# Joint MDB Methodological Principles for Assessment of Paris Agreement Alignment of New operations

## Intermediated financing

Version 1.0 June 2023

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These principles were prepared by a group of multilateral development banks (MDBs), composed of the African Development Bank (AfDB), the Asian Development Bank (ADB), the Asian Infrastructure Investment Bank (AIIB), the Council of Europe Development Bank (CEB), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), the Inter-American Development Bank Group (IDBG), the Islamic Development Bank (IsDB), the New Development Bank (NDB) and the World Bank Group (WBG).

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# Preface

The Paris Agreement and the Sustainable Development Goals (SDGs), both adopted in 2015, reflect a shared vision for sustainable development in the context of climate change, which requires scaling-up efforts to shift to a low-carbon and climate-resilient pathway while pursuing core development goals.

The Paris Agreement's stated aim is to "strengthen the global response to the threat of climate change, in the context of sustainable development and efforts to eradicate poverty," by keeping global warming "well below" 2°C above pre-industrial levels and pursuing efforts to stay below 1.5°C; fostering adaptation, resilience and low-emissions development without threatening food production; and making finance flows consistent with a pathway toward low-emissions, climate-resilient development.[1]

In 2017 and 2018 at the One Planet Summits, Multilateral Development Banks (MDBs) committed to align their financial flows with the objectives of the Paris Agreement. To ensure a consistent approach to the implementation of the Paris Alignment commitment, at the 2019 UN Secretary-General's Climate Summit, the MDBs reconfirmed their commitment to helping clients deliver on the goals of the Paris Agreement in a joint statement.[2]

To this end, the MDBs developed an approach for aligning activities with the Paris goals, with six building blocks: alignment with mitigation goals (BB1), adaptation and climate-resilient operations (BB2), accelerated contribution to the transition through climate finance (BB3), engagement and policy development support (BB4), reporting (BB5), and alignment of internal activities (BB6):published at COP24.[3]

These notes set out joint MDB methodological principles for assessment of Paris Agreement alignment, providing a common technical approach for a range of financial instruments and financing types MDBs may use, addressing both BB1 and BB2 within each. Joint MDB methodological principles have been prepared for: (i) Direct investment lending operations, (ii) Policy-based lending operations, (iii) Intermediated financing, and (iv) General corporate purpose finance. Universally aligned and universally non-aligned lists of activities were also prepared and included in a separate section.[4]

These joint MDB methodological principles will be used by the MDBs to inform and facilitate the Paris Alignment assessments of their new financing operations. They have been developed through piloting work that has been going on over the past two years and which will continue. Building on these joint MDB principles, MDBs may develop their own methodological guidance and toolkits[5] to be applied according to their internal processes and procedures to determine whether an operation is "aligned" or "not aligned" with the mitigation and adaptation goals of the Paris Agreement. MDBs will continue to work together to enable consistency and harmonization in the way the principles are applied across MDBs and update them as needed.

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[1] UNFCCC. 2015. "Paris Agreement." FCCC/CP/2015/10/Add.1. Paris: United Nations Framework Convention on Climate Change. http://unfccc.int/paris_agreement/items/9485.php. Art. 2.
[2] MDBs. 2019. "High Level MDB Statement." Issued at the UN Secretary-General's Climate Action Summit, September 22, 2019. New York: African Development Bank (AfDB), Asian Development Bank (ADB), Asian Infrastructure Investment Bank (AIIB), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Inter-American Development Bank Group (IDBG), Islamic Development Bank (IsDB), New Development Bank (NDB), and World Bank Group (WBG). https://www.iadb.org/document.cfm?id=EZSHARE-1729984378-16.
[3] Joint Declaration MDBs Alignment Approach to Paris Agreement_COP24_Final.docx (worldbank.org).
[4] The Universally Aligned List of activities includes those activities that contribute to climate action consistent with the mitigation goals of the Paris Agreement under all circumstances, and those that have no material impact on climate change, as they do not harm countries' transition to long-term low-greenhouse gas (GHG) emissions development pathways and do not lead to lock-in of carbon-intensive patterns. The Universally Non-Aligned List of activities includes those that are considered universally (regardless of context) inconsistent with countries' low-GHG emissions development pathways or incompatible with the mitigation goals of the Paris Agreement.
[5] Due to differing mandates, policies and strategies in MDBs there could be observable differences in the operationalisation of these principles, in which case the PA assessments will be carried out using the MDB's respective methodological guidance and toolkits. Some MDBs have already developed Paris alignment approaches building on the joint work of the MDBs over recent years and will in those cases take account of the latest joint MDB approaches during future updates.

