

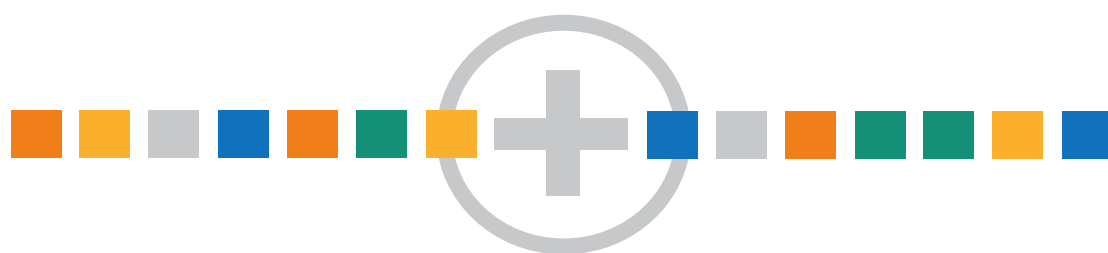
Using the right mix of financial instruments to provide and mobilize climate finance

Lessons for the Global Stocktake

Shakira Mustapha

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About the independent Global Stocktake (iGST) and Finance Working Group

The independent Global Stocktake (iGST) is a consortium of civil society actors working together to support the Global Stocktake (GST), the formal process established under the Paris Agreement to periodically take stock of collective progress toward its long-term goals.

The iGST aligns the independent community – from modellers and analysts, to campaigners and advocates – so we can push together for a robust GST that empowers countries to take greater climate action.

The Finance Working Group (FWG) of the independent Global Stocktake (iGST) is an open partnership bringing together a range of expert perspectives from the global north and south on the progress made toward financing climate action, co-chaired by Charlene Watson of ODI and Raju Pandit Chhetri of Prakriti Resources Centre. The FWG aims to support the official UNFCCC Global Stocktake (GST) process and is organised around two complementary themes: the provision of support to developing countries to mitigate and adapt to climate change and the consistency of finance flows with low-emission, climate-resilient development, as outlined in Article 2.1(c) of the Paris Agreement.

For more information, visit: www.independentgst.org



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+ Executive Summary



The climate crisis requires urgent action. Both science and recent catastrophes make it increasingly clear that climate change impacts – from extreme events as well as slow-onset processes – can disrupt governments, firms and society in both developed and developing countries. While not the only part of the solution, mobilising a large volume of public and private finance is critical to responding to the crisis.

While much international attention is focused on developed countries delivering on their promise to mobilise US\$100 billion a year by 2020 to support developing countries undertake climate action, it is also important that we look beyond this aggregate number. In particular, in what form is this financing being provided and is it fit for purpose? Are developed countries providing finance in a manner that is considered just and equitable by those who are least responsible for causing climate change but worst affected? These questions are relevant for part of the Global Stocktake (GST): a formal climate ambition-ratcheting process established under the Paris Agreement to periodically take stock of collective progress towards its long-term goals.

To help respond to these questions, this paper assesses the extent to which the main instruments (debt, equity investments, grants, guarantees and insurance) used to deliver climate finance for mitigation and adaptation, as well as to address climate-induced losses and damages, can be grounded in principles of equity and climate justice. The paper's main findings are as follows:

- **There is no 'one size fits all' when choosing the most appropriate instrument for ensuring climate finance is equitable and just.** Context is incredibly important. Debt, for example, is not necessarily bad if it is used to finance a project that has a high probability of generating returns and/or the borrower has the capabilities and institutions to ensure the debt is sustainable and productively used. However, given that debt vulnerabilities are high and fiscal space is limited in many developing countries, it is unlikely that providing the bulk of climate finance through traditional debt instruments will be appropriate from an equity perspective, especially for climate actions that are unlikely to generate a cash flow.

It is therefore important to use the GST to assess the extent to which development partners are following responsible lending practices when providing climate finance in the form of loans. There are numerous existing frameworks covering responsible lending practices that the GST can draw on, such as the UN Conference on Trade and Development (UNCTAD) Principles on Promoting Responsible Sovereign Lending and Borrowing, the G20 Operational Guidelines for Sustainable Financing, and the joint International Monetary Fund (IMF) and World Bank Debt Sustainability Framework.

- **It is not only the type of instrument that is important for equity but the modality through which it is arranged and delivered.** Although the traditional project-by-project model of climate finance generally supports individual solutions in individual sectors, it is unlikely to produce the transformative outcomes required to shift developing countries on to a low-carbon development pathway. Therefore, the extent to which climate finance is being delivered in a manner that supports the development and implementation of country-led plans and strategies and involves local actors needs to be assessed. Furthermore, with respect to addressing losses and damages, development partners should explore options to prearrange and pool a portion of their funds towards predictable climate-related crises on a multi-year, multi-sectoral basis. This can facilitate earlier and more predictable responses that prevent or reduce impacts on the poorest and most vulnerable.
- **Understanding how different instruments can work together to achieve climate goals in a just and equitable manner is key.** While insurance can play an important role in addressing climate-induced losses and damages from random and infrequent events, grants are likely to be critical for subsidising the premiums so that the poorest and most vulnerable do not have to bear an unfair burden. At the same time, non-insurance solutions are critical given the limits of insurance with respect to addressing losses and damages from slow-onset processes and non-economic losses and damages. Furthermore, developing countries and communities must have the space to articulate their needs, weigh the options and decide how they want to deal with the impacts of climate change that are likely to be unavoids and unavoidable.
- **Although public finance is helping to mobilise private climate finance, there is significant room for improvement to avoid wasting scarce public finance.** Development partners are relying to a large extent on instruments that traditionally have been used in aid programmes such as grants and loans, and underutilising other instruments, specifically guarantees, for which there is growing evidence of their significant leveraging potential. GST should assess the extent to which development partners supporting blended finance transactions are taking steps to ensure public value for money and to involve the local private sector.
- **There is a tension between using public finance to scale up private finance and to transfer resources from developed to developing countries.** Using scarce public finance to de-risk private investment in lower-income countries, with high-risk environments and no market access, is likely to achieve high development impact, but is unlikely to catalyse large volumes of finance. Emphasising this trade-off in the GST may help to find common ground for a post-2025 climate finance target.



+ 1. Introduction and Background



Limiting the rise in global temperature to 1.5°C requires mobilising substantial amounts of financing swiftly and at scale. Despite an upward trend in total climate finance flows over the last decade, these flows still fall well below what is needed.¹ An increase of at least 590% in annual climate finance is required to meet internationally agreed climate objectives by 2030 and to avoid the most dangerous impacts of climate change (Buchner et al., 2021). Developed countries have also failed to meet their pledge to jointly mobilise US\$100 billion a year for adaptation and mitigation in developing countries by 2020,² with projections suggesting that this target will be met in 2023 (Climate Finance Delivery Plan, 2021; OECD, 2022). Though inadequate for the task at hand, meeting the \$100 billion goal is critical in building and maintaining trust in multilateral climate negotiations. However, it is not only the volume of climate finance that is important.

