T20 Policy Brief

Task Force 5
Purpose & Performance: Reassessing the Global Financial Order

RETHINKING DEVELOPMENT FINANCE IN RESPONSE TO 21ST-CENTURY CHALLENGES: ISLAMIC CLIMATE FINANCE AND POST-CONFLICT RECOVERY

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Abstract

Traditional development financing is proving insufficient to address overlapping global challenges, such as climate change and fragile contexts. This brief explores new thinking in development finance through two examples. The first is Islamic climate finance, which constitutes less than 2 percent of global Islamic finance. The brief identifies policy priorities and proposes dedicated Islamic climate-finance windows (e.g., in the Green Climate Fund) to support enhanced climate action. The second explores development finance in fragile post-conflict contexts where traditional mechanisms have difficulty operating. This brief highlights the importance of establishing a strong initial foothold within a country through joint platforms led by functional local partners and organisations or donor countries that understand the local context. Both examples underscore latent sources of development finance within existing global structures that can be deployed and redirected. The G20 policy support could promote innovation and galvanise these underutilised development finance resources.

The Challenge

1

Global challenges are becoming increasingly complex and interconnected, from the escalating impact of climate change, to the swelling numbers of refugees, to rising food insecurity. Traditional development financing mechanisms are proving insufficient to address these challenges. Therefore, there is a need to introduce new financing models and prepare existing models to unlock resources and tackle underlying causes. New collaborations must be developed with non-traditional partners, such as the private sector, to ensure that funds flow to where they are needed most.

This policy brief explores new thinking in development finance through two examples—Islamic financing for climate action and development assistance in post-conflict and fragile contexts. The brief argues that it is possible to mobilise new development finance quickly in order to address these interconnected global challenges. However, donor countries, including the G20 countries, must explore new approaches that build upon existing global structures in new and innovative ways.

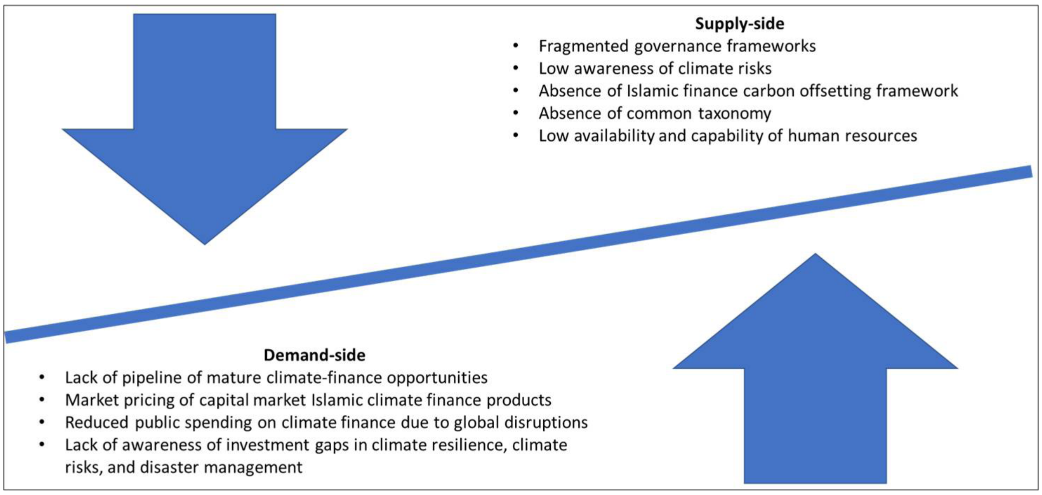
Enhancing Islamic finance for climate action

The international community is falling short of the Paris Agreement goals, with the 1.5°C global warming target likely to be exceeded within the next two decades. Urgent system-wide transformation, including an overhaul of the global financial system, is therefore required to avoid a global climate disaster.[1]

Despite annual climate finance almost doubling from 2011 to 2020, finance flows need to increase at least seven-fold (to US$4.3 trillion) by 2030 in order to avoid the worst impacts of climate change.[2] Climate finance from public and private sectors as well as from conventional and innovative sources needs to be mobilised.

