

## 22<sup>nd</sup> session of the Committee of Experts on Public Administration

### Written statement by Center for Public Policy Development-ESPOL Polytechnic University

*Agenda item 5: Institutional mechanisms for providing economic, financial and structural support to address climate change, reduce the use of fossil fuels and protect biodiversity*

#### **Principle-based mechanism design**

This submission recommends a principle-based approach to develop a global institutional arrangement for climate finance that facilitates political support and decision-making. These principles are:

1. Just-transition
2. High-integrity
3. Impact-driven

By following these three high-level principles, intergovernmental negotiations may facilitate progress in securing financial resources for climate action and biodiversity protection in the scale and speed needed while ensuring its effectiveness.

The following are comments to the recommendations contained in the expert paper prepared by the Committee. These recommendations have been group into those related to Quantity, Quality and Institutional Arrangements.

#### ***Quantity: Unknown goal***

First, the central limitation to deliver climate finance at the scale and speed needed is that it remains an undefined goal. Cancun long-term funding arrangements were aspirational – not science-based. Therefore, our first task is to defined a science-based goal for climate finance. This requires a joint effort using an IPCC-like approach and political endorsement. A global financial needs assessment should balance mitigation and adaptation targets. On Mitigation, financial targets should link emissions levels and timelines for 2030 and 2050 to facilitate an impact-driven framework for monitoring and verifying effectiveness of actions in line with Paris Agreement. To ensure joint delivery of adaptation outcomes, measurement of needs for enhance adaptive capacity and resilience should be specified in short, medium and long term to avoid irreversible damages in people and planet. The resulting science-based climate finance goal must be endorsed by a legally binding climate and economic agreement to catalyze institutional change including a clear plan for delivering (e.g., defining approaches for goal achievement such as bottom-up pledges or top-down distribution according to historic responsibility and current capabilities.)

#### ***Get the prices right***

Second, quantity of climate finance can be explored as a function of factor prices, relative prices of inputs such as energy, availability of technology, and quality of institutions. In this context, getting the prices right means that forest should be worth more live than dead and that avoidance costs should equate exploitation benefits while access to clean technologies should not be restricted by intellectual property rights. There are many available options for efficient carbon pricing (e.g., domestic fossil-fuel subsidies removal and carbon taxes tax on fossil fuel windfall revenues *vis-a-vis* carbon takeback obligations) and reducing barriers to climate

beneficial technologies. Reducing the financial attractiveness to public and private fossil fuel investment requires a higher risk premium to access capital. One complementary measure could be the overall increased stringency of climate risk disclosure requirements by countries. Credit rating agencies could use this information to define country's risk profile affecting their credit access. Limiting available finance for fossil fuel-related investment should require International finance institutions (IFI) and multilateral development banks (MDB) to cease new funding

### ***The business case for transition of megabiodiverse oil-rich countries***

Megabiodiverse developing countries are already at high risk of or are currently in debt distress. Many of these countries face a triple whammy; they are often most vulnerable to climate change impacts, and for some, have a high dependence on fossil fuels. Countries like Ecuador could see debt downgrades due to climate change (i.e., both physical and transitional risk exposure), making it even harder to finance debt.

Debt-for-climate swaps can help countries escape this triple threat and make the investments they need to make in low-carbon, high-biodiversity, climate-resilient development pathway such as sustainable bioeconomy. For instance, although framed as middle-income country, Ecuador economic development is limited to a narrow range of sectors such as petroleum production. It is a serial defaulter and its sovereign bonds are again trading at distressed levels, or a deep discount to their face value due to increased political instability-linked country risk. But it does have a wealth of biodiversity that it could leverage to diversify economic sectors in a wider region where biodiversity loss has reached an unprecedented level. The country is holding talks with banks and a nonprofit group in an attempt to reach a deal that would see about \$800 million of its debt refinanced more cheaply, freeing up the savings for conservation efforts.