# Joint MDB Methodological Principles for Assessment of Paris Alignment of Intermediated Financing

MDBs presented a high-level overview of its methodological principles for assessment of Paris Alignment for intermediated finance in November 2021. This note builds on the core principles of 'Direct Investment Lending Operations' to develop an approach for determining alignment of MDB financial flows via financial intermediaries. It provides two options to assess the PA of intermediated finance: (1) Transaction-based alignment, (2) Counterparty-based alignment.

## 1. Core Considerations

1. This joint MDB framework is designed to assess the Paris alignment of intermediated finance, including financing delivered through banks, non-banking financial institutions, leasing companies, funds, and other financial intermediaries. The framework does not apply directly to supply chain financing of real sector companies, unless done through a financial institution.

2. Assessment should be done by each MDB alone or jointly with the counterparty, and applied to new operations of the counterparty, to confirm that MDB financial flows do not undermine the climate change mitigation and resilience objectives of the Paris Agreement. It should result in activities being reported as aligned or not aligned.

3. Assessment should consider that most counterparties are broadly exposed to the economic activities and circumstances of the countries they operate in, and at the time of the MDB investment decision, there may be uncertainty or limited information on the attributes of the assets or activities to be financed from the MDB financial flows. Assessment should consider that counterparties are at varying levels of readiness and capabilities and may be subject to regulations that may affect their approach to Paris alignment.

4. Building Block 1 (BB1) is the component of the Joint MDB Assessment Framework for Paris Alignment for Direct Investment Lending Operations that assesses the alignment of investments with the mitigation objectives of the Paris Agreement. Building Block 2 (BB2) is the component that assesses alignment with the climate adaptation and resilience objectives of the Paris Agreement. The BB1 and BB2 criteria developed for direct investment lending operations have been adapted for intermediated finance, in line with the core considerations above.

5. Paris alignment of MDB financial flows via financial intermediaries may rely on counterparties' commitments for strengthening decision-making and risk management processes to be applied to assets or activities to be financed from MDB financial flows and/or assets or activities financed by the financial intermediary more broadly. Depending on the ambition and context of the counterparty, these processes may go beyond the MDB financial flows and benefit other activities of the counterparty.

6. Paris alignment of MDB financial flows via financial intermediaries may also rely on applicable regulations or supervisory expectations. To the extent that Paris alignment is not addressed by commitments or regulations, MDBs may embed Paris alignment criteria, activities, or policies in investment agreements with financial intermediaries, or in other contractual agreements (e.g., side letters). The Joint MDB approach does not prescribe requirements for any legal contracts between MDB counterparties and their sub-borrowers.

7. Each MDB is responsible to implement this framework in its respective institutional and political context, during the design, as applicable, assessment and approval of new financing operations, in conjunction with the overall implementation approaches developed by individual MDBs. Each MDB may offer technical assistance to support the Paris alignment of the counterparty so it can transition toward a low-carbon and climate-resilient pathway.