One modality that has the potential to support the global climate agenda is Islamic finance. Islamic finance emerged in the 1970s and refers to the provision of financial services in accordance with Islamic jurisprudence (Shari'ah). Today, it is an almost US$3 trillion industry[3] that is present in over 80 countries.[4] With its asset-backing and risk-sharing, Islamic finance can diversify the funding and risk exposures of conventional investors and contribute to the stabilisation of the global financial system against factors such as over-leverage and short-termism. Islamic finance principles support the protection of the environment, fair distribution of wealth, avoidance of harm, and equal opportunities for all,[5] which are well aligned with the Paris Agreement, the Sustainable Development Goals (SDGs), and the 2015 Islamic Declaration on Global Climate Change.[6] However, demand- and supply-side barriers (Figure 1) have limited Islamic climate finance to less than 2 percent of the broader Islamic finance services industry.[7] Therefore, Islamic climate finance has significant potential to support enhanced global climate action.

Figure 1: Barriers to Enhanced Islamic Climate Finance



Source: Adapted from ADB and IsDB (2022)[8]

This brief draws upon the findings of a joint Asian Development Bank and Islamic Development Bank 2022 study[9] to unlock Islamic climate finance around four areas of policy support:

- **Greening Islamic capital markets**: Readily scalable Islamic climate finance instruments include international and domestic green/ sustainability *sukuk* issuances, green infrastructure funds, and sustainable finance instruments.

Recent multibillion-dollar issuances of environmental-, social-, and governance-themed funds and green international and domestic sukuk are often heavily oversubscribed, indicating strong market demand. By tapping into global ESG investment sentiment, Islamic finance may access a large, diversified, and expanding investor base, estimated to be 30 times larger than its traditional investor base. For example, a 2022 green sukuk domestic issuance in Indonesia drew investors from North America, Europe, the Middle East, and Asia (domestic and regional). The sector diversification of Islamic green investment (beyond a current predominance in renewable energy) and standards development may help replicate the recent global green (conventional) bond market trajectory, which grew from US$5 billion to more than US$270 billion within a decade.

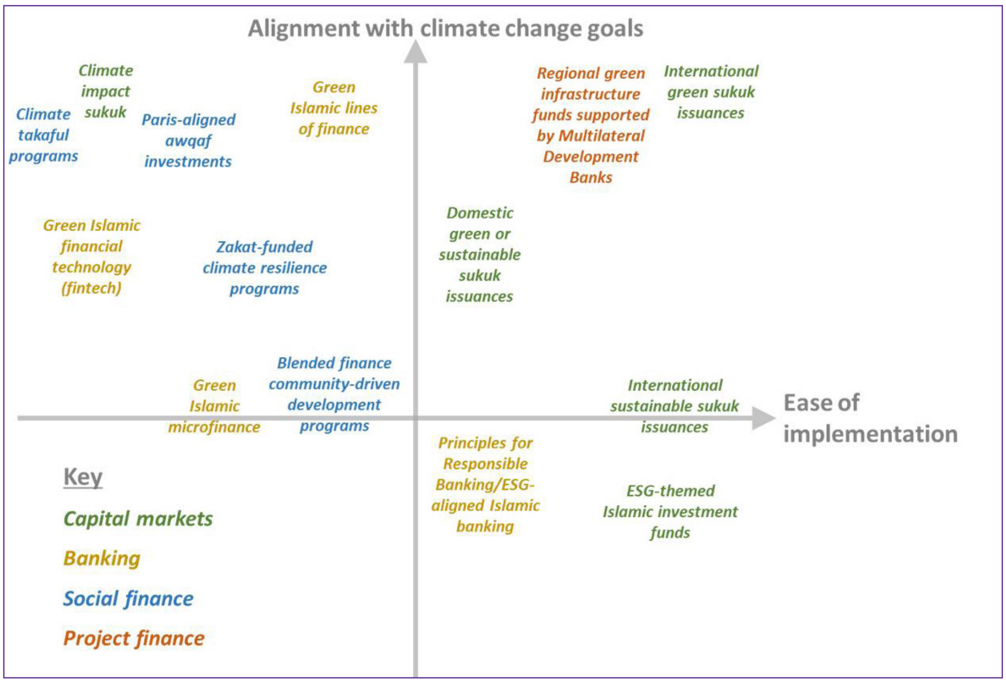
- **Greening Islamic social finance**: Social considerations, such as the rights of future generations and intergenerational solidarity, are the central tenets of Islamic finance. Islamic social finance instruments include redistributive compulsory alms-giving (*zakat*), voluntary donations (*sadaqah*), endowments (*awqaf*), and cooperative insurance systems (*takaful*), all of which support vulnerable populations and can be adapted to help tackle the impacts of climate disasters and improve resilience to future shocks. The recent mobilisation of Islamic social finance in response to the COVID-19 pandemic demonstrated its safety-net potential, with transferable lessons for managing climate shocks. Furthermore, vast social finance volumes remain untapped; zakat alone could mobilise up to US$1 trillion annually to support the SDG agenda, including SDG 13 on climate action.[10]

