not the sort of institution well suited to carry out any

oversight, and guidance without proper oversight tends to be ignored. It is for this reason that in the RFM2 model, the COP is meant to delegate oversight and guidance of operating entities to the Finance Board, which will meet more than just once a year, and hence be in a better position to follow up on its guidance on a regular basis.

Coordination under the RFM2: In the light of the institutional suggestions put forward for the Climate Registry ‘enhanced coordination’ model (see above), the proposed institutional architecture of the RFM2 model will fit perfectly with the Climate Registry ideas, with the Finance Board performing the role of the ‘Operating Body’, and the two other operating entities taking on the role of the two Boards, operating the two thematic registries.

The Role of other Existing Institutions: The RFM2 proposal may take care of two of the ‘existing entities’ – the Adaptation Fund Board and the (suitably reformed) GEF – as additional **operating entities**. This still leaves out other multilateral institutions that the Coordination Camp would like to involve, such as UNEP, UNDP, and the Multilateral Development Banks. These institutions can take on the role of **implementing entities** – although with direct access, this will no longer be the exclusive route to access funding. Moreover, there will be a need for **trustees**, and it stands to reason that most of these other existing entities, when fit for purpose, should not have to worry about participating in competitive tenders for performing these functions. Having said that, the question of ‘existing versus new institutions’ is sufficiently important to warrant a closer look.

Existing Institutions

In the debate on institutional arrangements for international climate finance, a powerful, mostly Northern school of thought contends that one should not create new institutions but only make use of existing ones. What is the basis of this contention?

‘EXISTING INSTITUTIONS’

The term ‘existing institutions’ has become an euphemism for the World Bank’s Climate Investment Funds (CIFs), the Global Environment Facility (GEF), and the regional Multilateral Development Banks (MDBs) in the current debate on institutions for climate change finance in the post-2012 period. Curiously, the Kyoto Protocol Adaptation Fund (AF) is usually not included even though it has as much legitimacy to carry this epithet as, say, the CIFs. Indeed, it is widely held among the advocates of the ‘No-New-Institutions’ school that all UN/UNFCCC institutions are inefficient and opaque, in contrast to other existing multilateral (i.e. Bretton Woods) institutions. Does this view hold up to closer scrutiny?

Take the oft-cited fact that the AF still has not actually funded any activities to date. Is this really a sign of UN inefficiency? Given that the counterpart of the AF at the World Bank, the Pilot Programme for Climate Resilience (PPCR), is not envisaged to disburse any funding before the end of 2010, two and a half years after its creation (July 2008), the AF – which will issue a first call for projects at COP15, exactly two years after its formal creation at COP13 in Bali – does seem to compare quite favourably.

As to the question of transparency and good governance in general, it turns out that some of the traditional ‘existing institutions’ are not necessarily the shining examples they are often portrayed to be by the No-New-Institutions school. Take the case of the World Bank Group. A recent high-level report on the modernization of the Group’s governance,¹¹ commissioned by World Bank President Robert Zoellick and chaired by former Mexican President Ernesto Zedillo, has revealed some *important shortcomings in three areas of the Group’s governance: strategy formulation, voice and participation, and accountability*. The report contends that *[c]urrent mechanisms for strategy formulation [of the World Bank] are not adequate for setting priorities and guiding operations. Mission creep is endemic, weakening accountability for results and increasing the risk that resources will be misallocated or spread too thin, undermining the institution’s effectiveness. The Group’s decision-making process is widely seen as too exclusive, offering many member countries too little voice and too few opportunities for participation. Insufficient institutional accountability for results*

*weakens the World Bank's effectiveness and legitimacy. And certain conventions and practices have contributed to the perception that the institution is accountable and responsive only to a handful of shareholders at best. These weaknesses spring in large measure from the fact that the World Bank's governance—forged in the 1940s—has not kept up with historical change and today is not adequate to deal with global problems that require forward-looking, flexible, inclusive, and legitimate multilateral institutions.*¹²

In the present context, it has to be pointed out that there are aspects of the CIF governance – such as the North-South balance on the governing bodies – that, for the Bank, are a step forward and in the direction of the Zedillo Report recommendations, even though they were only brought about by considerable outside pressure.¹³ Other recommendations, such as the need for a more equal voting system, do not fare so well: in creating the CIFs, it was decided to simply abolish voting altogether.

As to transparency, the CIFs do have a policy of publishing documents on the website, although the speed of publication is not always as one might wish. Six months after being presented to the PPCR Sub-Committee, the report by the PPCR Expert Group on the criteria for pilot country selection is still not published.

