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PEACE BONDS

Breaking the cycle: practical solutions to unlock climate finance for fragile states

JANUARY 2023

Key Messages

- › Peace bonds are an emerging financial instrument proposed by Interpeace to fund projects that contribute to development and peace objectives in countries affected by conflict and fragility.
- › They do not exist yet in the market, but offer a potential route to unlocking significant amounts of private sector finance, which is needed to add to public climate finance.
- › The innovation in the peace bonds approach is to cost and build peace-enhancing activities into the financial arrangements of the project, ensuring that private sector adaptation activities will be conflict-sensitive.

- › From a strategic perspective, the use of peace bonds could generate new information about the real vs perceived risks of operating in fragile and conflict-affected situations (FCS), helping the private sector overcome their risk-based aversion to investing in such contexts.
- › From a programme development perspective, the approach of commercial peace bonds could decrease borrowing costs for climate adaptation projects in FCS, while ensuring that risks are mitigated for both investors (financial risks) and communities (conflict and other socio-economic risks) – as opposed to the traditional approaches utilised to mobilise private finance, which focus only on the investors.
- › The reporting requirements of peace bonds could provide incentives to support conflict-sensitive adaptation projects by tying the verification of key peace impact indicators to the disbursement of funding.
- › **Recommendation 1:** Private arms of bilateral and multilateral funding organisations can learn from these features of peace bonds in mobilising private sector adaptation finance in FCS, by ensuring that blended approaches will lead to more accurate assessments of risks by the private sector and, over time, help to reduce that sector’s risk-based aversion toward such contexts.
- › **Recommendation 2:** Bilateral and multilateral climate funders could explore more results-based financing models as a way to use public finance more effectively to mobilise private finance for adaptation projects in FCS, as they currently tend not to use such models either in their grant-funded climate projects or their blended approaches.
- › **Recommendation 3:** Multilateral and bilateral actors, civil society, and the private sector all have incentives and active roles to play in support of the realisation of peace bonds:
 - › Multilateral development banks (MDBs) should play a catalytic role – similar to that played a decade ago with the creation of green bonds – by supporting the first issuances of (blended) peace bonds targeting climate (adaptation) projects. The concessional arm of MDBs and multilateral climate funds can support this process through the provision of blending instruments, such as grants, first-loss debt instruments, and risk transfers.
 - › Bilateral climate actors, especially those whose jurisdictions govern international bond issuances, could provide support to the creation of peace bonds by creating favourable legal frameworks and policy interventions to ensure interest from institutional investors (these would be the target lenders, as bond issuances are generally in the range of tens of millions of dollars).
 - › Civil society, NGOs, think tanks and professional services firms should support the creation of a peace bond market, in the first instance, by helping to develop principles and standards for peace bonds, and providing monitoring and verification services during the implementation of projects.

Introduction

The more fragile a country is, the less adaptation finance it receives. Previous research into why this is the case strongly suggests that complex operating environments, often characterised by weak governance institutions, higher risks due to rapidly changing situations, fast-evolving conflict dynamics, and security threats, are not aligned with the risk appetite and tolerance of climate funders (Cao et al., 2021). This has created challenges in implementing climate change adaptation efforts in fragile and conflict-affected contexts – challenges that

have been well documented (Gilder and Rumble, 2020; Cao et al., 2021; ICRC, 2021; Reda and Wong, 2021; CCCPA, 2022). The question, however, remains: what can be done to overcome them?

This is one of four case studies undertaken with the aim of identifying concrete solutions that could be implemented by major climate funders to increase climate adaptation finance delivery to fragile and conflict-affected situations (FCS). It draws on examples and learning from a few selected funders and specific mechanisms, both in the climate and non-climate space, which are already working effectively in FCS. The other case studies are:

- › The UN Peacebuilding Fund
- › Crisis modifiers
- › COVID-19 Vaccines Global Access (COVAX)

An overarching analysis, the learning from the case studies, and overall recommendations are drawn together into an umbrella document *Breaking the cycle: practical solutions to unlock climate finance for fragile states* which synthesises overall key messages and learnings available here. All the case studies, and the umbrella document, can be found at <https://www.mercycorps.org/research-resources/breaking-the-cycle>.

Understanding climate finance challenges through a life-cycle lens

The journey of climate finance, including barriers in access, disbursement and implementation, is best understood via its life-cycle (see Figure 1). Using a life-cycle framework, it is possible to map the common challenges across donors and recipient countries, and use this as a springboard to identify organisations implementing innovative practices that may offer solutions worth featuring as case studies.

