

A Climate Finance Initiative at COP30: A Multisovereign Guarantee Mechanism for Accelerated Climate Investments in Developing Countries

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The challenge: scaling up capital flows in an adverse global context

- The pressing challenge now is to scale up climate investments by a factor of three to four worldwide in the coming decades (IPCC SYR 2023). The design of a Baku-to-Belem \$1.3 trillion Roadmap for the coming COP30 is thus critical since the agreed financing commitment in Baku was only \$0.3 trillion.
- However, an effective and equitable cross-border climate financing mechanism faces an adverse context: narrowing fiscal spaces for public climate finance in many developed countries, some countries' exits from the Paris Climate Agreement, financial market risk aversion, and developing countries' preference for non-debt instruments (given their debt stress).
- Overcoming these multiple challenges will require a careful design of innovative financing instruments at scale backed by strong North-South partnerships—to reduce financing risks and mobilize higher global private financing, increase the leverage of public funds, and reduce the high costs of capital for low-carbon transitions facing many developing countries (where macroeconomic creditworthiness concerns often magnify individual project risks).
- Public sovereign guarantees are a natural instrument that, with careful design, can play a critical fulcrum role in overcoming these obstacles and scaling up private capital while supporting accelerated climate action in low and middle-income countries—with much lower effective costs for both developed and developing countries.

A fulcrum for scaling up climate and development finance

- A supporting institutional architecture for multi-sovereign guarantees (MSGA) established by willing official partners is essential to foster much greater use of such guarantee instruments for climate projects and programs—and, as will be explained, transform them into 'non-debt' instruments by changing the terms of the counter-party agreements.
- Expanded public sovereign guarantees through an MSGA supported by a North-South coalition of sovereign partners will have a very high multiplier impact (up to 15 times the leverage of \$1 in public capital to induce \$15 in private investment) and probability of success in various settings. However, this demands a careful design of national policy settings, strict rules for project selection, and careful calibration of guarantees to lend greater confidence to financial actors and secure projects 'climate and development additionality.'
- The expected outcomes of MSGA would be to expand developing countries' access to global capital markets at much lower cost and with longer maturities with the backing of highly credit-worthy — AAA-AA — guarantors. High-credit sovereigns can provide guarantees at a far lower price than private guarantors, as they do not need to set aside large capital provisions to reassure financiers about their capacity. A starting committed public capital stock guarantee pool of \$50 billion at COP-30

may trigger some \$0.8 trillion in real climate financing investments—rolling over every five years as guarantees would no longer be required as these projects become operational.

- The use of public guarantee instruments in mitigation (and some large-scale mitigation-cum-adaptation projects) would also be a triple ‘win-win-win’ by freeing up substantial public resources towards adaptation and loss and damage needs, thereby aligning ambitious climate action with the poverty alleviation imperative and the overarching objective of equitable access to sustainable development (Cancun COP 16). In addition, an MSGA can enhance the possibility of increased adaptation grant funding by linking them to projects with public guarantees while increasing the likelihood of establishing cooperative taxes to directly fund adaptation grants (from a share of taxes on high-net-worth incomes, maritime trade, aviation, digital industry, and financial transactions).

Designing the MSGA: Practical Elements of Operational Cooperation

- We propose to design the MSGA not as a new funding window but as a platform facilitating diverse cooperative arrangements. Below, we establish the principles to be respected when using them to launch a rejuvenated circle of trust between the North and the South, fuelled by the tangible social and economic benefits the expanded climate investments would provide to all parties.

- We present the elements of its governance and management structure as an open membership architecture, starting with a small group of willing partners to initiate a prototype MSGA and expanding over time to include new members.

- We suggest that COP 30 could launch a ‘**Design Lab**’ to determine its operational parameters, including the procedures and methods for the project selection and the calibration of guarantees, and a **high-powered political task force** to decide on its location and political governance arrangements.

