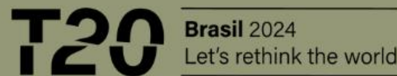
T20 Policy Brief



Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

From Conditionality to Commitment: A Sustainability-linked Approach to Financing the Green Transition

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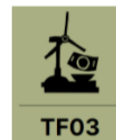
Abstract

There is an urgent need for innovation in sovereign financing. Credit enhancements in the form of bond guarantees, paired with a key performance indicator (KPI)-linked financing in the form of sustainability-linked bonds and loans, have demonstrated their potential to unlock substantial sums of funding for the green transition. To scale these innovations, multilateral development banks and development finance institutions need new approaches to optimize their balance sheets and engage with sovereign borrowers. This T20 Policy Brief recommends that the G20 champion a KPI-linked approach that can leverage the advantages of both loans and guarantees in a bundled financing package, thereby maximizing the volume of concessional and private capital that can be mobilized. A sustainability-linked approach ensures that credible commitment, robust performance tracking, and effective incentive mechanisms are in place to drive action towards sustainable development goals.

Keywords: Sustainability-linked financing, Sovereign Debt, Policy-based lending, Policy-based guarantees, Multilateral Development Bank

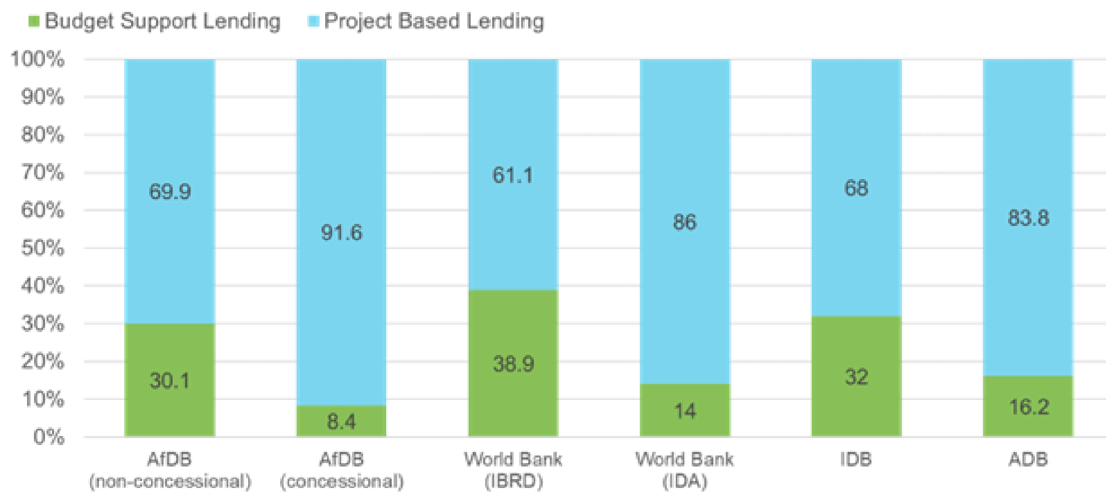


Diagnosis of the Issue

The latest estimates of the funding needs for the green transition are in the order of US$ 3-4 trillion per annum (G20, 2023a). By contrast, the current lending volumes by multilateral development banks (MDBs) hover around US$ 100 billion annually (CRS 2023). Even if calls to triple levels to US$ 390 billion per year by 2030 (G20, 2023b) are realized, that would still leave a prodigious financing gap to achieve the sustainable development goals.

Given the central role of governments in directing investments towards climate mitigation and adaptation, much of the MDB funding that is forthcoming will need to be channeled through governments via budget support loans. Also called policy-based loans (PBLs), these oblige the sovereign borrower to enact specific pre-agreed policy actions or reforms to unlock the funds. They tend to be large, quick to disburse, and flexible in terms of how the proceeds are used. Crucially in the context of rising debt distress across emerging markets and developing economies (EMDEs) (World Bank, 2022a), PBLs enable sovereigns to refinance maturing obligations and reprofile their debt stock. However, not all MDBs offer such facilities, and those that do tend to favor project-based lending that earmark proceeds for specific investments (see Exhibit 1).