METHODOLOGY

The case studies highlighted in this research were identified based on their relevance in offering potential solutions to the challenges of accessing and implementing climate finance in FCS. First, the different challenges for accessing and utilising climate finance in FCS were scoped. These challenges were developed into a lifecycle framework. Case studies which offered potential solutions across the whole lifecycle or for specific components of the lifecycle were then identified. Interviews were held with representatives from target organisations to collect further information, and strategic, programme and project level documentation was reviewed to triangulate findings. For each case study, a minimum of one representative and two external experts provided peer review and feedback to ensure the accuracy of the information presented. Whilst these case studies provide some innovative solutions, they are not exhaustive and there are likely to be other solutions, piloted in different contexts from which climate funders could also learn.

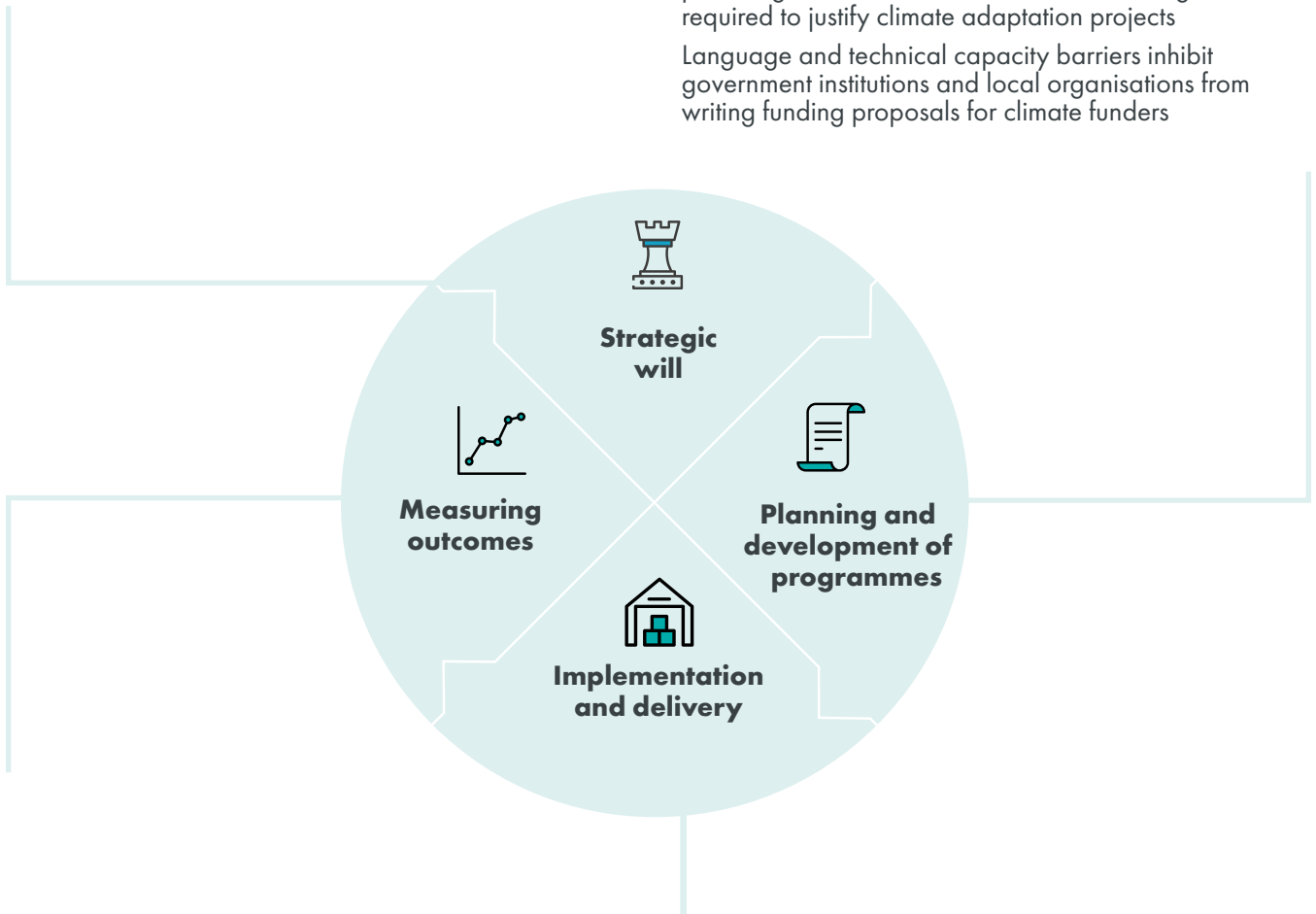
FIGURE 1 – CHALLENGES TO ACCESSING AND UTILISING CLIMATE FINANCE IN FCS

Strategic will

Perceived risk in FCS is too high for climate funders
 Funders’ risk aversion deprioritises vulnerable communities in less-secure areas from support
 Climate finance is delivered through state authorities, weakening delivery in non-state controlled areas
 Funders lack long-term strategies and organisational structures to manage compound climate–conflict risks
 Funders’ climate and conflict teams are siloed, preventing operational collaboration