The debt-for-climate swaps market has steadily picked up pace over the past two decades, adding another \$2.7bn of transactions, and some are now forecasting the market will grow as large as \$800bn. The business case for the instrument are nations like Ecuador with relatively high public debt and high mitigation potential; countries with substantial natural resources such as forests and other natural carbon sinks that are also heavily dependent on fossil fuels. An International Institute for Environment and Development's analysis shows that 58 countries, holding \$497bn in external public and publicly guaranteed debt, that could be part of a climate and nature-related Highly Indebted Poor Countries-liked initiative. It estimated that \$397bn could be written off, with 26.3% of that debt relief, \$104.5bn, being channelled to climate and nature action.

### ***Leverage private sector engagement and delivery***

One alternative is to improve performance of current available instruments gearing traction from private-sector while developing alternatives. The voluntary carbon market and fixed rate debt instruments such as green and sustainability-linked bonds can mobilize significant resources. While addressing integrity concerns and other critiques, these are two readily available tools that can channel finance at the scale and pace needed.

In addition, complementary tools can contribute to address integrity concerns. This is the case of the use of "share of proceeds" from carbon markets. This is an earmarked levy targeted to redistribute benefits for adaptation / loss and damage purposes from high mitigation potential regions to those most vulnerable yet with low mitigation potential. For instance, the use of a share of proceeds have mobilized 5% of total revenues from the Clean Development Mechanism. In fact, it has been one central financing source for the Adaptation Funds. In this context, the Voluntary Carbon Market (VCM) has been pointed as an instrument of a global financing strategy for sustainable development. Given the expected increase of size of the VCM, the fundraising potential for similar levies is promising (e.g., by 2030, the market is expected to reach between \$10 billion and \$40 billion).

### ***Quality: it's all about impact alignment and generation***

There is an increasing need for enhanced transparency and accountability in the effectiveness of climate finance – additionality and impact. The adoption of the UN-promoted Sustainable Development Goals (SDG) Impact Measurement and Management standards can address the need to differentiate between outputs (such as cost of capital), and outcomes (desired climate-positive change in investee activities). In fact, integrated national financing frameworks provide a framework for financing national sustainable development priorities and the SDGs at the country level. This impact framework has proven a useful tool to integrate the SDGs into national and subnational budgeting and financial management to ensure positive impact while avoiding negative effects on macroeconomic and financial stability. Other frameworks such as Policy Coherence for Sustainable Development can contribute to climate coherent policymaking, public investment planning and fiscal debt weights.

Impact is driving investment in the private sector. There are private-led efforts such as the Integrity Council for the Voluntary Carbon Market (VCM) aiming at developing high-integrity frameworks drawing from UN Principles of effective governance. In 2023, the Integrity Council will release its Core Carbon Principles (CCPs): a threshold for high-quality carbon credits. To be eligible for CCP labeling, mitigation activity developers and carbon crediting programs must meet several criteria, including on the robustness, additionality and permanence of impacts on emissions, governance, independent verification, and environmental and social safeguards and positive sustainable development impacts. Compliance is voluntary but the principles are expected to become a mark of credibility that will improve trust, practices and information across credit supply. This framework incorporates the need to identify, measure, report and verify positive sustainable development impacts beyond mitigation contributions (i.e., emissions reductions or removals).

In addition, impact standards and tools can contribute to incentivizing adaptation finance. For instance, UN SDG impact measurement and management frameworks can facilitate evidence of contributions to adaptation or biodiversity protection that can be linked to interested investors. This is the case of carbon market's adaptation co-benefits reporting. As high-integrity VCM credits evolve into financial derivatives it could be marketed along the lines of mortgage-backed securities. Such projects could mitigate investor risks by diversifying in terms of sector, region, scale and other dimensions.

Another alternative to contribute to the sharing of long-term climate risks and attract private investment is the use of long-dated financial instruments (i.e., "climate linkers," a novel class of financial instruments, bonds, swaps, and options) with payoffs indexed to climate-related variables, e.g., temperatures, sea levels, or carbon concentrations.

### ***Get institutions rights***

There is need for novel institutional arrangements to alleviate global massive debt distress and facilitate climate fiscal reform including debt relief and swaps as well as other complementary measures such as channeling a share of allocated Special Drawing Rights for adaptation purposes. In fact, to be deployed most effectively, any instrument of the climate fiscal reform needs to work as part of a suite of debt management and climate and nature financing tools – with any loan agreement building in climate resilient debt clauses as well. For instance, a recent UK and France joint leaders' declaration detailed on debt suspension for climate emergencies recalled their commitment to add a dedicated climate resilience debt clause to bilateral concessional export loans, which will allow countries to defer debt service repayments in the event of a major climate disaster as well as to encourage the uptake of Majority Voting Provisions in new sovereign loan agreements with commercial lenders to facilitate restructuring of syndicated loans.