Exhibit 1. **Budget Support vs. Project-Based Lending in Select MDB Portfolios**

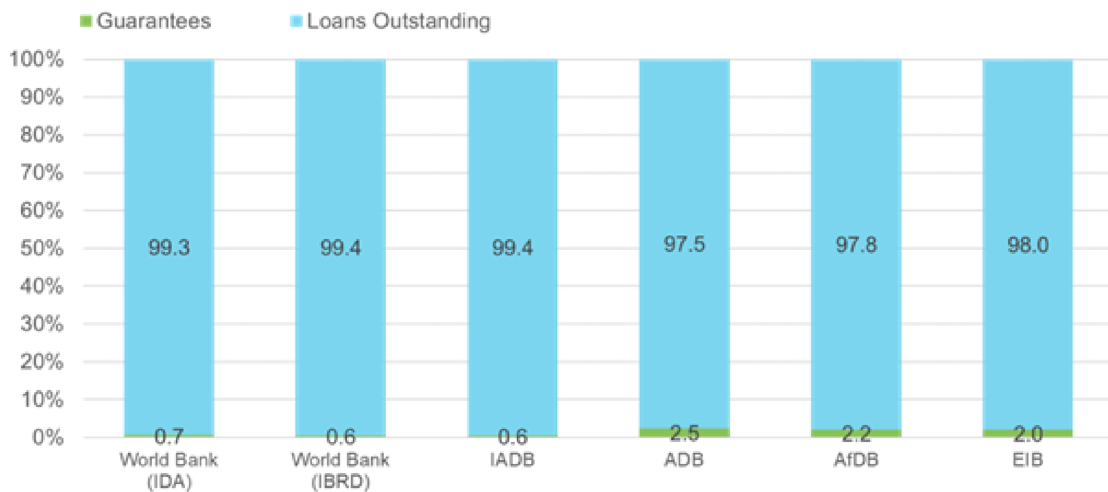


Source: Chris Humphrey, 2022.

Against this backdrop of constrained MBDs lending capacity amid escalating climate-related budgetary spending pressures for EMDE sovereigns, the need for private capital mobilization via credit enhancement is more pressing than ever. Credit guarantees and insurance bolster borrower's creditworthiness by transferring all or part of the credit risk to a higher-rated MDB or other guarantor. Most of the MDBs offer policy-based guarantees (PBGs), which like PBLs come with conditions attached. By appealing to a deeper pool of risk-averse lenders/investors, credit enhancement has been shown to mobilize upwards of 1.5x the equivalent of development lending (BFT, 2023).

Despite this higher mobilization potential, guarantees and credit insurance constitute less than 2% of MDBs portfolios (see Exhibit 2). This is partly because of institutional rules that skew the calculus for both borrowers and MDB in favor of loans. For example, MDBs generally treat guarantees as loans in terms of provisioning and pricing, and both guarantees and loans consume an equal amount of country limit even though the latter is a contingent instrument and guarantee call rates are much lower than loan default rates (Humphrey and Prizzon, 2014).

Exhibit 2. Loans vs. Guarantees at Select MDB Portfolios



Source: Annual Reports, Fitch Ratings

Such constraints may curtail the volume of financing that could be mobilized for sovereigns. Addressing them via institutional reforms is one avenue to correct this imbalance, for example, by giving guarantees a lower weighting for PBGs compared to PBLs in terms of country-limit utilization. Indeed, the World Bank's International Development Association (IDA) previously had a policy whereby a PBG counted only 1:4 against a sovereign's country lending envelope. For example, in 2015, Ghana opted for a USD 400 million guarantee on a USD 1 billion international bond instead of drawing down its remaining USD 100 million country borrowing limit for a PBL. The guarantee enabled the sovereign to secure external bond market access on favorable terms at a time of heightened financial market volatility and fiscal stress. The offering had the longest tenor of a Sub-Saharan African sovereign (excluding South Africa), the order book was 100% oversubscribed, and the bond was priced at 150-200 basis points below the theoretical "naked" bond (World Bank, 2017).