8. This joint MDB framework will be updated periodically based on learnings from MDBs.

## 2. Overview and Main Principles of the Joint Technical Framework

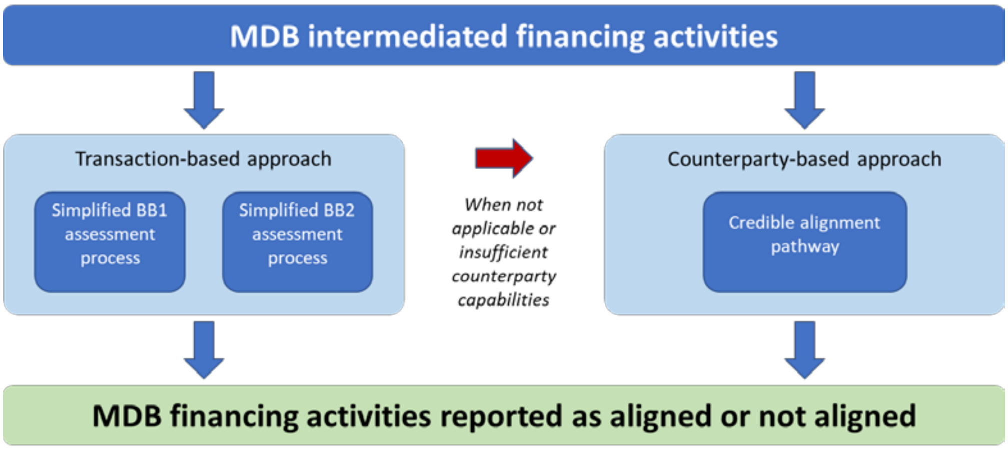
9. The framework includes two options to assess the Paris alignment of intermediated financing (see figure 1).

10. **Transaction-based alignment**, based on an analysis of use of proceeds (BB1), plus analysis of risk and materiality (BB2). BB1 alignment of the eligible use of proceeds can be assessed through the simplified BB1 assessment process described below and BB2 alignment, based on risk and materiality, can be assessed through the simplified BB2 assessment process described below.

11. **Counterparty-based alignment**, based on the analysis of a counterparty's credible Paris alignment pathway. This can be done through the counterparty-based approach described below.

12. If the MDB investment involves financing specific, defined activities or asset types, either option to demonstrate Paris alignment may be applicable and sufficient. Otherwise, only the counterparty-based option applies. MDBs may decide to combine the two options, based on the context of the counterparty and other factors. As the capabilities of the counterparty improve, the counterparty-based option may, over time, supersede the transaction-based option.

*Figure 1. Two approaches to assess the Paris alignment of intermediated financing*




## 3. Transaction-based approach

<u>BB1 Principles</u>

13. The eligible use of proceeds, as defined by the MDB, should exclude any investments/activities that is considered universally not-aligned with the Paris Agreement goals.

14. The eligible use of proceeds, as defined by the MDB, should be limited to aligned activities (see Step 2). Otherwise, if the eligible use of proceeds, as defined by the MDB, includes activities that may represent a potential material risk of undermining the mitigation objectives of the Paris Agreement (e.g. high risk of carbon lock-in) then the counterparty shall commit to gradually include an adapted BB1 assessment (adapted from the Joint MDB Assessment Framework for Paris Alignment for Direct Investment Lending Operations, noting core considerations for the assessment of Paris alignment) for relevant project types within its transition risk management systems and processes (e.g., Environmental and Social Management System (ESMS), risk management) during the tenor of the MDB investment.

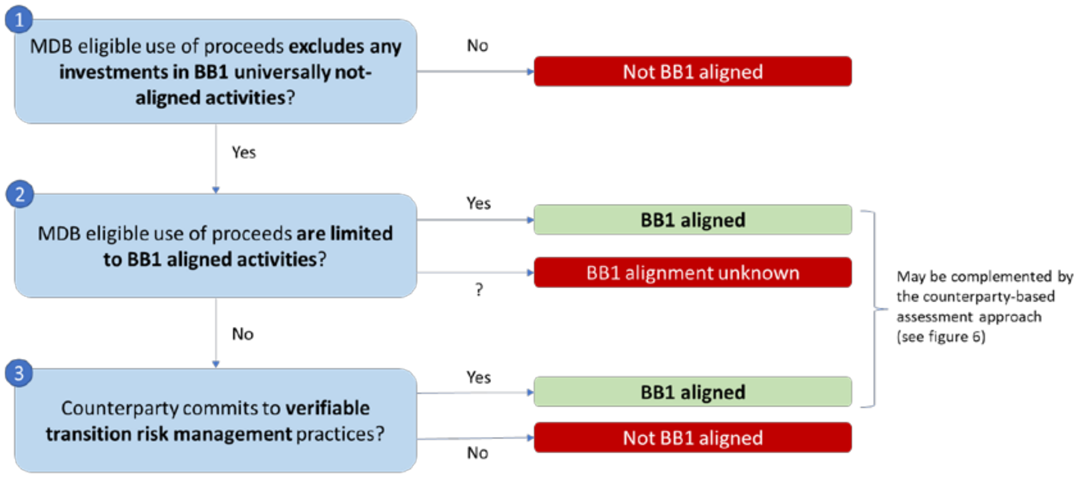
15. If it is not possible to implement this simplified BB1 assessment, then the counterparty-based approach should be used or a combination of the two approaches may be needed.