There is no doubt that the AF could, and should, learn certain governance lessons from the CIF experiment, not least as regards civil society participation. By and large, however, the AF need not fear a comparison with respect to the Zedillo Report recommendations.

To sum up, the argument here is *not* that institutions under the UNFCCC – such as the Kyoto Protocol Adaptation Fund – are perfect or better than other ‘existing institutions,’ but merely that some prevalent stereotypes to the contrary are misguided and based on prejudice, not fact.

METHODOLOGICAL APPROACHES

The question of how to construct an institutional architecture for international climate finance has been approached from a number of methodological vantage points, even within the No-New-Institutions school of thought.

Some seem to take as starting point a *set of existing institutions* which they think should be given a role, more often than not because they stand a better chance of controlling them.¹⁴ They then proceed to stretch the functions and governance of the climate finance regime across the *Procrustes' bed*¹⁵ of these existing institutions. The result – as in the legend – is unlikely to be viable.

A more promising route has been to start with an *analysis of the functions and purposes* of the envisaged regime and then see whether there are existing institutions that can perform those functions. In so doing, one should indeed apply a methodological principle known as *Ockham's razor*¹⁶ which can be used in favour of existing institutions by rejecting the introduction of unnecessary new entities. If an existing entity is fit for purpose, then a new one is not needed. But this does not mean that one can dispense with the creation of new institutions altogether (nor incidentally, that all existing ones should have a role!). Existing institutions should not be given precedence simply because they exist, but only if *they are genuinely fit for purpose*.

WHAT PURPOSE?

Many in the No-New-Institutions school believe that previous experience in climate finance makes existing institutions automatically more ‘fit for purpose’ than new ones. However, this depends on the purpose. For instance, the Reformed Financial Mechanism (RFM) proposal¹⁷ (Figure 3), envisages two distinct types of financial transactions. There would be the traditional international funding activities as undertaken by existing institutions (evaluation and approval of projects and programmes). But there would also be a *disbursement of funds* to in-country *designated funding entities* according to some (performance or formula-based) macro-criteria. While it may be useful to have some technical experience in delivering the international funding, the key to the success of such disbursements lies in political buy-in, not technical or procedural expertise.

The question therefore is: can existing institutions be made fit for these purposes, or would they be

able and willing to undergo such a reform? As I have argued elsewhere, such a reform might be possible for the purpose of international funding (despite the less than encouraging track record), but not for operating the disbursement function, which I believe requires the operating entity to be ‘under the authority of the COP’. Given that it will be impossible to adequately scale-up the financial flows to developing countries effectively without a significant devolution of funding decisions to them, it is clear that it will be equally impossible to have a international financial regime fit for purpose without the introduction of a new entity to oversee international funding and operate the required in-country disbursements.

CONCLUSIONS AND THE WAY FORWARD

Existing institutions have no automatic right to be involved simply because they exist. It is important to be clear about what purpose the institutions will be required to serve, before deciding whether the existing ones are fit for purpose. The mere prospect of reform is not sufficient to justify their involvement.

Experience has shown that *clarity on functional and governance arrangements* is the key to any fruitful discussion on institutional issues. In June 2006 – after six months of acrimonious exchanges about the desirability of the GEF as operating entity for the Adaptation Fund (AF) – the negotiations on operationalizing the AF were close to a break down, and expectations for a decision in Nairobi in December (CMP.2) were extremely low. The process was only salvaged at Nairobi because an implicit understanding had been reached between the G77+China and the EU *not to mention any existing institutions*, but to focus on the substance of the institutional architecture and governance. Without this, there would not have been a Nairobi decision on the AF (CMP.2/1) and the debate on whether the GEF should be the operational entity or not would probably still be raging.¹⁸

Given the limited negotiation time, the only successful way forward is to focus once more on the functional and governance structure of international climate finance in general; the UNFCCC financial mechanism in particular; and to postpone any discussion referring to existing institutions to post-Copenhagen. The aim of Copenhagen must be to design a functional and governance architecture that is sufficiently specific to allow existing institutions to reform themselves and to *present themselves as fit for purpose* when the time comes to make the relevant institutional arrangements. Given the experience with institutional reforms in and outside the ‘existing institutions’, the watchword has to be ‘prudence’; and it is clearly more prudent to assign functions on the basis of proven reforms rather than on promises to reform.

The Role of National Funds and Institutionsⁱ

There is consensus that present financial arrangements are not suitable for the task even under present conditions of a relatively small amount of funding available for developing country actions on climate change. With the envisaged increase in resources, the new regime would need to carefully explore the options for funding and disbursement (allocation). While it is clear that decisions on disbursement need to be taken centrally under the authority of the COP, the management of funds and the decisions on funding should be made close to the place where the decision on what to fund and how to manage the actions being funded are taken.