Planning and development of programmes

Multilateral climate funds’ complex/rigid accreditation standards are too much for government institutions and national organisations in FCS
 Accreditation barriers prevent local communities and CSOs directly accessing climate finance
 Climate funders’ project approval processes may mean 1–2 years’ unfunded work for applicants, without guarantee of application success
 Structural damage/access issues in FCS lead to difficulty providing the socio-economic and meteorological data required to justify climate adaptation projects
 Language and technical capacity barriers inhibit government institutions and local organisations from writing funding proposals for climate funders



Measuring outcomes

Standard project M&E processes, where information stays between executing organisations and communities, limit climate funders’ monitoring of fiduciary risks and accountability
 Project M&E cycles are too short for effective evaluation of integrated climate–conflict programming

Implementation and delivery

Inflexibility in pre-planned climate projects prevents adaptation to volatile FCS contexts, leading to delays, closure and waste
 Conflict-sensitive guidance for climate projects in FCS is inconsistently adopted and adaptation projects lacking conflict sensitivity may exacerbate conflict
 Funders and multilateral implementers may struggle to find right local organisations to operate in areas of conflict, or with relevant climate expertise

Overview: Peace bonds by Interpeace

Why peace bonds?

Peace bonds are a potential route to increasing private sector funding in climate finance. The private sector is expected to play a major role in delivering climate outcomes; yet, to date, private climate investments have been extremely limited. The OECD (2022) estimated that globally only \$0.19 of private climate finance was mobilised by each \$1 of bilateral and multilateral climate finance in 2020; this ratio was \$0.34 for each \$1 in 2013, showing a net decrease. Country-wise, the least developed countries have only attracted 6% of all the private finance that ODA has mobilised between 2012 and 2018 (OECD and UNCDF, 2020).

These low rates may be due to the borrowing premium that arises from conflict and political risks in fragile countries – and this is the very barrier that peace bonds could help eliminate. In fact, recent literature has shown that aversion to conflict risk, caused by a lack of targeted strategies to manage it, is a key barrier for climate funders to mobilise resources to fragile countries (Cao et al., 2021; ICRC et al., 2022).

What are peace bonds?

Peace bonds are a new financial instrument proposed by Interpeace – an international peacebuilding organisation – to fund projects that contribute to development and peace objectives in countries affected by conflict and fragility.¹

They are not yet available in the market, but Interpeace has proposed a working definition of peace bonds as ‘a type of bond instrument whose proceeds would be exclusively applied to partly or fully finance or re-finance new or existing projects that have a peace impact and are verifiably aligned with peace bond principles and standards’ (Interpeace and SEB, 2022: 15). Interpeace is developing the Peace Finance Impact Framework (PFIF) – a framework that provides a benchmark to define what ‘peace impacts’ mean for investors and communities involved in a project funded by peace bonds and other peace-oriented financial instruments (Hyslop, 2022a; 2022b). The PFIF will allow validation that bonds using the ‘peace’ label are indeed having a positive peace impact. The framework has three main components:

- › a set of core peace principles, to which parties to the project must commit (see further information below)
- › peace-enhancing mechanisms (PEMs) and partnerships that enable the success of projects in conflict-affected and fragile environments (see further information below), and
- › a process to align peace bond issuance and operations to the core peace principles and incorporate PEMs.

¹ Interpeace was created in 1994 as the ‘War-torn Societies Project’: a United Nations project to assist the international community and national actors to respond better to challenges of countries emerging from war. In 2000, the project transitioned to become an independent non-governmental organisation. It maintains a strong link and partnership with the United Nations and can operate either as an NGO or through the United Nations.

KEY TERMS USED IN THIS CASE STUDY

Bond: A financial instrument under which the issuer (debtor or borrower) owes the holder (creditor or lender) a debt. The debt repayment is composed of the principal (the amount borrowed) to be paid at the maturity date (the date on which the final payment is due) and an interest (called a coupon) over a specified period of time. Bonds can be thought of as IOUs, and are similar to bank loans but generally last longer (from one year to over 30 years). When institutions, companies, governments and other entities want to raise long-term finance but do not want to dilute their shareholdings (or can't issue share capital), they turn to the bond markets. The biggest investors are generally insurance companies and pension funds. They buy bonds to generate return, offset their liabilities, generate income or diversify their portfolios.

Green bond: Differentiated from a regular bond by its label, which signifies a commitment to exclusively use the funds raised to finance or re-finance projects, assets or business activities with environmental benefits. Many frameworks exist to align bonds with green, climate or environmental principles and processes.

Peace: Definitions of peace are diverse and can often be contested. This case study distinguishes between positive peace and negative peace. Positive peace is understood as an ongoing process of transformation where attitudes, institutions and norms at multiple levels enable societies to transform and remedy grievances in ways that are non-violent and perceived to be just, directly addressing issues of safety, social justice, equality, mutual trust and well-being. Negative peace is generally understood as the absence of violent conflict and fear of violence.