16. Aligned means high-risk activities are excluded or are screened, and the risks addressed/ reasonably managed at the time of the investment commitment or before the end of the investment tenor, OR the counterparty commits to implement or improve their transition-related risk management.

17. Not-aligned means high-risk activities are not excluded or not screened, or the risks are not addressed/reasonably managed AND the counterparty is not willing to commit to implement or improve their transition-related risk management before the end of the investment tenor.

<u>Simplified BB1 Assessment Steps</u>

*Figure 2. Decision making approach for determining alignment with the Paris Agreement's mitigation goals (BB1)*




i. **Step 1 - Exclusion of BB1 Universally Not-aligned Activities**

18. The first step of the transaction-based assessment should ensure that the MDB eligible use of proceeds excludes investments in activities on the universally not-aligned list as defined in the Joint MDB Assessment Framework for Paris Alignment for Direct Investment Lending Operations. This Joint MDB approach uses the list of not-aligned activities but may update the list periodically as needed.

ii. **Step 2 – Check for BB1 Aligned Activities**

19. BB1-aligned activities still need to demonstrate that they do not have a material impact on climate change, do not lead to the lock-in of carbon-intensive patterns that would be inconsistent with the mitigation objectives of the Paris Agreement, and are not inconsistent with countries' transition to low-greenhouse gas (GHG) development pathways and countries' climate policies. Such activities may include, but are not limited to:
    - Financial instruments where the transaction includes a commitment to deliver climate change mitigation benefits (e.g., financing instruments that target eligible green assets).
    - Financing of activities and assets included in the BB1 universally aligned list developed for direct investment lending operations (e.g., health, education, and financial sector service providers, such as financial technologies, mortgages, and leasing).
    - Financing of activities and assets that individually represent small volumes and diversified across industries, including SME finance that applies low/no materiality thresholds to ensure that exposure to value chains of BB1 not-aligned activities is marginal or zero; capital market transactions that aggregate retail; and refinancing Non-Performing Loans portfolios that focus on retail or SMEs—provided that the sub-borrowers have marginal or no exposure to BB1 not-aligned activities within the financed portfolio or pipeline.

- Low/no materiality thresholds based on short financing tenor (e.g., less than one year of exposure) or type of financial product (guarantees, trade and supply chain finance working capital, financing of commodities); where short-term financing may support gaseous and liquid fossil fuel supply the counterparty should commit to gradually reduce the exposure of the financed portfolio over time to marginal or near zero.

### iii. Step 3 – Risk Management Measures

20. If the MDB use of eligible proceeds includes investments that are not on the list of BB1 aligned activities and may lead to potential carbon lock-in and transition risks, then the MDB should demonstrate that at the time of investment either (i) the risks within the eligible use of proceeds have been addressed or reasonably managed, or (ii) the counterparty commits to verifiable management practices to ensure that carbon lock-in and transition risks are managed before the end of the investment tenor, as applicable.