The form of financing provided has significant implications for the intended beneficiaries and the climate agenda more broadly. Using the right mix of financial instruments for the appropriate geography, sector and project is key to maximising the impact of climate finance. The instrument chosen and its manner of delivery can influence whether the finance reaches and addresses the needs of the poorest and most vulnerable, whether it crowds in more financing, and even whether it crowds out critical government spending in other areas. There are also trade-offs that need to be carefully assessed, since progress towards one goal can jeopardise progress in another. Specifically, the drive to scale up finance to significant and adequate amounts does not neatly coincide with the goal of transferring resources from developed to developing countries, reflecting countries' common but differentiated responsibilities to address the climate crisis (Lankes, 2021; Pauw et al., 2022).

The aim of this paper is to leverage existing research and knowledge across climate finance, development finance and disaster risk finance to explore what financial instruments correspond best to different needs and risks across countries, sectors and projects, while also ensuring progress towards equity. In doing so, it highlights the importance of understanding the context and constraints within which an instrument operates. The paper focuses on the main types of instruments used by the international community to provide climate finance: grants, debt, equity investments, guarantees and insurance. The findings have implications for both the ongoing Global Stocktake (GST)

¹ Climate Policy Initiative's estimates of climate finance include primary investment into productive assets at the project level to capture new money targeting climate-specific outcomes – excluding secondary transactions that involve money changing hands but no physical impact. Data limitations prevent a full accounting of domestic government expenditures on climate finance, and of private sector investments in energy efficiency, transport, land use and adaptation.

² This refers to the commitment made by developed country Parties in Copenhagen in 2009, and reiterated since, that at least US\$100 billion per year would be mobilised from public and private sources to help developing countries mitigate and adapt to climate change by 2020 (COP Decision 2/CP.15).

and negotiations over a post-2025 climate finance goal. As described in Box 1, the GST aims to assess collective progress towards implementation of the Paris Agreement and achievement of its long-term goals, in the light of equity. In addition to mobilising finance to mitigate and adapt to climate change, the paper also considers finance to address climate-induced losses and damages. While loss and damage is not formulated as a goal in the GST or a thematic area on its own, Parties have agreed to take loss and damage into account in the technical dialogues of the GST (Watson and Roberts, 2019). Moreover, there is growing recognition that some climate change impacts are ‘beyond adaptation’; that they cannot or will not be avoided by mitigation or adaptation (Verheyen and Roderick, 2008; UNFCCC 2014; Warner and van der Geest, 2015). These residual risks and impacts are far from insignificant, with recent disasters providing a ‘wake-up call’ to the world on the very real threats of climate change.

After a brief overview of the different climate finance instruments (Section 2), the paper assesses the potential for different instruments to be grounded in principles of equity and climate justice, focusing on debt given it is the dominant form through which climate finance is provided (Section 3), and then examining instruments used to unlock finance from the private sector (Section 4). The trade-offs between equity and other climate finance objectives, for example, maximising broader development objectives, while an important question, is beyond the scope of this paper. Rather, it focuses on how different financial instruments can be designed to reflect principles of equity and climate justice.

Box 1: What is the Global Stocktake (GST)?

The Paris Agreement requires a collective assessment of progress towards its purpose and long-term goals every five years (Article 14). It is required to do so ‘in a comprehensive and facilitative manner ... and in the light of equity and the best available science’. Means of implementation and support (MoIS) is one of the three key pillars of the Paris Agreement, alongside mitigation and adaptation. While MoIS refers to finance, capacity and technology transfer, this paper considers only finance. The first GST is under way, to be completed in 2023.

It is currently unclear how equity will be addressed in finance themes, with significant scope for civil society to influence the process. The independent GST (iGST) brings together independent actors to push for a robust GST that empowers countries to take greater action on climate change. As part of this process, this paper seeks to demonstrate how different financial instruments can have implications for equity and justice based on theory as well as evidence. This in turn can help to inform principles and benchmarks that can be used in the GST to address equity considerations in the financing of climate action.



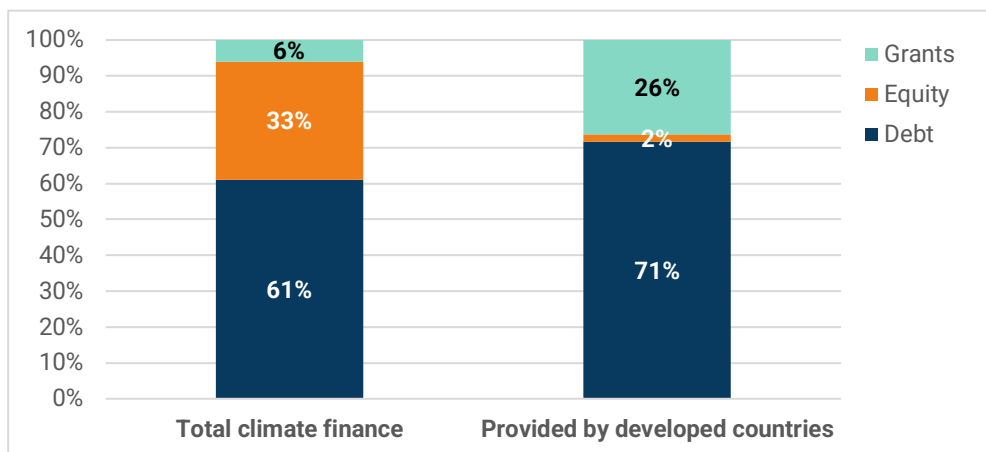
+ 2. Overview of climate finance instruments

This section briefly describes each instrument: its objectives, mechanics and share of total climate finance, as well as its share of public climate finance, provided and mobilised by developed countries for developing countries in the context of the \$100 billion target.

2.1. Debt

Debt instruments require the payment of a principal and typically interest at some point(s) in the future. They can take the form of loans and bonds. Loans are transfers in cash or in kind, for which the recipient incurs legal debt (and the resulting claim is not intended to be traded). Loans can be market rate or concessional, with more generous terms than the market through features like zero or low interest rates, and extended repayment schedules. Innovative debt instruments, known as state-contingent debt instruments (SCDIs), which link contractual debt service obligations to variables like gross domestic product (GDP), exports or commodity prices, are discussed in more detail in Section 3. Bonds are debt instruments, issued by governments, public utilities, banks or companies, which are tradable on financial markets. The issuance of sovereign and sub-sovereign green bonds is an increasingly common way for creditworthy countries, i.e. countries with market access, to raise funds for environmentally sustainable public investments. Green bonds are typically used to fund renewable energy technologies, energy efficiency programmes and clean transportation systems. They have, however, also been used for forestry and water projects, and to fund development of resilient infrastructure (Carter, 2020; CBI, 2021).

Figure 1: Composition of climate finance in 2020



Source: Buchner et al., 2021; OECD, 2022

Notes:

- i. Total climate finance estimates are based on a two-year average (2019 and 2020).
- ii. The sum of instruments may not add up to 100% due to rounding.

Most of total climate finance (61%) in 2020 was raised as debt (see Figure 1), of which 12% was low-cost or concessional debt (Buchner et al., 2021). Similarly, the total public

climate finance provided and mobilised by developed countries for developing countries in 2020 mainly took the form of loans (71% or \$48.6 billion, including both concessional and non-concessional loans) (OECD, 2022). The global green bond market has expanded with an average growth rate of 54% in the last five years, reaching a size of \$522.7 billion in 2021 (CBI, 2021). Although this is mostly issuances from private sector corporations and advanced economies, some sovereign issues are also from developing countries.