The "Ghana 2030" bond is illustrative not only in demonstrating the higher capital mobilization potential of guarantees compared to loans, but also as a case study of how

they perform when executed. For in 2022, Ghana defaulted on large swathes of its external debt, including the 2030 covered bonds, leading to the guarantee being called. A sovereign counter indemnity provision converts the guarantee into a USD400 million IDA loan with a preferred creditor status once it has fully paid out. Whether this outcome is, on balance, more favorable for Ghana than having opted for a smaller loan upfront is still open to debate (Weidemaier et al., 2023). However, weighing the trade-offs between PBLs and PBGs as presented in Exhibit 3, there are clear complementarities between the two options. Given this, might Ghana have been able to use both?

Exhibit 3. Policy-base loans vs. Policy-based guarantees

	Policy-Based Loan (PBL)	Policy-Based Guarantee (PBG)
Borrower	☑ Rapid disbursement ☑ Single counterparty ☑ Refinancing and liability management ☒ Limited country envelope ☒ No benefit for domestic capital market development	☒ Extra fees for issuance ☒ Added complexity due to additional counterparty (guarantor) ☑ Greater leverage via private capital mobilization ☑ Enables yield curve construction
Lender	☑ Rapid disbursement ☑ Professional incentives tied to "cash out the door" ☒ Limited country envelope/ mobilization potential	☒ Additional counterparties ☒ 1:1 equivalent loan pricing ☒ Fewer management incentives ☑ Higher mobilization potential

Source: Authors

Recommendations

The primary recommendation of this policy brief is to realize the potential complementarities of PBLs by combining loans and guarantees into one funding package, with the guarantee acting as an add-on to a loan. In this way, the borrower could draw part of its country envelope for a loan and the remainder for the guarantee, thereby mobilizing an extra amount through the bond market. The package could even contain a provision whereby the remainder of the outstanding guarantee would be automatically added to the loan balance in the event of a call. This would help to clarify the workout of guarantee under a debt restructuring.

The secondary recommendation is to structure the funding package according to a key performance indicator (KPI)-linked approach, as opposed to the established practice for PBLs and PBGs of attaching policy conditions that are designed *by the creditor*. A KPI-linked approach means that both the loan and the guarantee embed specific targets and specify KPIs that track progress against them, which are both selected *by the borrower*. When the targets and KPIs are linked to sustainability outcomes, it means packaging a sustainability-linked loan (SLL) with a guarantee on a sustainability-linked bond (SLB) containing the same sustainability targets and KPIs.

The targets and KPIs embedded in SLBs and SLLs are determined by the borrower in consultation with creditors and other market participants such as second opinion providers, who are contracted to validate ambitiousness of targets and verify the integrity of KPIs. This ensures that the targets are appropriately ambitious and the KPIs are sufficiently material to induce action towards the commitments while mitigate greenwashing. Meanwhile, having borrowers choose the targets and KPIs arguably imbues them with greater legitimacy than if they were imposed by the creditor, since the

government can select those that closely map to their self-defined policy priorities and homegrown development strategies.

At present, only a handful of SLLs and SLBs have been issued at the sovereign level. Chile was the pioneer in March 2022 with its inaugural SLB that contained emission and energy transition targets (Hacienda Chile, 2024). It incorporated a negative incentive mechanism whereby the coupon interest rate on the bond “step ups” if the targets are missed. Uruguay followed suit in October of that year with a native forest cover target and a novel symmetrical “step-up/-down” feature that rewards the issuer with a lower coupon rate if the targets are achieved. Uruguay set a precedent again late 2023 by securing the first sovereign SLL from the World Bank, which it labelled as a ‘development policy loan’ (DPL) (World Bank, 2023b). The USD 350 million loan included a “step-down only” feature with targets around the intensity of methane emissions from livestock production.

The lack of sovereign SLB issuance outside of two Latin American countries can be attributed to many factors, among them challenges of pricing and managing the risk of the embedded coupon ratchet feature. Both investors and issuers have expressed reservations about having an “embedded option” that renders the cash flows of the instrument contingent upon probabilistic events (Erlandsson, 2022). Yet removing it would arguably dilute the incentive for the borrower, and thereby undermine the value proposition of an SLB compared to a “plain vanilla” bond.