This proposal for COP30 is backed by a text for the T20¹ written by a group of scientists working together for years on climate and development finance including within the IPCC. This group was joined by Kainuma M. with whom many of us collaborate in the context of the LCS-Rnet, Grubb M who published a convergent paper for T20 <https://discovery.ucl.ac.uk/id/eprint/10196886/> and Sokona Y who is engaged in the same reflections within the African SESA www.aisesa.org

Aware of the risk of not doing justice to the originality of the contribution of the many scholars and groups, formal or informal, pursuing the same objective we preferred to write this text in a non-academic way, without quotation. Extensive literature can be found in chapter 15 of the WGIII of the 6th IPCC-AR and in a joint report of IPCC experts for the 1°5 C special report and of the GCF <https://www.greenclimate.fund/scaling-up-climate-finance>. We expect to join our efforts with other initiatives to facilitate, in the current adverse context, the success of COP 30.

¹ Hourcade, J.C.; Dasgupta, D.; De Coninck, H.; Glemarec, Y.; La Rovere, E. L.; Vallejo, L.; Murasawa, L.; Schneider, M. N.; Winkler, H.; “Towards a multi-sovereign guarantees mechanism for low carbon investments and climate resilience in developing countries”, T20 Brasil Mid-Term Conference Let’s rethink the world, June 2024. <https://www.t20brasil.org/en/commentaries>

Introduction- Bridging the climate investment deficit due to a chicken and egg mechanism

The climate mitigation investment deficit is an extreme case of the ‘microeconomic infrastructure paradox’ of unfunded projects despite high real returns of 4% to 8% during periods of low interest rates. At the roots of this paradox lies the time profile of investments with high upfront capital expenditure (CAPEX) and long pay-back periods. This problem is compounded for climate investments by the recourse to less mature technical options and less well-established organizational networks.

This microeconomic mechanism is magnified by macro-financial parameters that both narrow the fiscal space for government support and increase the risk perception of cross-border investments, starting with currency risks. This makes capital costs much higher, sometimes close to usurious levels, in most developing countries especially those in debt distress currency risks. This is the reason why COP 28 and COP 29 have insisted on the importance of capital flows generated by devices as close as possible as a non-debt instrument: any new loan, even funded at a low interest rate and even with important long term economic and social returns, starts being reported as a debt on the public balance sheet of the country and contributes to degrade its creditworthiness.

Because the scaling-up of grants is limited by the narrowing fiscal space of potential donor countries, the challenge is thus to break a chicken-and-egg mechanism that limits both the demand for funding climate initiatives and the supply of private funds by risk-averse financial intermediaries. Many climate initiatives are indeed deterred up-front by varied risks in the bidding and development phases when project initiators commit equity financing (uncertain permitting processes and pre-funding from credible partners) and remain high in the construction with potential bad surprises on equipment costs and performance. Such up-front risks combine with market uncertainty, especially in the case of projects in unfamiliar geographies, uncertain governance landscapes, and weak project preparation expertise.

Why public guarantees?

There is an increasing recognition that, in the context of narrowing fiscal space for governments to directly finance climate action, breaking this mechanism can be made by an **‘increased use of public guarantees to reduce risks and leverage private flows at lower cost’** (IPCC, SYR 2023 C.7.3). A public guarantee covers indeed the risk of loss for a lender supporting a project in the event of payment default. It does so for a broad range of risks and, contrary to insurance, does it up-front. Project initiators are then less deterred from risking their capital if, in case of ‘bad news’, they are released from paying a significant part of the interest on loans². For public treasuries, guarantees have the advantage over subsidies in that they receive taxes from successful projects and spend public money only if the borrower defaults.

Public guarantees are not a miracle device and should not be conceived independently from the wide array of the existing climate policy packages whose role is well understood but fail to hedge sufficiently against the up-front risk pricing ‘waterfall’. Carbon prices enhance the discounted value of low-carbon

² They may even hope resell their capital, modulo a discount to private and public investors

options but the penalty on high-carbon options occurs too late in the project cycle for the initiators and potential lenders. Non-price instruments (norms, standards, institutional regulations) address risks systemically but have long lags in establishing sufficient momentum. All kinds of financial support create a resistance of vested interests to their phasing out as the market matures, posing a problem for managers of public accounts.

Public guarantees' role is to maximize the effectiveness of climate policies by tackling directly the up-front risks, enhancing the investment risk-weighted profitability of climate investments by maximizing the leverage of public funds, and minimizing the risks of defaults, hence the call on funds.

LIMITS TO THE EFFICACY AND EXPANSION OF PUBLIC GUARANTEES?

Although guarantees leveraged 26% of all mobilized private finance between 2018-2020 they have played so far a very limited role in cross-border financing to developing countries other than China. This underutilization reflects both demand and supply constraints.