Peace impacts: These can be distinguished between direct peace impacts that are achieved when project activities do intentional peacebuilding work as their primary objective, by promoting dialogue, building trust, or mediating a conflict, and indirect peace impacts, which can be achieved in climate adaptation projects where the primary objective is developmental (e.g. to adapt to the impacts of anthropogenic climate change) but peace impacts are an intended co-benefit.

Sources: Interpeace and SEB, 2022; CBI, 2010

Core peace principles

The PFIF core peace principles commit the project developers, peace bond issuers and investors to (a) making a positive impact to peace, (b) verifying and disclosing that impact for accountability, and (c) including parameters for what counts as meeting peace principles for the investment – and what, conversely, counts as non-compliance, which would therefore preclude investments from being funded by peace bonds (e.g. investments that directly or indirectly support agricultural or afforestation operations on land designated as primary forest, in high-conservation-value areas, or in legally protected areas, as these are often connected to indigenous communities' livelihoods and may lead to environmental degradation and conflict if acquired for commercial purposes).

INTERPEACE HAS PROPOSED FIVE PROVISIONAL PEACE PRINCIPLES:

1. Parties to the project explicitly commit to **reducing both financial risks for the company developing the project and conflict and social risks for people and the environment** in the context of the investment. This is an important development, as existing risk mitigation approaches focus only on reducing or transferring financial risks for companies and investors.
2. Parties to the project deliberately and intentionally design the investment to **directly or indirectly support peace** guided by the PFIF. This will prevent investment approaches that may realise incidental development impacts from being erroneously described as related to peace.
3. The investment approach **includes local communities** in the process of designing the project and ensures that products or services consequent from the investment are **accessible in terms of their affordability and physical accessibility, and are ethically and culturally appropriate**.
4. The investment approach prioritises **the quality of the process used to engage key stakeholders and communities** throughout the lifespan of the project. This is important, as peace dynamics are highly relational, cultural and political, requiring a strong attention to the process used to achieve them.
5. Parties to the project invest in **new partnerships at multiple levels** to acquire the right information, capacities and skills **to mitigate or avoid conflict risk for communities and financial non-performance for investors, and create peace impacts**. Outside investors often lack the local contextual knowledge, networks and track record to guide and structure their investments in ways that better navigate the complex political and social risks associated with contexts of conflict and fragility. New partnerships can be supported by increased transparency, which is important for accountability, ongoing learning and iterative improvement.

Source: Hyslop et al., 2022

Peace-enhancing mechanisms and partnerships

If they wish to be successful, companies and investors need to engage differently when operating in fragile and conflict-affected settings compared to stable, high-income locations.

Peace-enhancing mechanisms (PEMs) are a series of activities that provide companies and investors with the required skills, domain knowledge, capacity, networks and practices to successfully reduce the risks of operating in such contexts. They include tools and approaches widely used in the development and peacebuilding sector to create engagement and dialogue and foster equitable governance within communities, as well as specific interventions to build peace (see Table 1). Companies and investors will need to partner with local actors and specialist development and peacebuilding organisations to fill their skills gap and mainstream them in investment projects.

TABLE 1 – EXAMPLES OF PEACE-ENHANCING MECHANISMS

Engagement, dialogue and governance approaches
Participatory peace and conflict and political economy analysis
Participatory action research and learning for action
Participatory governance approaches
Participatory development planning and policy-making
Benefit-sharing mechanisms
Community-led procurement
Peacebuilding interventions
Inter-religious dialogue
Restorative Justice and Reconciliation approaches
Disarmament, Demobilisation and Reintegration (DDR)
Formal and informal political mediation between leaders
Nonviolent Communication Training
Community Psychoeducation

Aligning peace bonds with peace principles and use of PEMs

The process to align peace bonds with the PFIF peace principles and create partnerships to deliver PEMs is predicated upon project developers and investors' close collaboration with PEM partners, who can provide locally-grounded insights and timely feedback to investors regarding the changing context dynamics on the ground and the potential positive and negative impacts of the investment activity.

The alignment process ensures that peace principles and PEMs are embedded and, more importantly, budgeted in the peace bond issuance, implementation and reporting. In particular, three key aspects of the issuance process and operations allow verification of the alignment:

- › **Use of bond proceeds:** In the pre-issuance and marketing stages, developers and the peace bond issuer need to communicate clearly to potential investors about how the money raised will be used, and the specific peace impacts the investment seeks to achieve. The project's peace strategy will be included in the 'bond prospectus' or 'offering memorandum' for investors (i.e. a legal document setting out the basic information of the investment, such as financing amount, interest rate, repayment period, main partners, key economic, social and environmental risks, etc.).
- › **Management of proceeds:** Spend should be tracked and transparently communicated to investors, often with the support of an external auditor or third party. The third party can require additional information on how the funds are used on the ground, which can include questions or an internal checklist to ensure that peace principles are being adhered to and PEMs are being delivered.

