

INNOVATIVE GUARANTEE INSTRUMENTS HAVE A ROLE TO PLAY IN OVERCOMING BARRIERS TO FINANCING LOW-CARBON TECHNOLOGIES IN THE WORLD'S POOREST COUNTRIES, SAYS **ASH SHARMA**

# A role for climate guarantees

It is well documented that developing countries need significant capital investment to adopt low-carbon technologies required to help in the fight against climate change. Key financing barriers to the deployment of sustainable energy technologies exist, particularly in the poorest countries – often the most vulnerable. This is because of difficult business environments for investment projects, project risks and insufficient risk-adjusted returns on investment. Here I look at the possible role of risk guarantee instruments in overcoming some of these barriers.

The experience of the carbon markets shows that this source of income alone cannot overcome financing barriers. The UN's clean development mechanism (CDM) and possibly new market mechanisms – such as crediting or supported nationally appropriate mitigation actions (Namas) – can help alleviate risks and promote good project performance. But the underlying assets still need financing.

CDM work undertaken by the Nordic Environment Finance Corporation (Nefco) has found a variety of financing barriers. For example, with renewable energy projects, which includes an unwillingness or inability by financial institutions to lend, or, at best, provide short-term lending with significant security demands.

Often, projects are commercially viable, but there are perceived risks for private sector lenders. Since many local financial institutions are conservative, and rightfully so, the purpose of such a guarantee is to persuade commercial banks to provide medium- and long-term loans with lower collateral requirements than they would otherwise need.

Local financial institutions typically judge their lending decisions solely on the creditworthiness of the client, usually based on an asset-backed security. This is typically in excess of 100 per cent of the loan provided or where the first 100 per cent is covered by physical assets. A risk guarantee instrument can mitigate some of these concerns for smaller scale renewable energy projects, where project proponents are often smaller and weakly capitalised companies.

The guarantee itself is similar to a loan, but is disbursed only in the event of a default. Upon default, the issuer of the

guarantee pays out the guarantee amount. Any paid-out sum under the guarantee will constitute a claim on the borrower that will be a junior claim to the issuer's claim in case of bankruptcy. In the worst case, it is written down. The issuer charges a fee to cover its costs.

In most cases, the risk guarantee is partial inasmuch as it covers a proportion of the risk, say the first 35 per cent of any given loss. For some commercial banks, they may be willing to take on the first loss situation for a given proportion since they will know and be best placed to assess their customers.

Some programmes, such as the Central American Bank for Economic Integration (Cabei) renewable energy project in Central America (see box, page 34), have the objective of supporting banks to introduce revenue-based lending policies and practices based on an analysis of the financial viability of the investment.

This approach requires a significant change in the operating practices of local banks, and needs to be supported with targeted capacity building. The key, however, is to secure buy-in from senior management, who are more likely to be convinced if third-party guarantee instruments can be

## Accelerating renewable energy investment through Cabei in Central America (Areca) by the UN Development programme

The objective of the programme is to promote small and medium-sized (<10MW) renewable energy investments in grid connected and decentralised applications, in Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica and Panama, through the removal of financing barriers. One of the components of Areca is the use of a risk mitigation mechanism using a Global Environment Facility-funded partial risk guarantee facility to increase the availability of bank financing. The facility provided a first loss guarantee to financial institutions in the region.



introduced. Risk management is after all their main concern.

In parallel, there is a growing recognition that public finance interventions can help address barriers through targeted risk mitigation instruments. This is highlighted by a number of recent guidance, including the 2010 report of the UN Secretary General Ban-ki Moon's High Level Advisory Group on Climate Change Financing. It counsels that "careful and wise use of public funds in combination with private funds can generate truly transformational investments."

Use of financial guarantees, as opposed to direct loans, to achieve policy objectives is not new. For example, the China utility-based energy efficiency finance programme implemented by the International Finance Corporation – the private sector arm of the World Bank (see box, page 35).

However, financial guarantees are not widely utilised as a tool to mobilise climate funding in the poorest countries. Guarantees have been used by the multilateral financial institutions to facilitate the financing of energy and environmental projects and programmes in developing countries. In these cases, risk is shared through public funds channelled through multilateral sources, such as the UN's Global Environment Facility (GEF), or bilateral sources, such as the Nordic countries.

Unfortunately, actuarial data on loss cover is unavailable publicly, so it is difficult to evaluate costs. In the case of the China programme – where there was a first loss component – the base case default rate was estimated at 4 per cent, with GEF financing expected to cover the potential losses. However, the leverage effect is likely to be significant, and losses for the public purse can be mitigated through judicious choice of partners and the risk management process, supported by the technical assistance components of programmes.

The results of such programmes have thus far been encouraging. Nefco is looking to utilise these guarantees for climate friendly clean energy investments at a smaller scale. In conjunction with the Nordic Development Fund (NDF), the organisation is currently evaluating opportunities to

utilise the ProClimate Guarantee Facility (ProCF) in some of the poorest and most vulnerable countries.

The facility seeks to work with local financial institutions to provide security for lending activities through pooled guarantees in the area of renewables, energy efficiency and cleaner production. It is experimenting with different modalities and charging structures, and is currently working with multilateral and local financial institutions in east Africa, south-east Asia and Central America. The ProCF will support its financial interventions with targeted technical assistance and has a set-aside in its funding for this.

Other initiatives have sought to combine the guarantee model with carbon finance, such as the Global Carbon Guarantee Consortium (GC)2. This is a loan facility structured and co-managed by Deutsche Bank and First Climate. The aim of (GC)2 is to finance small and medium-sized emission reduction projects in emerging markets.

The use of risk guarantee instruments in promoting renewables, energy efficiency and other climate friendly investments is proven in a small number of cases. However, widespread deployment is currently lacking, particularly with small-scale projects, and so this remains an important tool for leveraging public finance to meet the great challenges ahead. ●

**Ash Sharma is a vice president at Nefco, and head of the carbon finance and funds unit. He leads Nefco's work on new market mechanisms and long-term climate finance**

**Email: [Ash.Sharma@nefco.fi](mailto:Ash.Sharma@nefco.fi)**

### China utility-based energy efficiency finance programme (Chuee) implemented by the International Finance Corporation

The Chuee programme aimed to stimulate energy efficiency through the provision of bank guarantees for loans administered by three local financial institutions and technical assistance to market actors.

The loan rollout was impressive, more than \$500 million committed at the time of the evaluation in mid-2009, which supported 98 projects reducing emissions by 14 million tonnes of carbon dioxide equivalent a year. The guarantee programme included a subsidy element from the Global Environment Facility, which provided the loss cover.

Aside from the quantifiable benefits, the evaluators of the project found demonstration and spillover benefits.

Some of the lessons learnt included:

- judicious selection of financial partners is imperative;
- flexibility in programme design is needed to respond to unexpected changes, challenges and opportunities;
- the use of subsidies must be targeted at less mature policy priority areas to avoid impeding commercialisation of energy efficiency finance; and
- an exit plan is critical to terminate the programme or shift its focus.