Demand for guarantees is influenced by the amount of savings that a borrower can obtain using them relative to the cost of unguaranteed debt. The higher the perceived risks by the lenders, the higher the potential for reducing the interest rates by insulating it from the investor's performance, default, or bankruptcy. The lender in turn appraises the credit risk of the project on the rating of the guarantor rather than the rating of the borrower. Low reductions of interest rates and high guarantee fees thus cause a low demand for guarantees.

The supply of guarantees is driven by the guarantor's view of the actual credit risk of the borrower. A guarantor might provide a low-cost guarantee to a borrower if it assesses that capital markets overestimate actual risks. This is the case for good-quality projects in countries with unfavorable macroeconomic conditions. For the guarantor, the cost of guarantees depends on the size of financial provisions to be set aside as loss reserves and cash collaterals. To reduce expected credit default losses and required fees, guarantors usually negotiate a recourse contract with the borrower and require a counter-indemnity agreement to recover the payment if necessary.

Guarantees are powerful but complex instruments but can be very expensive because of their origination costs, their management costs, their paid-in capital requirements, and the costs of provisioning for expected indemnities in case of default (the callable capital). Their very prudent use (4.4% of their total financing till recently) by MDBs including MIGA, and climate funds such as GCF comes from their charters which impose to set aside 100% of the face value of guaranteed amounts on their capital, and further require counter-indemnities by host governments, to maintain their AAA credit ratings in institutional markets.

Scaling-up guarantees thus demand ***high credit sovereigns who do not need to set aside cash provisions to reassure financiers about the quality of their signature***. They might even decide to forgo any financial return on investment in recognition of the high aggregate value of guaranteed investment.

Basic Principles of a Multi-Sovereign Guarantee Architecture (MSGA)

An MSGA can overcome these limitations thanks to the ***credibility of the automaticity of default payments ensured by a deep front-line buffer, to a capitalization of contingency reserves independent***

of uncertain annual budgetary commitments of governments, and to prompt remedial actions in case of unforeseen rises in default rates and calls on guarantees. Contrary to guarantees spread out among smaller national public entities or existing multilateral financial institutions constrained by their charters, an MSGA could then change the terms of the counter-party agreements (percentage of the guarantee reported in counter indemnity, as a provision for default), minimizing the costs of guarantees for borrowers and donors and increasing the leverage of public funds.

Such an MSGA should not be designed as a new funding window but as *a platform facilitating a diversity of cooperative arrangements working under the same principles*, to support synergies between climate and development finance institutions; to lower the transaction costs that deter projects; to facilitate the financial bundling of small projects currently flying under the radar of capital markets; to enhance the capacity of national and local development banks to mobilize local savings; and to incentivize new private-public partnerships adapted to a diversity of sectoral and local circumstances.

The first set of its rules includes its *governance and management rules* that determine the commitments of its members and the procedures for strategic reforms of the system in the function of experience:

- Voluntarily fixed amount on paid-in capital to the system; for developed countries, a minimum fixed in proportion to their GDP;
- A commitment of developed countries to a minimum amount of guarantees per year over three years, with the commitments of developing countries being made on a purely voluntary basis. These guarantees should cover projects that deliver mitigation benefits, joint mitigation and adaptation benefits, and the marketable services contributing to adaptation;
- A commitment of guarantor's countries to dedicate a fraction of the tax revenues of the exports generated by guaranteed projects to grants dedicated to non-marketable services for adaptation;
- Commitments of host countries to respect the legal, fiscal, and economic parameters perceived as a positive business environment on signing the guarantee contract (complementary infrastructures, feed-in tariffs, or domestic public guarantees);
- Revision procedures of parameters that determine the cost of guarantees and their leverage, and strengthen the creditworthiness of the system;
- Guidelines for the recognition by the Board of the MSGA of the conformity to the general principles of facilities targeted to specific sectors in specific regions and social contexts; this would allow to fostering of innovative business models in different areas, including through complementary guarantees issued by sub-sovereign public institutions and private finance: transport infrastructure, basic needs in scattered settlements, agriculture, coordinated decarbonization efforts in highly energy-intensive activities, small islands.