***Debt-for-climate swaps linking adaptation, nature-positive carbon markets and private finance***

Debt swaps are not built into the international financial architecture, so transaction costs for individual swaps are typically high and public scrutiny shows increasing concern with regard to debt legitimacy and lack of processes transparency. Plus, for many credit rating agencies, a debt swap technically counts as a default, so it would negatively impact the credit rating of the country. Therefore, international arrangements should guide ratings agencies to change accordingly to properly align incentives.

Debt swaps transactions are not necessarily suitable for countries in severe debt distress, as by that point they would need extensive debt restructuring and relief. A global dialogue that incorporates creditors on the table – in particular private creditors holding developing country debt - should include agreements to standardized access for countries with high and prohibitive debt burdens who want to manage their debt to improve their economic situation.

A note of caution is in place for the Committee's report using existing debt swaps as good practice. The case presented includes the financial intermediary role of different for-profit consolidated affiliates and wholly owned subsidiary firms. At their simplest, these deals see expensive bonds or loans written down and replaced with cheaper financing, usually with the help of a credit guarantee from a multilateral development bank. Ecuador, for example, is in talks with the Pew Charitable Trusts plus the Inter-American Development Bank and U.S. International Development Finance Corporation to strike one of the largest debt swaps (i.e., \$800M). As with other cases, a for-profit private company is acting as intermediary.

A UN-backed debt swap mechanism should facilitate to achieve an investment-grade rating from credit ratings firms, low interest rates, a delayed payment schedule, and a long bond maturity without a complex financial architecture that increases transaction cost and may be challenged by civil society actors. In line with the proposed principle-based approach of this submission, the sovereignty of country decision should not be undermined while commitments and conditions for debt-swap or refinancing should be negotiated in full transparent framework, including disclosing which debt holders would be involved in the swap and how much debt would be forgiven.

Development banks should come together with expanded and standardized support to drive widespread use of debt swap instruments. Securing the buy-in of development banks is usually key for the economics of a deal. But as the banks must closely guard their capital and credit ratings to preserve their ability to borrow cheaply, that hurdle has long restricted the growth of swaps. Thus, all IFIs and MDBs should be instructed to "absolutely" start de-risking climate-linked debt swaps by providing credit guarantees to reduce transactions cost.

Private lenders are driven by commercial reasoning and will need to be incentivised. One way of achieving that would be for some of the private creditor debt to be exchanged for validated, high-quality carbon credits that could credibly support private sector net-zero targets and contribute with adaptation finance through their share of proceeds. This would also ensure that the swap proceeds are being used by developing country governments for financing their climate transition efforts reported to the United Nations Convention on Climate Change as part of their National Determined Contribution while contributing to the Adaptation Fund to address needs of those vulnerable countries with low mitigation potential.

Improvements are also needed in how climate / biodiversity pledges under debt swaps are monitored and verified so that creditors are satisfied that countries are meeting their commitments. Sovereigns should embrace KPI-linked adaptation and biodiversity bonds integrated into their national financing frameworks. Incentivizing the joint use of debt swaps with sovereign sustainability-linked bonds and green bonds can add one additional layer of monitoring and reporting in light with Green Bond Principle as best-practice to avoid over the counter negotiations with poor transparency and accountability, helping mobilize more private investment into mitigation and adaption finance consistent with sustainable development priorities and the SDGs at the country level.

***Enhance capacities to facilitate direct access to national / subnational / IP & LC***

There is need to ensure enhanced capacities at every level to ensure integrity, particularly to facilitate direct access by indigenous people and local communities. This requires phasing out agency-donor implementation models to reduce overhead and international bureaucracy costs across time. Deliver-as-one capacity building efforts is feasible if IFIs/MDBs adopt integrated KPI to avoid competing and ensuring effective deployment.

Lastly, the relevant UN bodies should aim at synergies and innovate on self-management and financing to unlock perceived UN donor-related blockage to new organizations and efforts.