- › **Reporting:** In the post-issuance stage, peace bond issuers will prepare annual reports of peace impact delivered by the investment projects, and arrange for these to be independently evaluated.

The role of commercial and blended peace bonds for climate adaptation

Peace bonds may be issued by Sovereigns (government peace bonds), corporations (commercial peace bonds), and corporate or non-profit entities with the support of public entities providing concessional finance (blended peace bonds).

This case study focuses on **commercial peace bonds** as an approach to fill the gap in financing for climate adaptation in FCS. The commercial peace bonds' primary purpose would be to fund climate adaptation investments in FCS while making indirect peace impacts in sectors where opportunities for both adaptation and peace abound (e.g. water sanitation and hygiene and shared water resources, agriculture, pastoralism, food security, and shared land use). To do so, the peace bonds would be aligned with the PFIF while ensuring they also meet existing, well-established standards that align bonds with climate objectives (e.g. [ICMA's Green Bond Principles](#) and CBI's [Climate Bonds Standard](#)).

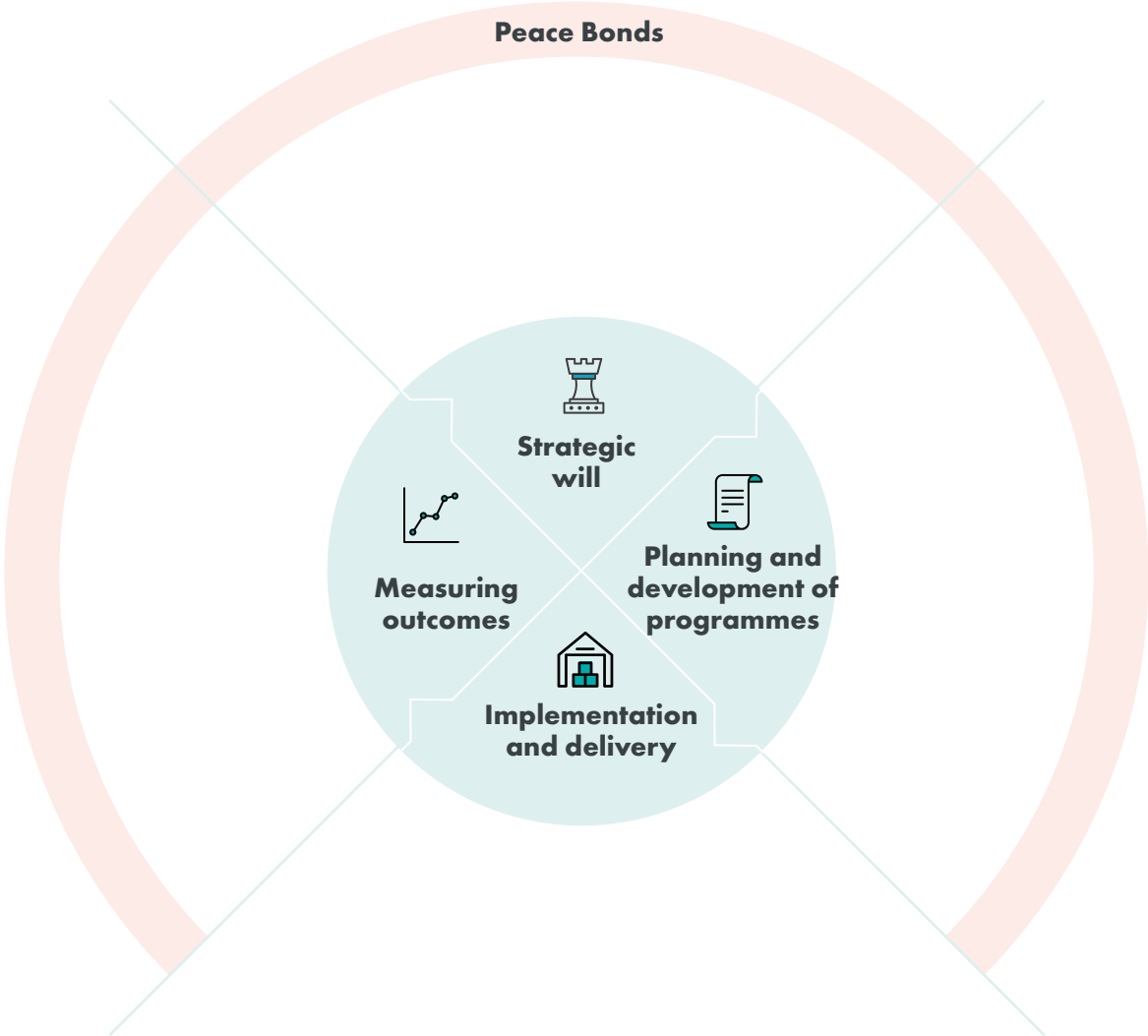
Commercial peace bonds could provide a strategically different funding approach for climate adaptation projects that would not burden the often-limited government fiscal resources and high government debt in FCS. The reporting requirements of peace bonds, which demand the inclusion of peace impact metrics, would also contribute to addressing the challenges of measuring and verifying the impacts of adaptation projects on the ground in FCS (see Figure 2).