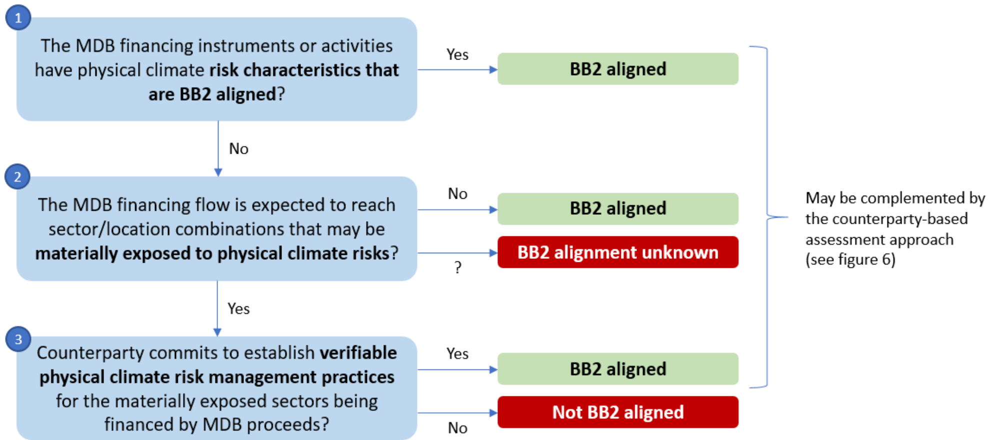
<u>BB2 Principles</u>

21. MDBs will engage with counterparties to help build readiness and capacity for physical climate risk management where appropriate.

22. Where applicable regulations and/or supervisory guidelines provide a relevant context and/or guidance for managing physical climate risk, MDBs' engagement on physical climate risk management will reflect them and, where appropriate, build on them. MDBs may engage with regulators/supervisors to support the emergence of an enabling environment and level the playing field on physical climate risk management and the adoption of associated good practices.

23. Aligned means high-risk projects are excluded or are screened and the risks addressed/ reasonably managed at the time of the investment commitment, OR the counterparty has committed to transitioning to verifiable physical climate risk management practices before the end of the investment tenor, as applicable.

*Figure 3. Decision making approach for determining alignment with the Paris Agreement's climate change adaptation and resilience goals.*




24. Not aligned means high-risk projects are not excluded or not screened, or the risks are not addressed/reasonably managed AND the counterparty is not willing to commit to transitioning to better climate-related risk management.

25. BB2 assessment for financial intermediary investments takes an approach in which MDBs support counterparties to implement steps reflecting a risk-based approach and the principle of materiality, as illustrated in the figure 3.

#### i. Step 1 – Risk Characteristics of the MDB Financing Flows

26. If a significant proportion[6] of the MDB financing flow through the counterparty is not expected to reach subprojects or sub-borrowers exposed to material physical climate risks, then this leads to automatic BB2 alignment.

27. BB2-**aligned financing instruments or activities** are those that do not have a long exposure window to physical climate risk or are with entities that have in place processes and procedures that correspond to adequate physical climate risk management or target assets in which any physical climate risks are likely to be widely dispersed across a broad range of sectors, industries, or locations. Such activities include, but are not limited to:
    - Financing activities that do not have a large exposure window to climate risk (e.g., working capital, mobile assets with limited exposure to physical climate risk) and/or do not contravene stated country national adaptation policies.
    - Financing instruments or activities with entities that have in place processes and procedures that correspond to adequate physical climate risk management, or that are already implementing a Paris alignment pathway (e.g., because of engagement on another transaction) or are otherwise do not contravene the adaptation objectives of the Paris Agreement, such as entities that are not sensitive or exposed to material climate risks (e.g., financial technologies) as defined by the respective MDBs.
    - Financial instruments and targeted financed assets in which any physical climate risks are likely to be widely dispersed across a broad range of sectors, industries, or locations (e.g., diversified SME financing, trade and supply chain finance, mortgages not concentrated in specific geographic areas) and are therefore unlikely to present a material risk of undermining the adaptation objectives of the Paris Agreement.

28. If a significant proportion of financed activities or instruments used do not have the characteristics above, then MDBs should implement Step 2.

#### ii. Step 2 – Risk Expectations of the MDB Financing Flows

29. The MDB will engage with the counterparty to collect additional information on the potential risk exposure and further assess whether a significant proportion of the intermediated financing flow is expected to reach subprojects or sub-borrowers in sector/location combinations that may be materially exposed to physical climate risks. If the answer to the assessment is no, then the operation is aligned under BB2. If the answer is yes or cannot be reasonably established, then the MDB will support the counterparty to be prepared to gradually implement Step 3, focusing on the sectors financed by MDB proceeds.

#### iii. Step 3 – Risk Management of the MDB Financing Flows

30. If a significant proportion of the intermediated financing flow is expected to reach subprojects in sector/location combinations exposed to material physical climate risks, the counterparty should commit to establishing verifiable physical climate risk management practices, specifically focusing on any materially exposed sector(s) being financed.