- **Mobilising Islamic project finance for green infrastructure**: Given its asset-backing and real economy focus, Islamic finance is aligned with the G20 quality infrastructure principles[11] and support for Paris Agreement aligned infrastructure investments. Specific Islamic financing modalities relevant to loans in green infrastructure, such as *istisna* or *ijara* financing, offer long-term financing structures and fixed returns, which may appeal to institutional and public investors.

- **Developing green and climate banking services for the unbanked to support financial inclusion**: Where access to banking services is low[12] and demand for Shari'ah-compliant consumer banking is high, there is an opportunity to leapfrog green banking principles into financial inclusion efforts and realise multiple co-benefits. For example, the greening of Islamic microfinance could build upon already high female representation and service to rural clients—i.e., demographics that may experience greater exposure to climate shocks. Islamic financial technology (fintech) may play an increasing role in deploying green Islamic microfinance and other green Islamic banking services to support financial inclusion and resilience building.

Figure 2 outlines growth opportunities for the Islamic climate finance market in the categories outlined above.

Figure 2: Islamic Climate Finance Market Growth Opportunities (Based on Alignment with Climate Goals and Ease of Implementation



Note: *Opportunities presented in the upper-right segment represent the most aligned and readily actionable.*

Source: Adapted from ADB and IsDB (2022)

By building upon the existing principles, structures, and networks of the broader Islamic finance industry, Islamic climate finance holds significant latent potential as an efficient and effective way to address the global climate finance shortfall. Macro-level policy support from the G20 could help activate this currently underutilised financial resource.

Rethinking development financing in fragile post-conflict environments

The past decade has witnessed a proliferation in global conflicts. As a result, the number of people displaced by conflict has more than doubled, from 42 million in 2012 to 89 million in 2021.[14] The Russia-Ukraine war, which escalated in 2022, has exacerbated these humanitarian pressures and brought conflict proliferation to Europe's doorstep. Bilateral donors, multilateral organisations, and private-aid groups are struggling to meet the growing needs, and global appeals for support are falling far short of targets. Disruptive global trends such as climate change will likely lead to further propagation of conflict and migration.

In this context, funding for post-conflict recovery and reconstruction is receiving increased attention. Failure to support recovery efforts at the right time can undermine a country's long-term stability and security, increase chances of conflict relapse, and prolong the plight of refugees and displaced persons.

The World Bank currently lists 35 countries and over one billion people[15] as being in fragile and conflict-affected situations (FCSs).[16] They face a variety of protracted challenges, from low institutional capacity, to limited public service delivery, to forced displacement and war.[17] Effective development assistance is critical when FCSs are attempting to transition out of conflict or fragility.