2.2. Equity investments

Unlike debt financing, where investors receive interest payments on a principal investment, equity investors become co-owners of the project or company in exchange for their investment. As such, they are entitled to a proportion of the company's or project's earnings once the debt investors have been paid. Equity can be split by level of seniority, i.e., the order in which the returns on the equity are distributed to shareholders. Equity finance can also be received through a number of different channels. The two principal channels are privately raised funding and publicly raised funding via listed exchanges. In many developing countries, where capital markets are not strong, privately raised equity plays an important role in funding renewable energy projects including hydro, solar, wind, biomass and geothermal projects. Private equity funds can also bring significant infrastructure experience, which can help improve project management and cost effectiveness. Foreign equity investments can also contribute to job creation, human capital development and the transition to a low-carbon economy. Yet, foreign direct investment (FDI)-related benefits are not automatic and often require investment policies to be tailored to the local circumstances in order to foster spillovers across local firms.

In 2020, equity accounted for 33% of total climate finance and flowed mainly to renewable energy systems, and 1.6% of public climate finance flowing from developed to developing countries (Buchner et al., 2021; OECD, 2022).

2.3. Grants

Grants are transfers made in cash, goods or services for which no repayment is required. Grants are usually provided for non-revenue-generating activities such as knowledge management and capacity building. Grants can be critically important for pipeline development, especially in less mature sectors and riskier geographies, creating significant crowding in of private capital. In 2020, grant finance accounted for 6% (\$36 billion) of total climate finance flows (Buchner et al., 2021) and 26% (or \$17.9 billion) of public climate finance flows from developed countries (OECD, 2022). Flows were largely focused on countries perceived to have the greatest need and highest vulnerabilities. While there is no agreed definition of 'need' and 'vulnerability', these are usually defined by development partners with reference to the recipient countries' risk of debt distress, income level and creditworthiness. The World Bank's International Development Association (IDA), for example, uses debt distress ratings under the Debt Sustainability Framework to determine the share of IDA grants and highly concessional IDA credits for each country (WB, n.d.). Countries at high risk or in debt distress can benefit from 100% grants, medium-risk countries from 50%, but low-risk countries cannot benefit from grants.



2.4. Guarantees

Guarantees are a form of credit enhancement. They provide protection to one party if the other party fails to perform an obligation. For example, the guarantor agrees to pay part or the entire amount due on a loan, equity or other instrument in the event of non-payment by the obligor or loss of value in case of an investment. Guarantees are provided by a third party (for example, Guarantco provides guarantees to bridge the gap between the financial requirements of a project and the financial terms available from the local market) and can provide a partial or entire coverage of the debt or investment. They strengthen the creditworthiness of the debt or investment, because of the promise from the guarantor to complete obligations in the event of default. As such, guarantees are one of the most catalytic forms of blending – though this instrument is currently under-utilised, as discussed in Section 4.

2.5. Insurance

Insurance provides protection by promising to compensate for a specified loss or damage in return for payment of a specified premium. There are many types of insurance: one of the most common for private investments is political risk insurance to protect against adverse government actions. Insurance provides a more stable environment for investments into developing countries (Carter, 2020). Insurance mechanisms, specifically micro-insurance and regional insurance pools, have also emerged as one of the main instruments proposed by development partners to address climate-induced loss and damage (Richards and Schalatek, 2018; Mustapha, 2022). However, there is growing recognition by some that this is an insufficient response (as discussed in Section 4).

2.6. Blended finance

Blended finance is not an instrument but a structuring approach that allows organisations with different objectives to invest alongside each other while achieving their own objectives (whether financial return, social impact or a blend of both). In the absence of an agreed definition, this paper uses the term to refer to using concessional public finance to mobilise private finance. There are different types of blended finance structures, which usually involve one or more of the instruments described above. Section 4 discusses the opportunities and challenges associated with blended finance in more detail.

Despite progress in developing methodologies to measure private finance mobilised by public finance, data continues to be incomplete and contested (OECD, 2020; Oxfam, 2020). Based on available data, public climate finance provided by developed countries mobilised \$13.1 billion in private finance in 2020, falling below previous stable levels slightly above \$14 billion in the previous three years (OECD, 2022).

Direct investment in companies and project finance special purpose vehicles (SPVs) mobilised nearly half (44%) of private climate finance from 2016 to 2020, followed by

guarantees (19%). Other mechanisms used in the mobilisation of private climate finance were syndicated loans (14%), credit lines (9%), simple co-financing arrangements (8%) and shares in collective investment vehicles (6%). **Except for guarantees, these mechanisms are largely underpinned by the public finance instruments discussed above (equity, grants, loans).** Each mechanism is described in further detail in Box 2.

Box 2: Examples of leveraging mechanisms used by public finance providers to mobilise private finance

- **Direct investment** refers to mobilising private investments in SPVs that are neither covered by official guarantors nor part of a syndicated loan. Beyond project finance, direct investment in companies refers to loans and equity investments in enterprises, alongside private investors, to provide liquidity for expansion purposes.
- **Syndicated loans** are defined as loans provided by a group of lenders who work together to provide funds to a single borrower. They are often employed to provide debt liquidity to project finance SPVs (often to implement large-scale infrastructure projects) or other borrowers, such as local finance institutions or enterprises.
- **Credit lines** refer to a standing credit amount that can be drawn upon by borrowers (typically local finance institutions) for on-lending purposes, mainly to small and medium-sized enterprises (SMEs).
- **Simple co-financing arrangements** refer to various business partnerships, business-to-business programmes, business surveys, matching programmes, co-financing of specific projects and similar arrangements where official providers extend finance in co-financing with the private sector. This usually involves official grants.
- **Shares in collective investment vehicles (CIVs)** are investments in pooling vehicles, such as investment funds and facilities, which typically use such finance to foster local SME development. These typically consist of equity investments.

Source: Adapted from OECD, 2022



+ 3. Operationalising equity and climate justice principles



The impacts of climate change – from extreme weather events to slow-onset processes – are already being felt, primarily by those in the poorest and least developed countries (LDCs) who have done the least to cause it and who are poorly equipped to bear the burden for addressing these impacts. The impacts not only threaten human rights but also limit countries' ability to pursue development goals such as poverty reduction, health, and food and water security.

In recognition of this imbalance, there has been a growing focus on ensuring that climate finance is just and equitable. Equity is enshrined as a core principle in the UN Framework Convention on Climate Change (UNFCCC), including in the 'common but differentiated responsibilities and respective capabilities' principle. This principle implicitly requires that countries with more historic responsibility for climate change and greater capability should provide finance to those with lower levels of responsibility and less capability. While the concept of justice is not directly raised in the UNFCCC, the Paris Agreement notes 'the importance for some of the concept of "climate justice"' (UNFCCC, 2015). Upholding equity in all climate finance dealings, however, has been undermined by the different perspectives of equity, absence of benchmarks and accountability, as well as political standoffs (Pettinotti et al., 2022).

In the absence of an agreed definition of equity and climate justice, this paper focuses on the distributive and procedural elements emphasised by academics, negotiators and other stakeholders in this space. These include historical responsibility, fairness, accountability, pro-poor/targeted support, predictability, ownership and participation (Pettinotti et al., 2022; Sharma-Khusha et al., 2022; Khan et al., 2020). This section assesses the extent to which different types of financial instruments can incorporate these principles, while also noting linkages with elements in the broader international architecture that can influence the impacts of these instruments.