31. If it is not possible to implement this simplified BB2 assessment process, the counterparty-based approach should be used. As counterparties' capabilities improve, the counterparty-based approach may supersede the targeted use of proceeds approach. MDBs or other entities could support any necessary improvement in physical climate risk management.

## 4. Counterparty-based Approach

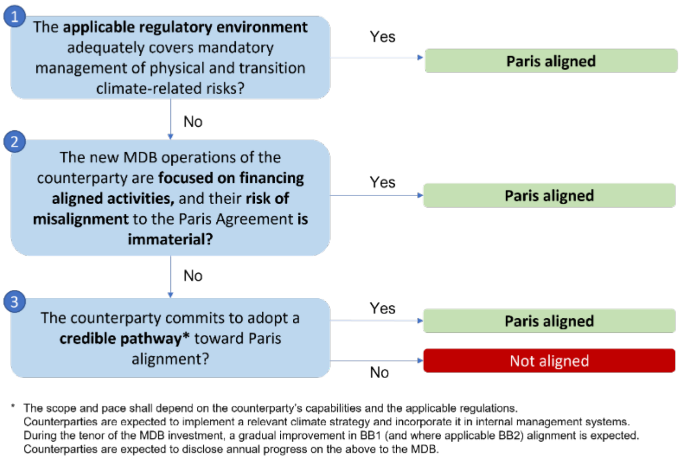
32. The counterparty-based approach is particularly relevant for general purpose financing, which could include a variety of types of financial intermediation (e.g., equity investments, guarantees, capital optimization, liquidity financing, as well as investment in equity funds). It may need to be applied together with the transaction-based approach.

[6] Each MDB may use its risk management approach to determine the threshold for a significant portion.

33. In particular, for equity funds, the MDB should support the funds to incorporate BB1 and BB2 risk considerations in their risk management systems (e.g., ESMS). If the risk cannot be mitigated, the MDB may opt out of investing in high-risk projects under a fund.

34. Based on the context of each counterparty, each MDB will determine the information to be used for assessment of Paris alignment. This may include, but not be limited to, existing portfolios, pipeline, or ex-ante projections.

*Figure 4. Decision making approach for determining alignment with the Paris Agreement's goals (BB1 and BB2) using counterparty-based assessment.*




## Requirements

35. If the applicable regulatory environment adequately[7] covers mandatory management of physical and transition climate-related risks (i.e., BB1 and BB2), then the MDB investment flow through the financial intermediary will be automatically aligned.

36. Otherwise, if the MDB determines that the counterparty's new operations focus on financing BB1 aligned activities (see Step 2 of transaction-based approach), and the risk of misalignment with the Paris Agreement is immaterial, all MDB financing for the counterparty will be deemed as aligned.

37. Otherwise, Paris alignment can be achieved if the counterparty commits to adopt a credible pathway toward Paris alignment.

38. The scope and the pace of the selected pathway and disclosures will depend on the counterparty's capabilities and the applicable regulations, and each MDB will define the specific conditions and features of the acceptable counterparty pathways. Specifically, the counterparties are expected to implement a relevant climate strategy and incorporate it in internal management systems. During the tenor of the MDB investment, this is expected to progressively move toward BB1 alignment of the counterparty's new operations (e.g., by gradually replacing not-aligned activities with aligned activities).

39. Financial intermediaries that are likelier to be exposed to physical climate risks, should commit to a gradual improvement of BB2 alignment for the material physical climate risks of the counterparty's new operations. MDBs may provide training, access to tools and platforms for physical climate risk screening, etc. Furthermore, the counterparties are expected to commit to disclosing to the MDB, unless applicable regulations do not allow for it, annual progress on the above.

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[7] The MDBs aim to work together and with others to identify how applicable regulatory environments would adequately cover management of physical and transition climate-related risks (i.e., BB1 and BB2).

40. Timelines for progress may vary depending on the counterparty's readiness and capacity. Pathways may include a combination of risk and opportunity commitments, including commitments driven by the regulatory environment in which the financial intermediary operates, specific and measurable low-carbon targets, and/or other voluntary commitments.