Our recommendation around this problem is to strip the SLB of the coupon ratchet feature while retaining it in an accompanying SLL. This SLB-SLL bundle would have *identical targets, KPIs, and terms*, such that the measure of success and failure would be the same. The SLB could therefore be priced and managed as a vanilla bond would, while still retaining the performance tracking feature and the incentive mechanisms of the SLL.

Since the step-up/-down applies only to the loan provided by the MDB, issuers cannot buy-back the loan early to avoid a step-up – a major loophole of SLBs. Furthermore, because the MDB enjoys preferred creditor status (i.e., superseniority), it is less likely that the bond issuer will not pay the penalty. This arrangement could therefore significantly strengthen the incentive mechanism while plugging some of the loopholes in existing SLB structures. It would also allow for other synergies. For example, the monitoring of the loan servicing might obviate the need for an external second-opinion provider, which should cut down on issuance costs and address vendor risks inherent in having third-party participants.

Based on these considerations, the authors make the following recommendations to the G20:

1. **Foster innovation in sustainability-linked sovereign financing:** The G20 should prioritise the scaling of innovative sovereign financing solutions with high capital mobilisation potential that embed sustainability targets, especially KPI-linked instruments and credit enhancement mechanisms, and call for their widespread adoption by MDBs. To this end, the G20 can ensure that these innovations are part of the research agenda of relevant internal and external technical working groups, including the Global Expert Review on Debt, Nature, and Climate (CBFP, 2023).

2. **Encourage a shift from "conditionality to commitment":** The G20 should initiate a dialogue on how MDBs can optimise the use of policy-based loans and guarantees by switching from a traditional conditionality to a KPI-linked approach. Furthermore, the G20 can leverage their authority as major shareholders to push for deeper collaboration among MDBs on common KPI-linking frameworks and sovereign financing models, including the packaged deals described in this policy note. This can be achieved, *inter alia*, by reinforcing and sustaining political backing for initiatives such as

the Task Force on Credit Enhancement for Sustainability-linked Sovereign Financing of Nature and Climate[1].

3. **Participate directly in transactions via development finance institutions (DFIs):** With the political backing and policy guidance of their respective G20 governments, DFIs can play a catalytic role in scaling up sustainability-linked sovereign financing models as both lenders and guarantors. Their ability to issue unfunded guarantees is a critical advantage over MDBs in terms of maximising the private capital mobilisation.

4. **Support the development of common platforms and shared standards for sustainability KPIs.** The G20 can prioritise across multiple working groups of the finance and sherpa tracks the development of standardized sustainability KPIs accessible on open-source platforms, which can be readily referenced and adopted in order to streamline the design of sustainability-linked transactions.

5. **Establish a common framework for treating guaranteed bonds in sovereign debt restructurings.** Giving investors in guaranteed sovereign bonds confidence that their claims under the guarantee will be honoured and that they will not be unfairly treated during sovereign debt workout is critical to ensure the necessary market uptake. Although many legal arbitration questions surrounding the Ghana 2030 bond restructuring are still being resolved, the case will serve as a key precedent for future guaranteed bond issuances. Therefore, the G20 should initiate a dialogue with relevant stakeholders in the process to help avert an outcome that could prejudice future guarantees and undermine demand for covered bonds going forward.

[1] See: https://creditenhancement.org/

Scenarios

There are multiple configurations for how loans and bonds can be packaged as a way to scale up sustainability-linked financing by MDBs and DFIs. We consider two scenarios, before laying out some major trade-offs and challenges for implementing the above recommendations.

A packaged deal requires both a lender and a guarantor, or a syndicate of either. An MDB can issue both, as the World Bank did in Uruguay and Ghana respectively. However, because the core business of MDBs is lending, they treat guarantees the same as loans from a pricing, accounting, and capital management standpoint. For example, the African Development Bank (AfDB) prices their guarantees on a loan equivalent basis, plus a front-end fee of 0-25 basis points for the guarantee (AFDB, 2021).