This case study will also explore **blended peace bonds**, as these may be needed at the early stages of introducing peace bonds in FCS due to 'bankability' barriers.² Bankability barriers are challenges that lead to a lack of investment-ready projects – including high costs, where financial returns do not compensate investors for the additional risk associated with unfavourable regulations and policies in low-income countries, or a lack of enabling environment due to an absence of adequate long-term climate and development plans, among others (CPI, n.d.). From the perspective of private investors, climate adaptation projects face higher bankability barriers than climate mitigation investments, as it is harder to generate monetisable revenue streams. Therefore, using public concessional finance to lower these barriers can attract private investors' participation. Moreover, there is already a developed market for blended finance in FCS, and focusing on it could provide learnings on how to develop a market for peace bonds: out of the 680 deals valued at \$161 billion in the Convergence database (a blended finance clearing house), more than half were made in FCS (Interpeace and SEB, 2022: 16).

Potential effects of peace bonds on climate adaptation action in FCS

² Bankability is a term originating in the finance sector; it is typically used by the private sector to refer to projects that have a financial return on investments or positive Net Present Value (NPV). The term, however, is not absolute and has different meaning for different actors in the context of climate investments. While the private sector values more highly the financial profits of a project, the public sector may put more emphasis on social returns, such as its climate adaptation and developmental potential. For more views on bankability, see Ellis and Pillay (2017).

Figure 2 –PRACTICAL SOLUTIONS IN THE CLIMATE ADAPTATION PROJECT LIFE-CYCLE: PEACE BONDS



Peace bonds could generate a number of positive effects to lower the risk of climate adaptation investments and enhance adaptation action in FCS. Albeit still unproven, Interpeace has determined in a feasibility study a number of positive effects at the project level and at a wider market-systemic level (see Interpeace and SEB, 2022).

At the project level, PEMs could decrease the borrowing cost for climate adaptation projects in FCS. Projects operating in FCS face high ‘credit risk’ (the risk of the borrower failing to repay or meet contractual obligations), which results in a higher interest rate (also called coupon rate) compared to projects in stabler settings. PEMS could lower the peace bond’s coupon rate by decreasing the adaptation project credit risk through activities that weaken conflict dynamics and support equitable governance and redistribution of benefits within local communities, increasing their acceptance of the project and decreasing the risk of project disruption, delay or cancellation. In a commercial appraisal of PEMs on a real, proposed solar PV plant in Ghana, Interpeace and Skandinaviska Enskilda Banken (SEB) found that the reduction of conflict and project credit risks through PEMs could reduce the coupon rate on the bond financing from 19% to 17%, increasing the net present value (NPV) of the project future cash flow by \$6 million. After factoring in the cost of the PEMS at \$1.63 million, the surplus value of utilising peace bonds to finance the project would be \$4.4 million – a net overall benefit (see Box 1 for more details).

PEMs could add to the information available about conflict risks to help investors understand real vs perceived risk. The borrowing premium that projects in FCS must pay does not always reflect the actual conflict and credit risks to the project; rather, it is often determined by the pre-existing perceptions of risk which investors associate with these contexts. By implementing mitigation measures, PEMs could add to the information available about these risks and enable future peace bond issuances to benefit from more accurate (and lower) risk pricing.

At the market and systemic level, peace bonds could drive additional investments in climate adaptation to FCS. ‘Additionality’ in this case indicates investments that would not have otherwise occurred without the use of commercial peace bonds. As mentioned, private sector climate adaptation programming in fragile and conflict settings with often hybrid governance (state and non-state actors) would require companies and investors to work differently to navigate the complex environment – and this cannot be achieved without establishing new partnerships with local development and peacebuilding actors. Peace bonds can build these partnerships and peace-enhancing activities into the financial cost of the investment, so that risks are reduced for both communities and investors (and not just for the investors, as existing financial risk mitigation mechanisms tend to do). By lowering conflict, project and financial risks, peace bonds could mean adaptation projects that had been deemed unviable may become viable.

By tying the verification of key peace impact indicators to the disbursement of funding, peace bonds could improve the implementation of conflict-sensitive guidance in climate adaptation and development projects. In cases of sovereign and blended peace bond issuances involving the public sector, the disbursement of bond tranches (bond proceeds are generally disbursed in tranches) can be tied to progress on key peace impact indicators and metrics. This will ensure that existing conflict-sensitive guidance can be more systematically implemented in the climate and development sectors and avoid the risk of exacerbating existing conflicts.

Over time, the development of a secondary peace bond market with robust peace standards and verification processes (e.g. in alignment with the PFIF) could incentivise the private sector to adhere to higher standards of governance and shift business practices to support peace in a more transparent way.