The second set of rules encompasses *transparent project selection procedures needed* to hedge against suspicions of political bias and the risks of funding projects that would have been funded anyway or which will be proved 'white elephants'. This imposes *securing* financial additionality (new equity, grant, and cash-grant equivalent inflows), mitigation additionality (greater avoided greenhouse gas emissions), and development additionality (catalytic impacts on broader development goals).

Securing the two first additionalities requires *finding the right balance between maximizing the*

‘statistical additionality’ of projects in the context of inaccurate knowledge of their future performance, and avoiding high transaction costs that deter initiatives.

Each project delivers jointly, in various proportions, mitigation, adaptation, and development benefits and it is legitimate to help projects with a real but small contribution to decarbonisation if this help suffices in turning beneficial a project that delivers significant adaptation and overall development benefits. What is critical, to ensure the overall cost-efficiency of the emission abatements generated by the MSGA is to respect ***agreed-upon calibration rules of the amount of guarantees*** based on:

- An assessment by a third-party expert body of the upper and lower bounds of expected emission abatement by types of projects in specific countries or regions. This body will mobilize peer-reviewed modeling exercises and local expertise to inform the negotiation on the extent of guarantees with uncertainty ranges of the mitigation additionality of projects given their insertion in specific development policies in an uncertain context,

- The use of a notional value per ton of avoided emission (Stiglitz et al., 2017) to improve the overall economic efficiency of the portfolio of funded projects for a given amount of avoided emissions. This value can be derived, by convention, from the range of the marginal costs of carbon abatement for 1.5 °C and 2°C targets given by a subset of scenarios assessed by the IPCC.

Securing the development additionality of the project demands in the first place to limit the access to the MSGA to projects directly contributing to host countries’ NDCs. The project’s selection will have to incorporate the country-specific "social, economic, and environmental value of mitigation actions [and] their co-benefits" (Article 108 of the Paris Agreement decision). This value will guide the negotiations between the host and donor countries about additional grants, subsidies, and supporting infrastructures apt to maximize the impacts of the projects in terms of employment, commercial balance, and fiscal revenues as well as their contribution to adaptation and sustainable development.

Mitigation, adaptation, and sustainable development benefits

The expected outcome of an MSGA is to ***expand developing countries' access to global capital markets at lower cost and longer maturities*** with the backing of highly credit-worthy — AAA-AA — guarantors. Potentially this access represents a financial support far higher than the 100 USD billion of the Paris Agreement in both equity inflows and cash grant equivalents from the reduction of loan interest rates.³

It would do so by overcoming three major constraints that fragilize the credibility and long-run sustainability of other options like the simple capital increase of development banks or the GCF, although this increase might be judged appropriate.

The first is to respond, in four ways, to the request of non-debt instruments (COP 28 (art 69) and COP29): a) the buffer brought by the MSGA would allow either not to impose counter indemnities and called capital, or to do this at a value representing a small share (say 10%) of the guarantee; b) Equity inflows not recorded as a debt; c) facilitation of the issuance by host countries of loans in national currency; and d) Climate Remediation Assets (CRA) with a face value that could be exchanged for cash

³ A study that includes the energy and transportation sectors only show yearly equity inflows up to 300 US billion over the next 20 years, and up to 160 US billion in cash-grant equivalents. Hourcade et al. (2021)

as government bonds (or credible enough to persuade rating agencies that the new debt is justified by the value of the built infrastructure as collateral).

The second is to lower the cost of guarantees thanks to the reduction of the provisions for losses and raise the number of private and public institutions acting as project guarantors needed to develop well-fitted financial devices in a diversity of sectors and scales. In addition, CRAs would help lower potential behavioral drifts of so-called non-bank banks freed from the regulatory constraints on banks and respond to the call from institutional fund managers to conditions for investing in developing countries.

The third is to overcome the reluctance on the part of public treasuries of developed countries to increase overseas assistance while they face growing internal demands (security, health, education, public infrastructure) and creditworthiness risks. As providers of guarantees, they will indeed improve their public accounts thanks to the tax revenues on the exports generated by successful projects.