3.1. Debt financing: a burden or blessing?

A central tenet of equity and climate justice is that financing used to achieve climate goals should not impose an additional burden or injustice on those with lower levels of responsibility and less capability. Climate finance solutions in the form of debt-creating instruments, which account for the majority of climate finance, as noted in section 1, have therefore been heavily criticised for violating this principle by exacerbating debt levels and vulnerabilities, and potentially contributing to a debt crisis (Crotti and Fresnillo, 2021; Achampong, 2022). Unlike grants, debts have to be repaid: the principal plus interest. A debtor country tends to prioritise these payments over other types of government expenditure given the potential negative legal, financial and reputational effects

associated with missing a debt payment.³ When the government can no longer pay its bill, a country enters debt distress, potentially threatening macroeconomic stability and setting back a country's development for years (Buchheit and Gulati, 2020). The poorest and most vulnerable in the distressed country also tend to be among the worst affected by austerity measures used to get debt onto a sustainable path (Stubbs et al., 2021).

In the current economic climate, emerging market and developing economies are entering or are already in perilous waters that evoke memories of past debt defaults. The pandemic has exacerbated already-high debt levels, leaving emerging market and developing economies more vulnerable to interest rate hikes. About 60% of LDCs and other low-income countries are now assessed as being at high risk of or in debt distress, double the 30% in 2015 (IMF, 2022). The average public debt-to-GDP ratio in emerging markets reached a record 67% in 2021, from about 52% before the pandemic (Ibid). With borrowing costs set to increase further due to inflationary pressures and monetary policies in advanced economies, interest expenses are expected to rise significantly, straining national budgets and making it increasingly difficult to service debt.

The outlook is particularly gloomy for many heavily indebted small island developing states (SIDS). Not only are they extremely vulnerable to climate change impacts and other shocks, they also face significant structural challenges in managing these risks due to their low economic diversification and their remoteness. In addition, several SIDS cannot access grants and concessional loans from the international community due to being classified as middle- or high-income countries. As of January 2022, nine SIDS were ineligible for official development assistance (ODA), which is aid that promotes and specifically targets the economic development and welfare of developing countries. This is despite the fact that, under the UNFCCC, these countries remain eligible to receive climate finance. The countries are Antigua and Barbuda, The Bahamas, Bahrain, Barbados, Cook Islands, Palau, Seychelles, St Kitts and Nevis, and Trinidad and Tobago.⁴

As a result, these SIDS increasingly rely on commercial instruments, exposing them to the vagaries of international financial markets, including sudden changes in exchange and interest rates. In the absence of reform, younger generations of SIDS citizens will most likely face the double jeopardy of crippling debt and climate change impacts, despite being the least responsible for these developments.

It is critical that all climate-vulnerable SIDS, regardless of their level of per capita income, have access to substantial external assistance on the right terms to adapt to climate change and address losses and damages. The climate crisis should not lead to a debt crisis. This sentiment is at the heart of the Bridgetown Agenda, recently launched by the Prime Minister of Barbados in September (see Box 3).

³ This includes penalty fees, delays in disbursements of funds, credit rating downgrades, increased cost of borrowing and, in extreme cases, loss of market access.

⁴ The next review of this list will take place in 2023.



Box 3: Prime Minister of Barbados, Mia Mottley, launches the Bridgetown Agenda

The Government of Barbados has kick-started a process in 2022 that engages civil society, academics, and other developed and developing countries to reform the global financial architecture. While addressing immediate needs associated with the cost of living, climate and debt crises is a priority, the Bridgetown Agenda also seeks to lay the path toward a new financial system that drives financial resources towards climate action and the Sustainable Development Goals (SDGs).

It identifies several priority reforms relating to the following three steps, which it considers both achievable and meaningful:

- The IMF must provide emergency liquidity to stop the debt crisis in its tracks. This includes re-channelling unused special drawing rights (SDRs) to those who need them, and operationalising the Resilience and Sustainability Trust.
- Multilateral development banks (MDBs) must implement reforms to expand multilateral lending to governments.
- The international community must create a new multilateral mechanism for raising reconstruction grants for any country just imperilled by a climate disaster.

The Government of Barbados is seeking to mobilise and coordinate broad support, helping form a coalition of like-minded leaders that are aligned on this critical agenda and that will support its implementation.

Source: Adapted from Government of Barbados, 2022

This is particularly important given the deeply entrenched flaws in the international architecture that prevent debt crises from being resolved in a timely and predictable manner. Unlike a corporate or individual debtor, there is no legally recognised procedure for restructuring the debt of bankrupt sovereigns; debt relief can only be obtained with the creditors' consent, leading to a power imbalance. Despite multiple proposals in the last decade to fix this problem (Krueger, 2002; Bohoslavsky, 2015), it is highly unlikely that an international bankruptcy mechanism will be created in the medium term to facilitate effective and fair sovereign debt restructurings.⁵ Moreover, despite efforts to facilitate creditor coordination through the use of contractual provisions, as well as the G20's Common Framework for Debt Treatments beyond the Debt Service Suspension Initiative (DSSI), persistent weaknesses have meant that sovereign debt restructurings continue to be a long, drawn-out, non-transparent process with a vague and uncertain end⁶ (Liu et al., 2020; IMF, 2020). Developing country governments and their creditors are often left at the mercy of individual creditors that decline to join a negotiated and consensual restructuring.

⁵ Resistance stems from the possible politicisation of decision-making and the reluctance of the US, as well as other governments, to cede the sovereignty of national courts in core areas to a supranational body.

⁶ For instance, an inadequate first restructuring agreement that raised the net present value (NPV) of a loan through the imposition of fees required Chad to restructure twice (2015, 2017) in circumstances involving a commercial collateralised lender. The Gambia's restructuring took two years to reach agreement in principle, complicated by the large role of some non-Paris Club creditors and other non-traditional lenders (IMF, 2020).

Faced with this reality, politicians delay facing up to an unsustainable debt burden as long as possible, to the detriment of all⁷ – the country and its creditors.

Debt-for-climate and debt-for-nature swaps, in which debt is reduced in exchange for the debtor undertaking climate-related spending or policy commitments, as recently done in Belize in 2021, is a potential option to explore. However, not all debt-for-nature swaps will have the same impact as the one in Belize, at least not on the debt side (as described in Box 4). The general consensus is that these complex transactions are unlikely to be the right tools for addressing unsustainable debt burdens. They typically take a long time to design (possibly as long as four years) and usually involve partial debt relief that is insufficient for restoring debt sustainability (Volz et al., 2021; Chamon et al., 2022). Furthermore, contrary to empowering the beneficiary country, these supposedly ‘mutually beneficial’ transactions can open the door to donor conditionality, with the creditor dictating how freed up resources are allocated. Moreover, a debt-for-climate swap is normally a less efficient form of fiscal support than grants since some of the debt relief generated by debt swaps may end up subsidising non-participating creditors rather than benefiting citizens (Chamon et al., 2022). On the other hand, when the objective is to expand fiscal space for climate investment, and grants or more comprehensive debt relief are not on the table, debt-for-climate swaps are an option worth exploring, especially for SIDS where there is a strong economic case. **In these circumstances, swaps should be designed in such a way that the beneficiary country has sufficient ownership over the climate conditions, and the transaction costs and burdens are minimised.**

Box 4: Belize swaps debt for marine conservation

In 2021, the Government of Belize signed a debt-for-nature swap with The Nature Conservancy (TNC), an environmental organisation, which reduced the country’s external debt by a notable 10% of GDP. Under the agreement, a TNC subsidiary lent funds to Belize to buy back a \$553 million bond, equivalent to 30% of GDP – at a discounted price of 55 cents per dollar. In return, Belize agreed to spend about \$4 million a year on marine conservation until 2041. This will double the country’s marine-protection parks – spanning coral reefs, mangroves and the sea grasses where fish spawn – from 15.9% of its oceans to 30% by 2026. An endowment fund of \$23.5 million will finance conservation after 2040.

