

Scoping Note on Green Guarantees

The **Green Guarantee Group (GGG)** has been designed as an initiative seeking to **produce solutions-oriented recommendations for decision-makers and a way forward to significantly increase the use of green guarantees.**

It was announced at COP28 by the Federal Foreign Office (AA) and the Federal Ministry for Economic Affairs and Climate Action (BMWK) of the German government. Since March 2024, it has gathered experts from various backgrounds (governments, Multilateral Development Banks (MDBs), Development Finance Institutions (DFIs) and Development Agencies, Think Tanks, private sector, academia, civil society) to exchange ideas on the topic of green guarantees.

Considering the high potential of green guarantees, the growing knowledge base and the strong need for action, AA and BMWK decided to significantly scale-up the GGG initiative to pave the way for concrete action by COP30. This includes i.e.:

- **strengthening political momentum and high-level engagement**, including milestone events led by the GGG's Chair Prof. Röller, to broaden and deepen the network of supporters and experts accompanied by outreach activities.
- building on the foundational work and knowledge provided by the Climate Policy Initiative, a leading think tank, along with insights from GGG's Technical Expert Group meetings, to **develop and implement actionable recommendations** on green guarantees in collaboration with practitioners, policymakers, and researchers.
- **identifying several “lighthouse projects”** where the recommendations of the GGG could be put into practice.
- potentially, after COP30, considering the creation of a **“project pipeline”** to address the asymmetry of information between demand and supply of projects.

This paper has benefitted from the work by CPI (CPI, 2024. Landscape of Guarantees for Climate Finance in EMDEs) and forthcoming work on green guarantees.

The views expressed in the scoping paper do not necessarily reflect the official positions of the German Federal Government and are the results of the GGG Technical Expert Meetings and events held thus far.

Context

There is an urgent need to secure additional, predictable, and adequate financial resources at scale to support the green transition. Based on the COP 28 Declaration on a Global Climate Finance Framework, around USD 5 trillion are needed annually for the global green transformation. According to the High-Level Expert Group on Climate Finance (IHLEG) USD 2.4 trillion per year (excluding China) will be needed from 2022 onwards, particularly for Emerging Markets and Developing Economies (EMDEs) to put their economies on a resilient, low-carbon and nature-positive path. However, more than 90% of green investments still go to developed economies.

In this context, guarantees are an important, but under-utilised tool for mobilising private capital for green investments. The purpose of this paper is to provide an overview of the challenges that will be addressed by the GGG (<https://www.climatepolicyinitiative.org/green-guarantee-group/>). In line with its mandate, the GGG will publish its final recommendation by COP30 in 2025.

Existing challenges/current obstacles

Several challenges are preventing the full potential of green guarantees from being realised. Despite their importance and contribution to sustainable development, many stakeholders encounter obstacles that hinder full-fledged use and scale-up of this instrument.

Previous analysis on guarantees by CPI has shown that **most gaps can be identified in the following general areas**: the **geographical coverage** (guarantees tend to be concentrated on the African continent and targeted at middle and high-income countries), the **climate coverage** of guarantees is lacking for climate-related projects, **the type of instruments guaranteed** (predominance of debt guarantees and only few investment equity guarantees), the **risk covered** (most guarantees focus on the commercial risk rather than the political and currency risks which are considered as more complex and costly), and the **currency** (lack of guarantee companies issuing credit guarantees in local currency).

Based on this landscape analysis and the GGG's Technical Expert Meetings (TEM), this scoping note identifies **some key policy areas** critical to the effective uptake of green guarantees that the GGG will explore further with the goal of proposing some implementable policy recommendations by COP 30 in 2025. We already welcome comments at this stage. These policy areas are grouped into the following two areas:

A. Data, capacity gaps and complexity

1. Data availability/bridging the data gaps

- The lack of data/data gaps is a significant barrier to increasing the use and efficiency of guarantees for both guarantee providers and borrowers in EMDEs. The **limited availability, sharing, and transparency** of data on guarantees' performance, risk factors, and market conditions among institutions creates challenges related to pricing. Risks and returns cannot be adequately assessed without comprehensive and consistent data sets.

- Data of guarantees also have a public good nature and should therefore be publicly available. **The current lack of publicly available data** limits analysis and research on guarantee products (incl. risk coverage) for e.g., ECAs, DFIs, FIs.

2. Capacity and knowledge at local level

- **Capacity-building (including transfer of knowledge and skills) already exists and is provided in particular by Development Financial Institutions (DFIs).** However, in their current form, they may be insufficient or ineffective to scale up the use of guarantees (e.g. due to a non-tailored approach, lack of staff/capacities within the DFIs, lack of resources...).
- **Limited capacity and knowledge on guarantees**, as well as insufficient pipelines of bankable projects are considered as key impediments to the deployment of guarantees in EMDEs and more generally to access climate finance.
- **On the supply side, some guarantee actors also have limited technical capacity and expertise to support the provision of guarantees.**

3. Complexity in setting up guarantee mechanisms as a source of transaction costs

- Guarantees **add complexity to transaction design**. Multiple and misaligned **reporting requirements** across guarantee products increase the reporting burden on borrowers vis-à-vis DFIs and MDBs and discourage the use of guarantees. In some cases, uneven **access to information** also makes it difficult for borrowers to understand the breadth of guarantees products available to them (e.g. depending on the size and location of the company's headquarters).
- **A lack of coordination** between members of the guarantees ecosystem sometimes leaves borrowers with sub-optimal terms. In addition, it is **difficult** for development practitioners **to link guarantees to impact, and guarantees do not count as Official Development Assistance (ODA)** potentially limiting partnerships with international donor organizations.

