BETTER GUARANTEES, BETTER FINANCE

INPUT PAPER TO THE IMPACT TASKFORCE PREPARED BY THE BLENDED FINANCE TASKFORCE HOSTED BY SYSTEMIQ

DECEMBER 2023

Bigger and better guarantees help unlock $2.4 trillion a year in emerging markets and developing economies for climate action. To narrow the climate finance funding gap, leaders should commit to scaling existing guarantee products and creating new green guarantee facilities which can mobilise private capital in developing countries to accelerate the transition to net zero. A smarter use of public capital in guarantee products which address credit and currency risks, are streamlined to reduce transaction costs and which are structurally linked to project development can help meet the 5x scale up in climate finance which is needed in emerging markets for sustainable and inclusive growth.

BETTER FINANCE

As the cost of climate change rapidly increases and the gap between pledges and action widens, trust between North and South is at an all-time low. The most recent studies show that global warming has already reached 1.2C above pre-industrial levels – surpassing a “safe and just” threshold for humans. The window to keep sight of limiting global warming to 1.5C is quickly closing. As always, this impacts everyone, but disproportionately affects the most vulnerable.

Finance is one of the most important levers to tackle this challenge. About $2.4 trillion per year is needed in Emerging Markets and Developing Economies excluding China (EMDEs) for climate action – requiring a fivefold increase from current levels of investment.

The good news is that much of the $2.4 trillion can come from private sector investment into opportunities that are – or soon will be – commercially attractive. “Technology tipping points” like cheap renewable energy are making low-carbon and nature-positive solutions investable – with the cost of green technologies dropping lower than their fossil-based alternatives.

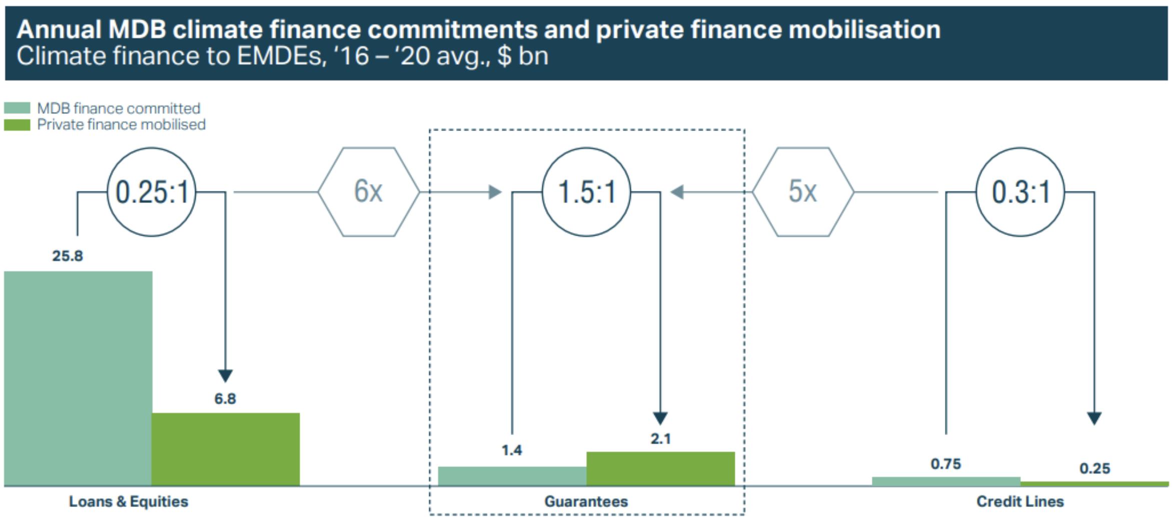
Even so, capital is not flowing fast enough or at scale to meet this need or capture these new opportunities – often because of a high perception of country risk and a lack of pipeline in the places where these investments are needed. This results in an inflated cost of capital and currency risk in EMDEs.

BETTER GUARANTEES

Scaling climate finance in EMDEs by 5x current investment levels will require a smarter use of public capital to tackle some of these risks and bring down the cost of capital to unlock private investment. Today, less than 30 cents of private capital is unlocked (mobilised) by a dollar of public climate finance.

Increasing these mobilisation ratios (with appropriate safeguards) will be a critical lever to unlock capital and ensure the financial system is fit-for-purpose to capture emerging green investment opportunities in EMDEs. Guarantees can help. Our new report highlights that guarantees can mobilise at least 5 times the average mobilisation ratio, yet guarantees represent less than 5% of climate finance instruments.

Mobilisation ratios by financial instruments



Sources MDB joint climate finance reports[18], OECD[19]
Note Private finance mobilised figures represent ADB, AfDB, IADB, EIB, EBRD & WB (not AIIB nor ISDB). Average mobilisation ratios are calculated by dividing average private finance mobilised by average total public commitments by instrument between 2016-2020. Please find more details on methodology and limitations in Technical Annex A

The Blended Finance Taskforce report: "**Better Guarantees, Better Finance**" calls for more catalytic use of public capital to scale existing guarantee products and create new green guarantee facilities to reduce the cost of capital by mitigating the perception of country/currency risk. It calls for guarantees to have a structural link to pipeline development and to be applied for energy and infrastructure as well as investments in other sectors like food and nature.

Guarantees can vary in many ways, notably the risk they cover and the financing agreement or institution they are applied to.

In the context of development finance, the three types of guarantees most often used are:

1. **Credit guarantees** protect the lender from losses in the event of non- or late payment of debt obligations. These are often referred to as credit enhancement products. Credit guarantees are the most common type of guarantee and are issued by guarantors like GuarantCo – a PIDG company, the United States Development Finance Corporation (US DFC), as well as export credit agencies and several MDBs

2. **Risk guarantees** or political risk insurance protect investors against pre-defined political risks such as expropriation, currency inconvertibility, breach of contract, war and civil disturbance. The World Bank's Multilateral Investment Guarantee Agency (MIGA) is a main issuer of political risk guarantees, together with export credit agencies.

3. **Currency guarantees** protect the lender from losses due to fluctuations in exchange rates. These typically come in the form of 'hedges', which are forward agreements on a certain exchange rate between two parties and (unlike guarantees) tradable products on liquid markets. The need to tackle currency risk and the lack of products in the market led to the launch of The Currency Exchange Fund (TCX) by donors to offer solutions to manage currency risk in developing and frontier markets. Currency risk management mechanisms are becoming a higher priority in the broader development finance system reform agenda as they are key to mobilising international capital. At present, currency hedges for emerging markets and developing economies are often expensive as they incorporate high (perceived) macroeconomic risks[32].

Other types of guarantees relevant in the context of scaling investments are liquidity extension guarantees, payment guarantees and performance guarantees – see the glossary for definitions.

Analysis in the report shows that a $1bn grant could unlock $30bn investment in climate action in emerging markets and have a significant market-making impact. The report specifically calls on leaders to:

1. Include a climate mobilisation mandate for public capital (with appropriate safeguards
2. Scale and accelerate access to guarantees at existing institutions with proven track record
3. Develop new global green guarantee platforms targeting higher mobilisation, lower transaction costs and a structural link to project preparation

Grant funding could come from countries with significant oil & gas windfall profits like Norway as has been advocated by the Blended Finance Taskforce, the Nobel Foundation, and former UK Prime Minister Gordon Brown. The ITF will reinforce this call to action as part of using public capital more catalytically to unlock private investment in climate action and the SDGs.