Three key factors most likely contributed to the success of this deal, the first two of which may not be easily found in other countries:

- The bond was trading at an especially deep discount, which made it possible to buy back at such a large discount (i.e., below its face value).
- Belize bought back the government’s entire stock of external commercial debt, equivalent to 30% of GDP.
- The buy-back was funded by ‘blue bonds’ that received a strong investment-grade credit rating due to insurance from the US government’s development bank, the International Development Finance Corporation (DFC). Consequently, even risk-averse investors, such as pension funds, could be confident they would be repaid (Owen, 2021).

⁷ Debt restructurings are typically associated with significant output costs, but these costs are lower in cases where restructuring is pre-emptive (Asonuma et al., 2019).



3.2. Responsible borrowing and lending practices are critical

It is important to recognise that debt is not inherently bad under certain conditions. It allows the borrower to do something now and pay for it later, when the borrower has more income. Given the scarcity of grants relative to finance needs, it would be counter-productive and impractical to reject all debt financing for climate projects solely on the grounds that it has to be repaid, especially in an economy with the capacity to repay under different shock scenarios. Adaptation investment, albeit costly, can also make the economy resilient against natural disasters, limiting a post-disaster rise in public debt (Aligishiev et al., 2022). Moreover, some creditors such as IDA recycle all the debt service payments they receive into new financial assistance for the poorest countries, enabling them to do more than if they only provided grants.

Where there is fiscal space and the risks of debt distress are being properly managed, debt with the appropriate terms and conditions can be beneficial, especially if the alternative is that a critical adaptation or mitigation project would be postponed or cancelled. This in turn requires the debtors and creditors to engage in responsible borrowing and lending practices. However, in order to ensure that a country can continue to pursue sustainable development, it is crucial to ensure that a country does not fall into debt distress as a result of climate finance loans. While sovereign debt restructuring deals with problems ex-post, responsible borrowing and lending are ex-ante measures that can prevent unsustainable debt burdens from arising in the first place. Towards this end, there are several standard-setting frameworks that seek to encourage responsible borrowing and lending. The most influential are the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing, the G20 Operational Guidelines for Sustainability Finance, and the joint IMF and World Bank Debt Sustainability Framework (DSF).

On the sovereign debtor side, responsible borrowing entails using debt, particularly market rate debt, to finance investment projects with credibly high rates of return so that projects can essentially repay the borrowing costs, and/or to finance investments like infrastructure that enhance a country's productive and fiscal capacity over relevant time horizons. On the other hand, governments must carefully allocate scarce grant resources across climate actions and other development priorities, while considering the distributional effects of their programmes. For this type of decision-making to happen in a robust manner, it is essential to build country capacity and systems to develop national climate action plans and integrate climate actions into national development planning and public investment management. This could refer to prioritised lists of projects across sectors, income and population groups, tools for better project design, and making information publicly available so that government leaders can be held accountable for their spending and borrowing decisions by the legislature and the wider public. These are not easy reforms. Previous attempts to improve public financial management in developing countries highlight that political will and long-term donor financing are essential for reforms to embed into day-to-day life and produce the desired impacts (Fritz et al., 2017; Andrews et al., 2018).

On the other side of the transaction, responsible lending requires an approach that does not result in unwieldy debt service payments that overwhelm a country's ability to provide

essential government services. This involves assessing the impact of new loans on the borrower's debt position, before providing those new loans, using a debt sustainability framework similar to the IMF/WB's (IMF, 2018). While several MDBs use this type of analysis to inform their lending decisions, particularly the degree of concessionality,⁸ the lending practices of other large creditors are opaque (Mustapha and Olivares-Caminal, 2020; Rivetti, 2021; Gelpern et al., 2021). Moreover, the IMF/WB's analytical tool is also only as good as the underlying data and assumptions and has been criticised in the past for being over-optimistic about a country's repayment capacity (Atingi-Ego et al., 2021; Mooney and Soyres, 2017).

Responsible borrowing and lending also involve adopting new or better instruments to share risks, including those related to climate change. State-contingent debt instruments (SCDIs) are one way of doing this, by linking debt service obligations to a predefined state variable (GDP, exports or commodity prices, for example). In particular, disaster-linked clauses in debt contracts can be designed to provide relief in bad times, such as climate disasters, temporarily suspending debt service payments so money that would otherwise be used to service debt can be redirected by the country towards rescue, relief and rebuilding efforts in the wake of a natural disaster. However, climate disaster clauses (more commonly known as 'natural disaster clauses' and 'hurricane clauses') have been adopted in only two countries as part of debt restructurings: Grenada in 2015 and Barbados in 2018. Faced with soaring sovereign debt levels and risks, there is a renewed impetus and appetite among the international community for sovereign debt clauses that automatically suspend and postpone principal and/or interest payments in the event of large idiosyncratic and exogenous shocks, especially for small sovereign issuers (Cohen et al., 2020). This is an additional reform being pushed by the Bridgetown Agenda, with the Government of Barbados introducing the world's first of its kind pandemic clause into a commercial debt contract in 2022 (GoB, 2022).

3.3. Choosing an appropriate modality to foster country ownership and respond to local needs

The instrument modality is also important. Whether a grant or loan is delivered as budget support or tied to a project has implications for equity and climate justice, by placing reciprocal obligations on the recipient in exchange for the finance. These obligations usually take the form of:

- **Conditionality:** policy measures that the recipient is required to implement as a condition of the financing. These conditions may be at the macro level, sectoral level or project level.
- **Earmarking:** limitations placed on what the money can be spent on. Financing provided as general budget support usually involves no earmarking, while grants or loans tied to projects involve a high level of earmarking.
- **Disbursement channels and accountability:** the agreement on how the funds will be disbursed, accounted for and audited. While some development partners are making a concerted effort to use and strengthen country systems to disburse

⁸ Under IDA, countries at high risk of or already in debt distress can benefit from 100% grants, medium-risk countries from 50% grants, while low-risk countries cannot benefit from grants.



funds, others rely on costly, parallel systems that may actually undermine country systems in the long run.

All three types of obligations, if poorly designed, can be intrusive, undermining country ownership and straining government systems and capacity. In fact, the countries that urgently need support and that would benefit the most from it often struggle to meet donor requirements. Pacific island countries (PICs), for example, have faced significant challenges in getting accredited for direct access from facilities such as the Green Climate Fund (GCF) due to low capacity in public financial management (PFM) (Aligishiev et al., 2022). While strengthening PFM is essential to ensure money is being efficiently and effectively used, unachievable requirements might hold up disbursement of critical finance to the countries that are most vulnerable to climate change. Moving from project-based financing to a new programmatic approach to climate finance can potentially facilitate greater access and fewer burdens on recipients of climate finance. The Taskforce on Access to Climate Finance has started taking steps to make this a reality with the approach being trialled in pilot countries.