Shifting the management of funds and the responsibility of funding to the national level would have several advantages. In addition to the important enhancing aspects of ownership and a more conducive environment for alignment to national priorities, other advantages are equally important, such as the possibility for enhancing synergies among sectors and between mitigation, adaptation and

ⁱ This section has been contributed by Luis Gomez-Echeverri

REDD (Reduced Emissions from Deforestation and Degradation).

Shifting the responsibility of management of funding to the national level brings other challenges that need to be addressed. There is general agreement about the weak institutional capacities of many developing countries. Climate change programmes, whether in the areas of mitigation, adaptation or REDD are complex and require skills that are scarce in most developing countries. These skills are needed urgently. The assignment of greater responsibilities coupled with intensive capacity development programmes to address these weaknesses would reap attractive co-benefits of having developing countries more fully engaged, managing their own funds and programmes, and building their capacities in the process.

There are a few national institutions already in place from which other countries can build on the lessons learned and their best practices. Some common principles are emerging as minimum requirements for these institutions to be credible. In addition to being able to carry out the complex and specific functions on climate change, they need to be equitable, efficient and effective. Their governance must have credibility with and be accountable to the general public and for this reason, it needs to be fair, transparent, and fully open to oversight and scrutiny.

Following is an illustrative (not comprehensive) list of types of functions that local institutions would need to perform, coordinate or ensure that they take place as part of their responsibilities in managing funds and disbursements of climate change funds at the national level:¹

- **Alignment with national policies:** In addition to the fiduciary responsibilities and performance assessment, the national institutions would also be responsible for coordinating the task of aligning policies and programme priorities for mitigation, adaptation and REDD in the country with actions to be funded on the ground.
- **Financial support:** Helping to mobilize resources, leveraging investments and preparing up-to-date information to keep financiers and stakeholders informed at all times.
- **Standards Setting:** In addition to the standards needed for exercising their fiduciary responsibilities, national institutions would also be responsible for helping to fine tune the eligibility criteria of the Financial Mechanism to the national conditions, and to set sustainable development standards.
- **Certification of Results:** Based on their expert assessment, this function includes ensuring the quality of the implementing actors involved and of the results of the actions performed. The MRV function would be included here. The institutions would need to verify that the funded programmes deliver adequate emissions reduction, adaptation needs, and REDD reference levels.
- **Accountability:** In addition to being accountable for its own actions and responsibilities, national institutions would also be responsible for ensuring that the various implementing partners are also accountable and can be held responsible for their actions under their funded programmes and projects.

The National Funding Entities of the proposed Reformed Financial Mechanism will have to address the issue of how best to perform these different functions.

Raising the Necessary Revenue

The proposed compromise, however, will fail if the consolidated disbursement arm is treated as just another placebo fund to buy in developing countries during a crucial phase of the negotiations, but subsequently to be essentially left empty. Establishing the institutional infrastructure will not be

¹ Adapted from Meridian Institute Report: REDD+ Institutional Options Report: Developing an efficient, effective, and equitable Institutional Framework for REDD+ under the UNFCCC, September 2009.

sufficient. There will have to be agreement that a significant share of (national/international) public sector finance will be channelled through the RFM, so that the mechanism stands a fair chance of proving itself.

The problem is that to prove itself in ensuring the fairness and thematic balance of the overall financial regime, and to show that it is more efficient than the traditional fragmented funding model, the proposed extended RFM will require a significant amount of (consolidated) revenue. Developed country treasuries are unlikely to provide if they lack faith in the mechanism. This potential Catch 22 can be overcome by following the example of the Adaptation Fund: by using innovative financial instruments to raise sufficient funds. There are a number of proposals for such instruments on the table (in the AWG-LCA negotiations text):

- the LDC Group proposal of an *International Air Passenger Adaptation Levy* (IAPAL);
- the Norwegian proposal of a *set aside reserve of emission allowances* to be auctioned internationally (akin to the monetization of the share of CERs set aside for the Adaptation Fund);
- the Indian proposal of a *levy on international financial market transactions*.

The advantage of these instruments is that they do not involve transfers of funds from the domestic consolidated funds (budgets). There are also ways in which direct competition with budget items can be avoided even for revenue collected domestically: for instance, by declaring certain (new) revenue sources, such as carbon permit auctioning, 'off-budget' so they can be earmarked without infringement of general budgeting principles.¹⁹

The envisaged RFM compromise will not only have to contain an agreement on the relevant institutional arrangements, but also on a significant level of revenue for the (consolidated arm of the) RFM to be (i) supplied by innovative international finance instruments and assessed contributions, and (ii) reviewed together with the overall financial commitments of developed countries.