B. Areas requiring policy adjustments

1. Risk analysis/perception and mispricing

- **Proper risk analysis and pricing** are instrumental in ensuring effective guarantee products are available at an appropriate and affordable price, as high guarantee costs often **limit accessibility**. **As highlighted in section A, data gaps and high transaction costs add an extra "cost layer" making guarantee instruments more expensive and uncompetitive in terms of expected returns.** In the context of these operational barriers, investors tend to "over-price" the perceived risk of a guarantee instrument, without paying due attention to the idiosyncrasies of a specific country or project / portfolio. This leads to an excessive risk premium which, in turn, limits the use of guarantees.
- **The pricing of guarantees is to some extent related to the credit rating of the issuer as determined by credit rating agencies.** The sovereign rating of a

country serves as a benchmark on top of which investors will charge a risk premium. Credit rating agencies also face the same operational challenges highlighted in section A, but particular attention should also be paid to their own methodologies to identify areas for improvement and ensure a more accurate credit risk assessment.

- Guarantees must **cover all costs assumed by the guarantor and counter-guarantor**, including the cost of potential default/ cost of risk, the cost of capital and administrative costs. A challenge in this context is to look at the whole value chain, e.g. Energy Performance Contracts (EPCs), and **see where de-risking can be applied and be the most effective**.

2. Legal framework and overall investment environment

- **Investing in green projects in EMDEs requires an overall favourable legal and financial environment** including investor protection, insolvency law, due process, a stable creditor hierarchy, a well-functioning judicial system, tax system, accounting and disclosure framework, the rule of law...These elements are reflected in investors' risk analysis as operational risk, political risk, foreign exchange risk or liquidity risk and any perceived flaw in one of those dimensions leads to a risk premium.
- **Besides, there may also be some sector-specific regulatory impediments for example in financial regulation or accounting which may discourage investors.** Also, EMDEs tend to be much more exposed to climate-related risks (especially physical risks), while coverage for climate-related losses is very limited (the so called "insurance gap").
- **Regulatory divergences between the donor and host countries also pose further challenges.** Lack of guidance or transparency on climate-related standards (e.g. taxonomy or ESG disclosure), inconsistent implementation of global standards in EMDEs and donor jurisdictions could also be a barrier.
- The nature of the challenges and issues also varies according to the type of guarantee: sovereign guarantees, MDBs/DFIs guarantees and third-party guarantees (private guarantors), which would require further research/clarifications.

3. Development of local capital markets

- **In general, the local cost of capital and risk premium are lower in countries with a deep and liquid equity and debt markets in local currency.** Foreign exchange risk is one the most expensive risks to be hedge for projects in EMDEs, and managing currency risk/issues remains a key driver for the increased use of guarantees. The development of guarantee instruments is therefore linked to the broader reform agenda and structural policy changes for example under the IMF article 4 exercise or Financial Sector Assessment Program (FSAP).
- **The role of Public National Development Banks is an important point to consider in the development of local markets.** They can help to reduce some of the factors that contribute to the private sector's perception of high risk or help to increase the viability of projects by providing longer-term financing in local currency.

At present, however, they don't have the size, resources, capacity and concrete mandate to contribute to scaling up the use of green guarantees.

- Issuance of guarantees in local currency to mobilise private debt in domestic markets is an essential step in unlocking the potential of domestic capital markets to attract further climate finance and provide additionality.

4. Resource mobilization for guarantees

- Guarantees should be a “crowding-in” instrument to mobilise some additional private capital. The perceived risk profile of some EMDEs countries and the perceived potential risk of default (see sections A and B) may have encouraged public authorities and DFIs to shift guarantees towards the least risky countries and projects, thereby crowding out some private investments and not bringing in additional resources. It is therefore useful to examine some existing mechanisms **to identify some best practices.**

5. Better coordination within the public sector, and between the public and private sector

- **Lack of coordination within the public sector at all levels of the guarantees deployment process often leads to increased challenges and ultimately costs.** Divergence amongst MDBs / DFIs on their standards, requirements, targets and policies for green projects can lead to a lack of coordination within the MDBs / DFIs themselves and between the multilateral/regional and local levels. On the ground, the work from MDBs / DFIs may overlap and in some cases compete with that of the private sector. A clear definition of roles and mandates is essential to ensure the smooth delivery of guarantees.
- **Coordination between the public and the private sector in particular financial institutions** (banks, investment funds, insurance companies) is also crucial. Throughout the life cycle of projects, different financial institutions may take the lead and play a specific role: equity or infrastructure funds in the early stages, banking institutions to provide for foreign exchange hedging, insurance companies.
- **One best practice example is the new World Bank Group Guarantee Platform hosted by MIGA, which serves as a one-stop-shop for all WBG guarantee business.** Through this one-stop-shop approach, MIGA is accelerating and simplifying collaboration among the various stakeholders to increase efficiency and joint investments across institutions.

6. Geographical and climate coverage: an increased focus on EMDE climate investments

- Existing gaps in the geographical coverage of guarantees include Asia and Latin America as well as low-income countries. Guarantee products have tended to focus on middle and high-income countries and have increasingly been used on the African continent. The GGG will work to identify, on the basis of some case studies, will work to identify the requirements expanding guarantees to new markets, considering the specificities and different risk profile of low-income countries.