Providers of climate finance must also recognise that inclusive country ownership goes beyond government ownership and requires climate finance to be channelled to the local level. The voices and concerns of local actors who are at the forefront of climate impacts need to be meaningfully included in deciding how interventions that affect them are financed, designed and implemented. The reality is that most planning still occurs at the international and national levels, with local institutions and actors participating on the margins and as beneficiaries, not as agents of change or champions. This is due to numerous deeply ingrained barriers to locally led finance. These include climate funds and development partners prioritising large-scale results and avoiding small-scale projects with higher transaction costs; insufficient support to build local capacities to manage funds and processes; inappropriate co-financing requirements; and poor enforcement of policies for community engagement (Soanes et al., 2017). However, there are some positive examples of this changing. In Philippines, for example, there are guidelines for formulating local climate change action plans for local government units (LGUs), with some LGUs even taking the initiative to develop comprehensive climate change adaptation plans (ICSC, 2022).

Reforms to increase the flow of climate finance to the local level should focus on setting an ambitious yet achievable international goal for local financing,⁹ earmarking small, flexible grant funding for local programmes for which large grants or loans are likely to be inappropriate, and including local actors in decision-making from start to finish and building their technical capacity to engage. The LoCAL facility under the UN Capital Development Fund (UNCDF) is an example of an initiative using domestic national budget systems to target adaptation actions at the local level. It uses a performance-based climate resilience grant system to channel climate finance and improve local responses to climate change. The underlying logic is that small-scale grants at the local level can potentially produce many small results that deliver a big impact. Although LoCAL aims to be the standard LDC-owned mechanism for subnational direct access to climate finance, it faces significant financial and human capacity constraints, having mobilised \$124.83

⁹ The LDC 2050 plan includes a goal that 70% of all climate finance should support local climate action by 2030 (LIFE-AR, 2019).

million in funding as of December 2021 for 17 countries (LoCAL-UNCDF, 2022). There is an urgent need to establish modalities to secure and scale up long-term and stable financing for locally led initiatives once there is sufficient evidence of their effectiveness.

There is also an urgent need to improve the international community's approach to financing predictable humanitarian crises relating to both slow-onset changes and extreme events. Humanitarian needs linked to extreme weather are rising dramatically, and the current approach is not fit for purpose (Oxfam, 2022). In the absence of a dedicated international financing facility to address loss and damage, humanitarian assistance is likely to continue to play an important role in providing relief for climate change impacts that are unavoided and unavoidable. While post-disaster humanitarian assistance from donors is a crucial source of funding, the timing and volume tends to be unpredictable and slow to mobilise (Bowen et al., 2020). Building on growing evidence that acting prior to the onset of a predictable shock can prevent or reduce acute humanitarian impacts, anticipatory humanitarian assistance (also known as 'forecast-based financing') has gained traction among the biggest humanitarian actors (OECD, 2021). Given that most initiatives are pilots, documenting evidence and learning from each is critical to assess if anticipatory humanitarian action at scale works; for what climate-related hazards and the extent to which it facilitates a faster, more cost-effective and dignified response that involves local actors.



+ 4. Unlocking private climate finance for climate investments



Public climate finance alone, from governments and development partners, will not be sufficient to achieve climate goals; it needs to catalyse and mobilise other sources of funds, particularly private finance. This is recognised in Article 2.1(c) of the UNFCCC Paris Agreement goal of making all finance (both public and private, domestic and international) consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. By no means does this make the role of public finance any less important. Mobilising at-scale private finance requires public finance and game-changing public interventions, be it of a regulatory, legislative and/or jurisdictional nature. There may also be trade-offs, with implications for equity and climate justice that need to be carefully evaluated.

The central question addressed in this section is when and how should scarce public finance best be used to leverage private investment in order to achieve ambitious climate goals, while also adhering to principles of equity and climate justice. Compared to the previous section, it considers an additional element of equity and climate justice relating to ensuring public value for money. This is due to concerns about public finance being used inappropriately to generate unjustifiable windfalls for private parties. The section will specifically consider using public finance:

- to de-risk high-impact projects that otherwise would not be seen as attractive investments to private investors seeking a return
- to make market-based solutions like insurance affordable for addressing climate-induced losses and damages.

4.1. Using public finance to de-risk climate investments for the private sector

Deploying public finance to match risk-adjusted returns to investor requirements when the benefits to society exceed the return to investors makes good economic sense. In the absence of public intervention, there is too little investment from society's point of view. This argument is particularly compelling for mitigation or adaptation investments that have a business rationale and potential cash flows to repay the private investor, but for which excessive risks make the risk-return profile of the investment financially unattractive.

These risks may be real or perceived and typically arise from the following in developing countries: poorly functioning local financial markets; poor understanding of developing countries' markets and local risks; and political and financial uncertainty arising from a poor regulatory environment, exchange-rate fluctuations and/or a long time-frame for achieving returns. Technology risks are another type of risk mainly associated with new and untested technologies, and are typically relevant to all countries regardless of their level of development (such as frontier renewable energy sectors in battery storage, hydrogen, offshore wind and floating solar) (Attridge et al., 2020). The main objective of blended finance is to use public finance to address these barriers and unlock investment

– and to do this with minimum concessionality to avoid wasting public funds. Table 1 illustrates the most common types of instruments used in blended finance transactions to improve the risk–return profile of a project and attract commercial private financing.

Table 1: Selected instruments and the mechanics of blending

Instrument	Blended finance rationale
Grants and technical assistance	Typically deployed when development impact needs to be supported by specific project capacity or when overall project costs are too high. Technical assistance can be grant funded and is usually provided in the project preparation phase to support feasibility studies, policy advice and capacity building to contribute to the overall success of a project and, in doing so, to boost investor confidence.
Debt and equity	Direct contribution within the capital structure to lower the overall cost of capital or to provide an additional layer of protection to private investors through junior/ subordinated capital (so that if something goes wrong, the most junior/subordinated tranche will be paid out last). Concessional senior debt can be used to improve cash flow when there are lifetime cashflow risks.
Guarantees	Provide credit enhancement by protecting against a range of risks, including political, policy, regulatory, credit and technology risks.
Insurance	Provides credit enhancement by transferring the risk of loss to the provider for a predefined premium. Insurance is used to cover political risks, as well as technical/physical risks in the infrastructure landscape.

Alternatively, while a development partner (or the public sector more generally) might be able to finance the entirety of an investment without involving private finance, there are typically two justifications for getting the private sector involved. First, given the resource constraints facing both development partners and governments in developing countries, mobilising private finance is seen as a way of funding critical investments without burdening public budgets. This in turn frees up public finance for other priority areas that are less attractive for the market. Second, the private investment may bring with it desirable attributes not readily available in the public sector. For example, the participation of private corporations and financial institutions can enable knowledge transfer and mutual learning that accelerates decarbonisation (Ahmad et al., 2019).

At the same time, while there is a track record of successful blending operations, specifically with respect to clean energy (Lankes, 2021; Tonkonogy et al., 2018; Attridge et al., 2020), there is significant room for improvement going forward to ensure public value for money and effective policy-making and allocation of scarce public resources.