Once the mechanism has a chance to show it can work, it is likely to become the vehicle of choice, like the Montreal Protocol Multilateral Fund, where most Parties choose to channel their full commitment through the fund, even though they are entitled to spend up to 20 percent of their commitments bilaterally.

Endnotes

- ¹ http://unfccc.int/files/meetings/ad_hoc_working_groups/lca/application/pdf/finance140809.pdf
- ² Philippines on Behalf of the Group of 77 and China, *Financial mechanism for meeting financial commitments under the Convention*, 25 August 2008, FCCC/AWGLCA/2008/MISC.2/Add.1, pp. 35-8.
- ³ More detailed descriptions of the RFM proposal are available at:
<http://www.oxfordclimatepolicy.org/publications/mueller.html>
- ⁴ This section is based on preliminary findings of the Climate Strategies project on *Oversight in the Reformed Financial Mechanism*.
- ⁵ This polarized characterization is not exhaustive: there are a number of intermediate positions that can and have been put forward.
- ⁶ New York, 22 September 2009, http://www.mofa.go.jp/u_news/2/20090923_003732.html
- ⁷ David Reed, Andrea Kutter, Athena Ballesteros, Edward Fendley, Maria del Socorro Flores Liera, Jochen Harnisch, Saleemul Huq, and Hans Olav Ibrekk, *The Institutional Architecture for Financing a Global Climate Deal: An Options Paper*, June 2009 (available at www.usclimatenetwork.org/resource-database).
- ⁸ *A significant portion of such funding should flow through the Copenhagen Green Climate Fund.* [Accord: §8]
- ⁸ *We decide that the Copenhagen Green Climate Fund shall be established as an operating entity of the financial mechanism of the Convention.* [Accord: §10]
- ⁹ FCCC/AWGLCA/2009/L.7/Add.2/Rev.1
- ¹⁰ This comes out of the idea that they would also cover funding for technology transfer and capacity building in their themes.
- ¹¹ <http://siteresources.worldbank.org/NEWS/Resources/WBGovernanceCOMMISSIONREPORT.pdf>
- ¹² Ernesto Zedillo et al., *Repowering the World Bank for the 21st Century: Report of the High Level Commission on Modernization of World Bank Group Governance*, October 2009: p.x.
- ¹³ See, for example, Benito Müller and Harald Winkler, *One Step Forward, Two Steps Back? The Governance of the World Bank Climate Investment Funds*. Oxford Energy and Environment Comment, February 2008
- ¹⁴ Indeed, the difference in control seems to be the main reason why the Adaptation Fund is generally not included in the list of 'existing institutions'
- ¹⁵ Procrustes, in Greek mythology, had an iron bed on which he compelled his victims to lie. If a victim was shorter than the bed, he stretched him by racking the body to fit. If he was longer, he cut off his legs to make the body fit the bed's length. In either case, the victim died. (See 'Procrustes', in *Encyclopædia Britannica*, (2009).
- ¹⁶ The philosophical principle referred to by the nineteenth Century Scottish philosopher Sir William Hamilton as 'Ockham's razor' (also known as *principle of economy/parsimony*) is attributed to the 14th-century English logician William of Ockham. It is sometimes expressed as *pluralitas non est ponenda sine necessitate*; (plurality should not be posited without necessity), or *entia non sunt multiplicanda praeter necessitatem* (entities should not be multiplied unnecessarily). See, for example, Claude Panaccio, 'William of Ockham'; or Edward Craig, 'Pluralism', both in E. Craig (Ed.), (1998) *Routledge Encyclopaedia of Philosophy*. London: Routledge; or 'Ockham's razor' in *Encyclopædia Britannica*, (2009).
- ¹⁷ For more on the RFM proposal, see <http://www.oxfordclimatepolicy.org/publications/mueller.html>
- ¹⁸ For more on this, see, for example, 'Message from the ecbi Director' in *ecbi Annual Report 2007/08*: pp.3-4. Available at www.eurocapacity.org. Benito Müller, *Nairobi 2006 - Trust and the Future of Adaptation Funding*, Oxford Institute for Energy Studies EV38, January 2007; *Climate of Distrust: The 2006 Bonn Climate Change Adaptation Fund Negotiations*, Oxford Energy and Environment Comment, June 2006, both available at <http://www.oxfordclimatepolicy.org/publications/mueller.html>.
- ¹⁹ For more on this, see Benito Müller, *To Earmark or Not to Earmark? A far-reaching debate on the use of auction revenue from (EU) Emissions Trading*, Oxford: Oxford Institute for Energy Studies, EV 43, November 2008.