However, multilateral development organisations find it difficult to engage in post-conflict contexts, as these situations are complex, unstable, and ill-suited for the usual development financing instruments. The countries are not creditworthy. The fiscal institutions meant to oversee financial flows have atrophied and in need of rebuilding, and funding can easily end up in the "wrong" hands. Conflicts can restart, risking investments made in recovery and reconstruction. The failure of post-conflict efforts in Afghanistan and Iraq raises questions on the best ways to deploy development aid in fragile post-conflict environments.

Therefore, there is a need to focus on financing options that provide sustainable alternatives to long-term humanitarian assistance while rebuilding the capacities of local institutions and ensuring that the funds reach the right people and projects while minimising waste, misallocation, and misappropriation and navigating political pitfalls, bottlenecks, and landmines.

In 2020, the World Bank released a new strategy for engaging with fragile and conflict-affected states. The International Monetary Fund (IMF) followed with its own strategy.[18] Both strategies seek to expand available funding to fragile and conflict-affected areas. They also recognise the need for different priorities during different phases of a conflict, with more effort directed towards preventing conflicts and remaining engaged during conflicts by working to preserve and expand institutional capacity and human capital, both of which are critical for recovery efforts.[19]

The strategies are less clear about what can be done to support post-conflict recovery, which is often complex, fragile, and fraught with moral compromises. The underlying causes of the initial conflict are rarely resolved and likely to be lingering below the surface. About half of all conflicts relapse within a decade.[20] Old grievances are overlaid by new ones. Parties to human rights violations are often rehabilitated as part of political settlements, reducing the likelihood of justice and accountability. However, the strategies do emphasise the importance of rethinking what long-term success looks like, tailoring interventions to contexts, and supporting vulnerable populations.[21,22] Four key elements include:

- **Partnerships:** Developing and improving partnerships is a key element that all strategies agree on, including with other international organisations, the private sector, and civil society. Involving the private sector is important, as improving livelihoods and reducing dependence on humanitarian assistance requires a vibrant private sector that can grow and create jobs.

- **Enhanced flexibility:** Operational flexibility is essential to ensure flexibility on the timing and pace of reforms and developing contingencies in the face of implementation challenges in volatile, unstable conditions. Greater flexibility must be balanced by enhancing monitoring and evaluation tools and promoting the use of portfolio reviews.

- **Alignment of expectations:** Ensuring better alignment between donor expectations and local absorption capacity, as well as considering each country's accountability and transparency levels, is important. Goals, interests, and expectations need to be communicated, especially in the post-conflict contexts of polarised societies, disinformation, and propaganda.

- **Community-driven:** Building the capacity of inclusive local institutions and enhancing the use of community-driven development are essential, even though the latter has often been noted for its lack of long-term sustainability. It is also critical to remain vigilant about conflict triggers and underlying sources of conflict, such as by introducing conflict filters and using peace lenses.

The G20's Role

2

New and innovative thinking in development finance is required to address the complex, interconnected challenges of the 21st century. This brief calls for G20 leadership to explore and experiment with the broadening of current development financing paradigms. There is a need to introduce new institutional frameworks to mobilise additional resources and direct them more effectively towards achieving impactful development outcomes. In this regard, the G20's role at the forefront of global development finance mobilisation can extend to support Islamic climate finance and finance for fragile post-conflict environments by building upon the following:

- The G20 Sustainable Finance Working Group (SFWG) supports enhanced climate action. More broadly, the G20 has reaffirmed a 2010 commitment by developed countries to jointly mobilise US$100 billion of climate finance per year for developing countries by 2020, and annually through 2025.[23] In this regard, the G20 has an opportunity to support the leveraging of existing and new Islamic climate finance modalities to help meet these commitments.

- Development financing in fragile and post-conflict contexts requires a level of flexibility and partnership coordination that traditional multilateral development organisations have had difficulty meeting. The G20 can fill the growing need for post-conflict financing by developing partnership-based platforms led by functional partners and one or more G20 members that possess knowledge of local contexts. These platforms can manage aid dissemination and monitoring efforts.