First, it is important to recognise the tension between two potentially conflicting goals of blended finance in the climate space: scaling up private investments on the one hand and delivering high-impact investments in developing countries on the other. While using blended finance to support projects in lower-income countries, which have high-risk environments and no market access, is likely to achieve high development impact given large development gaps, this approach is unlikely to catalyse large volumes of finance (Lankes, 2021). Opportunities for the latter are more likely to be found in more creditworthy countries where risks are less extreme and there are near-ready market opportunities. While scale and impact represent important policy goals, combining them is likely to be problematic since the challenges and solutions differ (Lankes, 2021). From an equity perspective, focusing on development impact rather than scale may help to increase the size and effectiveness of blended finance for the poorest developing countries. However, given the need to shift finance flows in the context of Art. 2.1(c), trade-offs between these two goals need to be clearly identified to increase transparency, manage expectations and develop appropriate targets for mobilising private finance. This might involve expanding and monitoring the goal to mobilise private climate finance through the targeted use of public climate finance along two tracks: 1) enabling high-impact investments in the poorest countries and 2) enabling scaling up of private investment in countries with risk ratings at the edge of or below investment grade.

Second, there is a gap between the types of instruments most needed and those actually offered in the blended finance space, increasing the risk of a misallocation of public funds (Attridge and Engen, 2019; Tonkonogy et al., 2018; OECD, 2018; Garbacz et al., 2021, Lankes, 2021). Despite several studies identifying guarantees as the most effective instrument for mobilising private finance, senior concessional loans still account for by far the largest share of blended finance investments (Convergence, 2019; Lankes, 2021; Benn et al., 2017). Several challenges restrict the widespread use of guarantees among development partners. First, they are not currently ODA eligible, which deters development partners from using the instrument in their bilateral programme (despite ODA eligibility not necessarily being a climate finance precondition). Guarantees are also often considered complex to implement, given the lack of pricing standardisation across development finance institutions and MDB providers, and because they introduce an additional instrument and third party into transaction negotiations (Convergence, 2021). Additionally, limited awareness and evidence regarding the use of guarantees for development purposes constrain their use. More broadly, transparency and reasonably disaggregated data are critical for assessing the effectiveness and efficiency of blended finance deals, the absence of which is a recognised weakness in the blended finance literature (Lankes, 2021). Addressing these weaknesses is an urgent priority before development partners scale up blended finance.

Third, in some developing countries, using public finance in blended finance deals may not be the most appropriate approach to overcome barriers to private investment. It may be more cost-effective to first use public finance to support governments with their private sector development strategies, strengthening the enabling environment before financing specific blended deals. Blending cannot make up for a weak policy environment and lack of investable opportunities (Attridge and Engen, 2019). Scaling up mobilisation of private finance will in many developing countries and sectors need to involve a strategic partnership between developing country governments and

international partners, and include the local private sector and financial institutions. This is in fact the motivation behind South Africa's Just Energy Transition Partnership (JETP). Announced at Conference of the Parties (COP)26 in 2021, the US, Germany, France, the UK and the EU – together forming the International Partners Group (IPG) – committed to provide and mobilise \$8.5 billion over the next three-to-five years to help the Government of South Africa accelerate the decarbonisation of its electricity sector. Although the details are still being worked out, there is an expectation that some of this international public finance will be used to mobilise financing from the private sector (domestic and international) to invest in renewable energy, increase energy efficiency and pursue green industrialisation (Hadley et al., 2022). Since (COP)26, the Government of South Africa has also taken steps to implement critical domestic policy reforms to transform the country's electricity sector. The crucial next step in the JETP is the development of a country-led investment plan in which international partners will align their support.

4.2. Using public finance to make private sector solutions affordable

Private sector financial products and services could be invaluable for addressing loss and damage, but they need to be carefully designed to achieve the desired impact. Private sector interaction with loss and damage, to date, more frequently takes the form of facilitating the provision of insurance, such as index-based weather or parametric insurance programmes (Linnerooth-Bayer et al., 2018). While insurance can potentially provide funds reliably and quickly when disasters occur, affordability challenges and market inefficiencies remain persistent barriers. Limited uptake of insurance solutions threatens the sustainability of supply at affordable prices in vulnerable countries. Risk carriers lack diversification and economies of scale, which drives up the cost of capital and operations, resulting in higher premiums that vulnerable countries and people are unable to afford (Töpfer and Stadtmüller, 2021).

Private, market-based insurance is underpinned by the principle of mutuality, whereby clients enter the pool usually voluntarily and pay according to the best estimate of the risk they bring with them (Linnerooth-Bayer et al., 2018). Although it is not the role of commercial insurance to address structural inequalities that lead to certain marginalised groups facing higher risks than others, the designers and funders of such schemes should be aware of power dynamics in order to not inadvertently favour or exclude certain people, thereby exacerbating inequalities (Hillier, 2018). The international community is also playing an important role in addressing affordability barriers, providing grants to help countries and people financially with the payment of insurance premiums and providing cheap capital for vehicles that offer insurance. Through the joint efforts under the InsuResilience Global Partnership¹⁰ (IGP), 150 million poor and vulnerable people benefited from climate and disaster risk finance and insurance (CDRFI) solutions in 2021 alone. Furthermore, IGP aims to scale up CDRFI solutions to 500 million poor and vulnerable people by 2025, to accelerate a shift from ex-post financing (i.e., humanitarian and disaster reconstruction funds arranged after disasters) to prearranged risk finance that provides funds reliably and quickly when disasters occur.

¹⁰ IGP comprises more than 118 partners from governments, civil society, international organisations, academia and the private sector.



Using public resources (domestic and international) to subsidise insurance premiums, however, does not automatically satisfy equity concerns. Care must be taken to ensure that subsidies benefit the intended beneficiaries rather than insurers. In a heavily subsidised weather-based crop insurance scheme in India, insurers were perceived to profit at the expense of poor farmers, with payouts to farmers totalling just 40% of the money paid into the scheme, of which 60% came from the farmers and 40% from the government (Reeves, 2016). It is also important that grants or other types of concessional financial support for insurance subsidies are backed by reliable, sustained support from development partners, rather than sporadic, unpredictable funding. This is explicitly recognised in the SMART Principles for Premium and Capital Support created by IGP to give clear guidance on the sustainable, fair and effective allocation of premium financing (Töpfer and Stadtmüller, 2021; IGP, 2019).

Furthermore, the cost effectiveness of using grants to subsidise insurance premiums should be proved to be more than using grants for other measures to address loss and damage, with this re-evaluated at regular intervals. Currently, there is a lack of evidence of this, leading to assertions that donor support for insurance mechanisms is driven by an ideology that favours private sector solutions, not facts (Richards and Schalatek, 2018). In addition, as explained in Box 5, there are clear limits to the types of climate change impacts and risks that are insurable, especially with respect to slow-onset processes and non-economic losses and damages (Schäfer et al., 2018; Mustapha, 2022). Insurance is best viewed as part of a holistic climate risk management approach, complemented by other non-insurance solutions funded by the international community. As suggested in the literature (for example, Richards and Schalatek, 2018), these solutions could include:

- A global solidarity fund/ loss and damage facility to provide grants to the poorest and most vulnerable countries facing climate impacts from both extreme events and slow onset processes.
- Contingent emergency credit following an extreme event, such as flooding or drought, for countries with more fiscal space can provide a cushion for a wide range of risks, rather than formal insurance – which requires each risk to be separately insured and the payment of multiple policies.
- Alternative livelihood programmes and relocation funds to help communities forced to move by rising sea levels and other slow-onset processes.