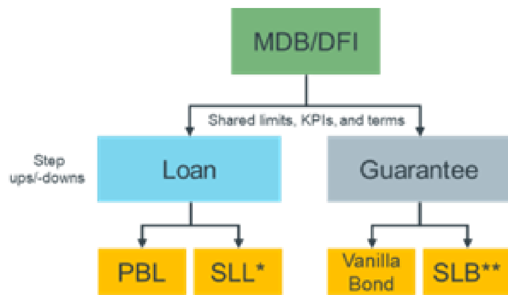
By contrast, specialized guarantee providers, such as the World Bank's Multilateral Investment Guarantee Agency (MIGA) or the US Development Finance Corporation (DFC), operate more like insurance companies and price their guarantees accordingly. For example, MIGA's non-honoring of sovereign financial obligations (NHFO) facility, which offers credit insurance against non-payment by sovereigns, charges premiums and fees much as a private-sector credit insurer would (MIGA, 2024). This enables it to reinsure a substantial portion of its portfolio, meaning it can redeploy capital soon after a guarantee has been issued. However, NHFO facility is available only to sovereigns rated 'BB-' or higher, which limits access for the most vulnerable sovereigns. And although the facility can accommodate both loans and bonds, only one bond has been covered so far (World Bank, 2022).

Two scenarios for how to package a KPI-linked loan and guaranteed bond are displayed in Exhibit 4. The right-hand panel depicts a loan issued by a development bank

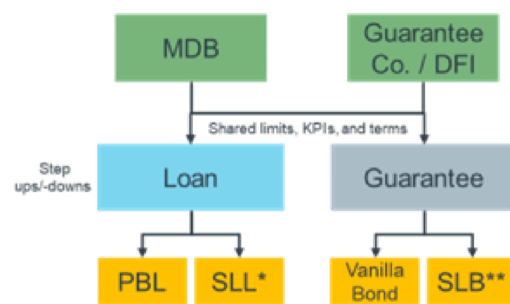
and a guarantee issued by specialized agency. This is arguably the optimal structure since the advantages of differentiated pricing and capital consumption can be fully exploited.

Exhibit 4: Stylized scenarios for packaging loans and guarantees

A. Single Provider Scenario



B. Risk-Sharing Scenario



*Sustainability-linked loan (SLL). Sustainability-linked bond (SLB)

Source: Authors

Scenario B necessitates close collaboration between separate agencies to align contractual terms, targets, and KPIs. This can be challenging in light of distinct and possibly contradictory mandates, risk appetites and management practices, and political priorities. Harmonizing processes and standardizing policies will require considerable investments of time and resources to coordinate actions across institutions and jurisdictions, which could detract from other activities. We argue that these trade-offs are worthwhile owing to the efficiency gains and mobilization potential of such a risk sharing partnership. The G20 can help to facilitate this collaboration by bringing the pressure of principal shareholder status to bear.

A separate challenge concerns the treatment of guarantees in the event of default. If it carries a counter guarantee obliging the sovereign to indemnify the guarantor in such a scenario, then the resulting loan could complicate a debt restructuring, especially if

preferred creditor status places it outside of the restructuring perimeter. However, not all guarantors demand counter indemnity agreements — for example, the US DFC did not for its political risk insurance covers in the Belize, Ecuador, and Gabon debt-for-nature swaps — and the amount need not equal the full notional of the original guarantee. The G20 governments can, via their DFIs, accept lower or no indemnities in order to spur uptake of covered bonds by sovereign issuers.

A final potential trade-off is the possibility that increasing the role of guarantees may lessen pressure to expand the lending capacity of MDBs. At scale, they may also give rise to significant contingent liabilities for guarantors and their governments, especially if the facilities are unfunded. A synchronized debt crises across EMDEs could potentially see multiple simultaneous calls, putting excessive pressure on MDB and DFI balance sheets. Furthermore, where the guarantees contain counter indemnity provisions, the conversion into loans in the event of default could inadvertently exceed country risk exposure limits and crowd out vital lending in other books of business. Yet we think these risks are remote and manageable, as the volume of sovereign guarantees will likely remain small relative to the overall portfolios, the MDBs would retain “skin in the game” in a packaged deal via the loan, and the risks can be shared with other MDBs/DFIs or transferred into international reinsurance markets.

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