GHANA–BURKINA FASO RENEWABLE ENERGY COMMERCIAL PEACE BOND APPRAISAL

Interpeace and SEB carried out an appraisal in 2021 to finance with commercial peace bonds a proposed 50MW solar PV farm in northern Ghana, on the border with Burkina Faso. The project is set to deliver electricity across the border to 1 million people in Burkina Faso, which corresponds to 5% of the population and 14% of the country's annual energy imports. The farm would save 20 gigatonnes of CO₂ per year. The investment cost of the project is \$35.1 million without the use of commercial peace bonds; with commercial peace bonds, the upfront cost would be \$36.73 million, but the savings over the lifetime of the project would be \$4.4 million.

The project is located in a region where governance and state–society challenges exist, exposing the project to potential conflict and socio-economic risks:

- › In Ghana, chieftaincy is a recognised part of the country's governance – chiefs govern community lands and settle conflicts. The project requires the acquisition of 150 acres of land in northern Ghana, where conflicts between the Dagbon, Bawku, Bimbilla, Bolga and Bole have been longstanding, running along ethnic and family-dynamic faultlines.
- › In Burkina Faso, many conflicts are caused by development disparities rooted in issues of governance, rural/urban divides, land disputes, resource competition, and state legitimacy. There is a wide gap in public service provision between urban and rural areas: only 5% of the rural population has access to electricity, compared with 60% of the urban population. In rural areas, many conflicts are caused by poor management of resources and land disputes between sedentary crop farmers and transhumant pastoralists. The absence of basic services reflects the absence of the state in many rural areas, which feeds popular mistrust of state institutions, in turn limiting their ability and legitimacy to mediate existing conflicts.

Interpeace and SEB estimates that the use of peace bonds and of PEMs built into the investment could reduce conflict and credit risks through the following channels:

1. Improve State–society relations and trust in Burkina Faso by improving delivery of services and energy to under-served rural communities.
2. Help to reduce natural resource competition in agricultural areas of Burkina Faso by earmarking energy use to specific under-served rural communities, or for specified agricultural purposes that can reduce resource competition, potentially alongside coordinated development actions by peacebuilding and food security actors.
3. Further strengthen cross-border ties between Ghana and Burkina Faso, as well as regional economic integration, boosting the resilience of regional diplomacy and cross border co-operation.
4. Improve horizontal (inter- and intra-community) and vertical (community–State) trust and cohesion in northern Ghana by establishing a community land acquisition dialogue mechanism and establishing long-term benefit-sharing mechanisms (training, maintenance, local governance).
5. Create peace additionality by: (1) increasing the opportunity cost of engaging in violence and destruction of investment assets by means of benefit sharing and community engagement;

(2) earmarking a proportion or percentage of profits from the energy venture to intentional peacebuilding actions led by local civil society and peacebuilding actors in co-agreed areas of need.

6. Create financial additionality by demonstrating that real asset risks in the region can be controlled, potentially stimulating future investment to meet other development needs. (Interpeace and SEB, 2022: 82–83)

The use of PEMs would also lower the interest rate on the investment's debt borrowing from 19% (without PEMS) to 17%, by directly mitigating the conflict risk to the project (which is estimated at two percentage points). This would improve the net present value (NPV) of the project by \$6 million. After accounting for the cost of PEMs (\$1.63 million), the use of commercial peace bonds would save ~\$4.4 million (i.e. \$6 million minus \$1.63 million) over the lifetime of the investment.

In addition to saving money and lowering conflict and credit risks, the project would also lower electricity costs for consumers in Burkina Faso, as the Purchasing Power Agreement (PPA), in which the government of Burkina Faso commits to buying the electricity from the solar PV farm, is set at a price of \$130/MWh against an average price of \$220–\$250 per MWh – one of the highest electricity prices in West Africa.

Source: Interpeace and SEB, 2022

Challenges to the creation and adoption of peace bonds in FCS

Since peace bonds only exist in a proposal form that needs wider socialisation within the development, climate and peacebuilding communities, as well as in the private sector, understanding potential challenges to their creation and adoption is not straightforward. There are many parallels, however, that can be drawn from the challenges affecting the more established field of Environmental, Social and Governance (ESG) investing – known more widely as 'sustainable' investing – and there are two potential categories of challenges for peace bonds.

The first challenge concerns **standard setting and measuring**: the social aspects of ESG (the S in ESG) are considered the most difficult to assess and properly embed in financial instruments and investment strategies. A 2017 study comparing major rating agencies' approaches to assessing social aspects of ESG found that social measurements tended to evaluate 'what is most convenient, not what is most meaningful', and noted a lack of consistent standards underpinning the measurement of social sustainability across the ESG industry (O'Connor and Labowitz, 2017). This has given rise to significant variation in measurement ratings between different ESG frameworks, even when in agreement on the scope of things measured. The recent EU Social Taxonomy final report highlighted how most ESG frameworks that aligned on the important issues to FCS, such as human rights and community relations, did not correlate with each other at all – meaning they would each give entirely different results (in Hyslop et al., 2022).