Recommendations to the G20

3

Islamic climate finance

To catalyse Islamic climate finance at scale, the G20 could promote the establishment of Islamic climate finance windows in existing global climate institutions, such as the Green Climate Fund (GCF). This could elevate the profile of Islamic climate finance by leveraging existing global climate finance frameworks. This could also activate significant latent climate finance for markets and countries where climate finance is most needed. Globally recognised multilateral Islamic finance institutions could help channel public and private resources towards enhanced climate action. The establishment of a dedicated International Islamic Climate Finance Agency (and associated Global Islamic Climate Fund) could be considered subject to the success of such avenues.

Priority policy actions to mobilise Islamic climate finance under the umbrella of such initiatives include:[24]

- **Greening Islamic capital markets**:

a. Adopt harmonized standards and legal documentation for green sukuk issuances;

b. Develop trading platforms and rating methodologies, and unify pricing;

c. Converge with ESG principles and streamline impact measurement; and

d. Introduce environmental impact sukuk and develop sustainable sukuk

- **Greening Islamic social finance**:

a. Mobilise zakat for green recovery, emergency response, and climate resilience;

b. Adopt shared governance standards and set up global green Islamic philanthropy initiative; and

c. Develop innovative social finance structures (e.g., takaful and awqaf) for climate action

- **Mobilising Islamic project finance for green infrastructure**:

a. Mobilise funds for project preparation;

b. Create or scale up de-risking facilities to improve bankability and reduce the cost of capital;

c. Set up green infrastructure equity funds; and

d. Mobilise traditional and blended finance

- **Developing a framework to support domestic green banking services for the unbanked and to increase financial inclusion**:

a. Develop distribution networks and competitive and Shari'ah-compliant banking offers; and

b. Leverage financial technology for efficient financial inclusion

Post-conflict recovery

International organisations, while trying to improve their approach,[25] are hampered by internal rules that have evolved over time to avoid risk. Even new approaches are not likely to wander far from the purview of rigorous financial oversight. In this context, the G20 can consider several innovative strategies to unlock financing in post-conflict contexts and improve the effectiveness of aid delivery:

- **Co-align work through partners with knowledge of local contexts:** To increase effectiveness, avoid duplication, and improve coordination with local institutions, the G20 countries should develop platforms led by organisations or countries that have remained engaged during the conflict and understand the local context. Recovery funds can be created that are administered through the platform. Leadership of the platform will serve as a central node for communication and oversight, thereby reducing reporting burdens on weak local institutions.

- **Identify and work through viable local partners:** During conflict, many institutions—including public institutions, private-sector actors, and even social institutions—cease to function or are captured by vested interests. While recovery efforts must work to rebuild all institutions (and build new ones), the most functional and least captured efforts—even if unusual—need to prioritised. Partnership platform can help identify and vet non-traditional local partners that the G20 countries can then support.

- **Make and rigorously monitor an initial demand:** In post-conflict situations, it is important, though difficult, to specify conditions aimed at ensuring that aid flows to the right places and that the key elements of the post-conflict political architecture are met. To avoid an overly complex web of conditions that may be difficult to monitor, the partnership platform should initially identify a single requirement that is then rigorously monitored and enforced. While this will differ from country to country, it should involve a zero-tolerance policy in order to be credible. This will also allow for the creation of a monitoring and enforcement infrastructure that local authorities, donor countries, and institutions can expand and build upon.

- **Articulate a path forward:** Recovery and reconstruction funds should flow to areas that are most affected by the conflict, but these areas may not be evenly distributed across the country. Donors should articulate a vision or a prize that the entire country can mobilise around, such as trade agreements, investment treaties, or the lifting of sanctions. Examples include Ukraine's candidacy to the EU or Yemen joining a Gulf Cooperation Council Plus (GCC+) grouping.

Attribution: Bradley Hiller et al., "Rethinking Development Finance in Response to 21st-Century Challenges: Islamic Climate Finance and Post-Conflict Recovery," *T20 Policy Brief*, November 2023.

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