Box 5: Limitations of insurance mechanisms in addressing loss and damage

- **Insurance is not an appropriate measure for all types of risks**

For insurance to be viable, it needs to cover events that are sufficiently random and infrequent in their occurrence. Insurance is therefore not appropriate for slower-onset, climate-induced impacts, which will happen with high certainty under different climate change scenarios, such as desertification and the loss of glaciers and other cryospheric water sources.

- **Insurance cannot cover all types of losses**

Insurance is not well suited to addressing non-economic losses and damages that do not have a market price and cannot easily be given a monetary value. These include

loss of species, cultural and psychological losses, temporary or permanent impairment of people's mobility, and lost opportunities for children and future generations (Tschakert et al., 2019). Attempts to assign a monetary value are likely to require making assumptions that are hard to justify or are not widely accepted.

- **Climate change may make some risks uninsurable**

Given that climate change will increase the intensity and frequency of extreme weather events, there may come a time when some extreme weather events, such as recurrent flooding, become so severe or frequent that they are uninsurable. Globally linked weather events may also become more difficult to diversify.

Source: Adapted from Schäfer et al., 2018



+ 5. Conclusion



Public climate finance from developed countries plays a vital role in supporting developing countries to achieve their climate goals. This precious resource can be provided in a variety of ways: via debt, grants, equity investments, guarantees and insurance. Currently, most climate finance provided and mobilised by developed countries, in pursuit of the elusive \$100 billion annual target, is provided in the form of debt. Although the terms tend to be more generous than those of the market (i.e., terms from commercial banks or international capital markets), this reliance on debt financing has been heavily criticised by some developing country negotiators and civil society actors for imposing an unfair burden on its recipients in the form of debt service payments, thereby undermining equity and climate justice.

While recognising that this argument is valid in some cases, this paper explores the extent to which all instruments, including debt, can be designed to align with different views of equity and climate justice. Table 2 summarises the key findings of the paper with respect to each instrument. This can in turn be used to inform principles and benchmarks used for the GST, given the current conceptual ambiguity surrounding equity (Pettinotti et al., 2022). This list is not intended to be comprehensive, and instead highlights the key issues in existing literature and thematic debates explored in this paper.

Table 2: A checklist for aligning climate finance to equity and climate justice principles

Instrument	Considerations for achieving equity and climate justice
Grants	<ul style="list-style-type: none">✓ Target and prioritise those with the greatest ‘need’ based on clearly defined, multidimensional criteria.✓ Provide in a predictable manner that allows for planning and for long-term action, especially when addressing losses and damages from risks that can be anticipated.✓ Procedures for accessing funds are simple and not cumbersome relative to the intended recipients’ capacity (specifically SIDS and LDCs).✓ When used to mobilise private finance (in blending), grants have a clear development objective and, where appropriate, are used alongside efforts to promote a sound enabling environment.
Loans	<ul style="list-style-type: none">✓ Provide in a way that does not undermine public debt sustainability or crowd out critical public spending via onerous debt service payments.

Instrument	Considerations for achieving equity and climate justice
	<ul style="list-style-type: none"> ✓ Responsible borrowing and lending practices are developed and adhered to. ✓ Where appropriate, state-contingent debt features like disaster-linked clauses are used. ✓ Where appropriate, debt swaps are used, based on the country's priorities. ✓ When used to mobilise private finance (in blending), loans have a clear development objective and, where appropriate, are used alongside efforts to promote a sound enabling environment.
Equity	<ul style="list-style-type: none"> ✓ When used to mobilise private finance (in blending), equity investments have a clear development objective and, where appropriate, are used alongside efforts to promote a sound enabling environment.
Guarantees	<ul style="list-style-type: none"> ✓ When used to mobilise private finance (in blending), guarantees have a clear development objective and, where appropriate, are used alongside efforts to promote a sound enabling environment.
Insurance	<ul style="list-style-type: none"> ✓ Where appropriate, insurance premiums are subsidised for the poorest and most vulnerable. ✓ Provide adequate and reliable payouts. ✓ Forms part of a risk-layering approach to address loss and damage. ✓ When used to mobilise private finance (in blending), it has a clear development objective and, where appropriate, is used alongside efforts to promote a sound enabling environment.

The paper's main conclusions and recommendations are summarised below:

- There is no 'one size fits all' when choosing the most appropriate instrument. Country-specific and project-specific factors can have major implications. Debt, for example, is not necessarily bad if it is used to finance a project that has a high probability of generating returns and/or the borrower has the capabilities and institutions to ensure that debt is sustainable and productively used.

The special case of SIDS further demonstrates the importance of country context. Based on income alone, many are likely to be excluded from accessing grants and concessional resources. However, when one considers their unique characteristics



and needs, a compelling case can be made for providing them with grants and concessional financing. Innovative financial instruments such as debt-for-climate swaps and state-contingent debt instruments are also likely to be highly beneficial to SIDS when properly designed.

- All instruments discussed in this report have the potential to be badly designed and executed from an equity and climate justice perspective. For example, tedious procedures and stringent requirements can prevent the intended beneficiaries from accessing grants from multilateral climate funds on a timely basis. For loans, irresponsible lending practices can wreak havoc on the recipient's economy and result in untold hardships for the poorest and most vulnerable citizens. Poorly designed insurance mechanisms, meanwhile, can make insurance unaffordable to those most affected but least responsible for climate change or might provide payouts that are too little, too late. Blended finance deals that subsidise private investments that would have happened anyway can be a waste of scarce public concessional finance.
- It is not only the type of instrument that is important but the modality through which it is delivered. In this respect, the shift away from project-based finance to a more programmatic approach that supports the recipient's long-term development plans and uses country systems is a positive development. However, past efforts demonstrate that measures to ensure country ownership are insufficient for facilitating locally led finance. Instruments must be carefully designed to enable finance to reach and meet the direct needs of local communities.
- It is imperative that the international community understands and utilises the complementary strengths of the different types of financing instruments. With respect to addressing loss and damage, insurance is likely to be just one component of a wider risk-layering approach, with different instruments needed to address the impacts from slow-onset processes as well as non-economic losses and damages. The blended finance approach also shows the potential benefits of combining different instruments to achieve greater impact and scale. Notably, the appropriate instrument largely depends on the barrier to private investment being addressed.
- Finally, there is growing evidence and recognition of the underlying tension between mobilising investment at scale and transferring resources from developed to developing countries. Achieving greater scale as well as impact will most likely require strategies targeting each of these objectives, rather than combining them. In the case of blended finance, enabling high-impact investments is likely to involve focusing on supporting frontier adaptation investments in lower income countries, while enabling scale of private mobilisation will require focusing on investments in sub-investment grade countries and established technologies (Lankes, 2021). This underlying tension needs to be considered in the Global Stocktake that will assess progress towards means of implementation, which includes climate finance. The way in which the GST considers this tension is also likely to be reflected when designing the post-2025 climate finance targets.

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