All these issues have created confusion for investors and enabled the potential for 'greenwashing' or 'social-good washing', undermining market trust. To avoid and mitigate similar challenges, it will be key for a proposed Peace Finance Impact Framework to provide clarity about what peace impacts are, how they can be achieved, how they

can be measured and verified, and the best approaches for peace impacts.

The second challenge relates to **investor demand for peace bonds**. Most low-income FCS face many challenges in courting investments due to their income status, smaller size, higher perceived risk, and difficulty for investors to sell investments in these countries. In contrast, bond issuances generally tend to target large, long-term investors that are less attuned to the potential political, economic, and financial risks that these markets present. Notwithstanding this, there may be potential appetite from large investors for peace bonds. Many chief investment officers of pension funds and sovereign wealth funds attending the Fiduciary Investors Symposium (convened by Conexus Financial and [Top1000funds.com](https://www.top1000funds.com) at Harvard University in October 2019) signed a letter for Interpeace supporting the concept of peace bonds, indicating that if these were launched they would look to invest (Interpeace and SEB, 2022: 73).

Conclusions: What can climate actors learn from this experience?

The features and design of peace bonds provide several lessons for climate actors on how to address barriers and mobilise private finance for climate adaptation in FCS.

First, from a strategic perspective, the use of PEMs embedded in peace bonds could generate new information about the real vs perceived risks of operating in FCS, helping the private sector overcome their risk-based aversion to investing in such contexts. From a programme development perspective, the approach of commercial peace bonds could decrease borrowing costs for climate adaptation projects in FCS, while ensuring that risks are mitigated for both investors (financial risks) and communities (conflict and other socio-economic risks), as opposed to the traditional approaches utilised to mobilise private finance, which focus only on the investors. The innovation in the peace bonds approach is to cost and build peace enhancing activities into the financial arrangements of the project, ensuring that private sector adaptation activities will be conflict-sensitive.

- › **Recommendation 1:** Private arms of bilateral and multilateral funding organisations can learn from these features of peace bonds in mobilising private sector adaptation finance in FCS, by ensuring that blended approaches will lead to more accurate assessments of risk by the private sector and, over time, decrease their risk-based aversion towards such contexts.

Second, the reporting requirements of results-based financing instruments,³ such as peace bonds, could provide incentives to support conflict-sensitive adaptation projects by tying the verification of key peace impact indicators to the disbursement of funding. Such an approach is generally appealing to funders as they only pay for results achieved; further, it can incentivise the private sector to focus on the quality and delivery of projects and ensure that the investment will not exacerbate conflict dynamics.

- › **Recommendation 2:** Bilateral and multilateral climate funders could explore more results-based financing models as a way to use public finance more effectively to mobilise private finance for adaptation projects in FCS, as they currently tend not to use such models in either their grant-funded climate projects or their blended approaches.

3 These financial instruments strengthen project accountability by linking financing to the achievement of measurable, pre-agreed results.

Last, given the importance of mobilising private finance in the climate sector, organisations and institutions working in the climate domain should engage in further exploration of peace bonds and actively support the realisation of a ‘proof of concept’ to mobilise sorely-needed funding for adaptation action in FCS.

Recommendation 3:

- › Multilateral development banks (MDBs) should play a catalytic role – similar to that played a decade ago with the creation of green bonds – by supporting the first issuances of (blended) peace bonds targeting climate (adaptation) projects. The concessional arm of MDBs and multilateral climate funds can support this process through the provision of blending instruments, such as grants, first-loss debt instruments, and risk transfers.
- › Bilateral climate actors, especially those whose jurisdictions govern international bond issuances, could provide support to the creation of peace bonds by creating favourable legal frameworks and policy interventions to ensure interest from institutional investors (these would be the target lenders, as bond issuances are generally in the range of tens of millions of dollars).
- › Civil society, NGOs, think tanks and professional services firms should support the creation of a peace bond market, in the first instance, by helping to develop principles and standards for peace bonds, delivering PEM activities, and providing monitoring and verification services during the implementation of projects.

Acknowledgements

This case study was authored by Yue Cao (independent consultant). The author is grateful to Tilly Alcayna (independent consultant), Adrianna Hardaway (Mercy Corps) and Debbie Hillier (Mercy Corps) for their guidance, advice, and thoughtful comments on this research project, as well as to Daniel Hyslop (Interpeace) for his time during interviews and comments on earlier drafts.

How to cite this work

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Mercy Corps is a leading global organization powered by the belief that a better world is possible. In disaster, in hardship, in more than 40 countries around the world, we partner to put bold solutions into action — helping people triumph over adversity and build stronger communities from within. Now, and for the future.



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