A MSGA could then, and this is a condition for success, help MDBs, the GCF, and other UNFCCC institutions to work synergistically; to allow National Development Banks (NDBs) to finance smaller-scale projects; to encourage the development of co-guaranteeing entities (cities and other local financing entities). It could thus ***provide mutual benefits apt to fuel a circle of trust*** around the alignment of climate and development policies. The viability of this circle of trust depends critically on the equity of access to these benefits. Three elements of the MSGA are in this respect critical:

- The use of a universal value of carbon to calibrate the guarantees redirects towards low-income countries a higher share of capital inflows than their share in the total world GDP. The lower the per capita income of a country, the higher the distance between this value and the universal value of carbon abatement, and projects unleashed by the system.
- The cash-grant equivalent of the system will be higher for countries in debt distress and low creditworthiness and where there is an important gap between the perceived risks of the project by lenders and capital markets and its intrinsic risks.
- The establishment of complementarity between mitigation and adaptation to hedge against a division line between countries that will mostly benefit from mitigation investments and countries more concerned by adaptation investments. The MSGA would indeed strongly enhance directly the adaptation capabilities of countries via the support of projects generating both adaptation and mitigation benefits and the recycling into grants (for non-marketable services) of a share of the fiscal revenues raised on the exports generated by the guaranteed projects. A MSGA would in addition free up the capacity of development banks for grant donations thanks to the crowding-in of private savings for marketable goods and services.

However, such grants might not respond to social demands, for example for losses and damages. They thus need to be complemented by grants funded by taxes (on the rich, on maritime trade, aviation, financial transactions, digital industry). An MSGA can facilitate them thanks to its capacity to mobilize guarantees in addition to grants and concessional loans and, thanks to the quality of its selection process to remove suspicions about the misuse of their product.

Also important, although pervasive and not translatable into numerical terms, is the structural inclusiveness impact of an MSGA designed not as a 'universal' facility leading to the overdominance of large-scale projects in the energy sector to the detriment of other sectors, small-scale projects, and local initiatives but as a platform backing dedicated facilities. It would indeed support innovative

climate finance interventions that embrace the diversity of sectors, territories, communities, and initiative takers and technical options from the most advanced to the vernacular.

An MSGA is potentially a tool to forge a world alliance against global warming. Developed countries should be interested in the fiscal benefit of the generated exports and the employment benefit that will help them combat the taxpayers' fatigue vis-à-vis overseas assistance. The OPEC countries who understand the necessity of preparing for the post-hydrocarbon era could see in the MSGA a tool to reinvest their rent in activities that generate assets more relevant than the tower Burj Khalifa to diversify their domestic economy and change the structure of their foreign trade. The emerging economies will see in this system a way to accelerate the building of the bulk of their infrastructure without risking overindebtedness. As to the less developed countries, often in debt stress, the use of the MSGA to support non-debt devices will help them to access capital markets at reasonable interest rates and they will benefit from the grants it generates directly or indirectly.

From basic principles to an operational MSGA: what steps forward?

In his framing statement for COP30, André Aranha Corrêa do Lago reminds the Archimede sentence, 'give me a lever long enough and a fulcrum on which to place it and I will move the world'. It also calls for 'small changes that can result in large impacts on complex systems'. We venture to think that an MSGA is such a fulcrum.

The strategic vision behind our proposal is that a group of willing countries can create a prototype of MSGA and use it to launch a circle of trust thanks to tangible mutual benefits for the participating countries. This circle of trust could then progressively embark on a diversity of new members. Depending upon the strength and size of this climate alliance, more fundamental reforms could then be debated in appropriate fora such as the recognition of CRAs in interbank payments as a common currency anchored on an indicator of real wealth; the reform of the Basel III rules set after the 2008 financial crash that penalize long-maturity investments; and the devices for using the surplus SDRs of developed countries to alleviate the debt constraint of developing countries.

In addition, its important knock-on effect on the world economy of unleashing the growth potential of countries under debt stress and redirecting to infrastructures and production capital part of the world savings that go today to land and speculative assets could ultimately create the conditions for more fundamental reforms of the financial mechanisms at the roots of fault lines of the existing economic system. The experience gained thanks to the MSGA would indeed demonstrate how *"to build capacity in the South through an international economic system favourable to a sustainable development"* and conduct an *"evolution of fundamental mechanisms of the economy carried out in a non-conflictual and non-punitive way"*. These are the key demands of COP28.

We would then increase the *'chances for a future that is not dictated by climate tragedy but rather by resilience and agency towards a vision we design ourselves'* (André Corrêa do Lago).

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