

# Financing Instruments in Climate Finance for Asset Recycling

## Full Description

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Climate finance is, first and foremost, finance, so the available instruments are the typical financial instruments that may be used for any type of financial transaction. In other words, what makes an investment climate aligned is not the nature of the instrument used, but the fact that the investment supports interventions that contribute to climate change mitigation action and adaptation efforts.

Accordingly, the four (4) main categories of financial instruments to be utilized by an asset recycling transaction for climate finance are the typical financial instruments available for any type of financial transaction, namely:

- i. [debt instruments](#);
- ii. [equity instruments](#);
- iii. [credit enhancement instruments](#); and,
- iv. [risk transfer instruments](#).

The difference between a typical financial instrument and a climate finance instrument is that funds raised under climate finance sources are ring-fenced for the purpose of achieving the specific climate-related objective, project, or physical asset.

The following table lists the types of financial instruments that can be utilized for climate finance, the definition of each financial instrument, and related examples of climate finance providers from public and private sources.

| Financial Instruments |                        | Definition                                                                                                                                                                                                                                                     | Finance provider from Public or Private sources                                             |
|-----------------------|------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------|
| Debt instruments      | Non-concessional loans | Loans that are provided at a market rate of interest for climate change activities.                                                                                                                                                                            | Commercial banks, corporate                                                                 |
|                       | Concessional loans     | Loans provided for the purpose of addressing climate change/sustainable objectives, characterized by longer repayment terms, lower interest rates and extended grace periods.                                                                                  | Governments, DFIs, Climate Funds                                                            |
|                       | Grants                 | Sum of money that is given for climate change activities but does not need to be repaid. They are usually allocated to support early-stage activities of a project such as the development of a project concept, or for specific capacity building activities. | Climate Funds, Governments, DFIs, public and private institutions (including philanthropic) |

|                                                                                                      |                                                                                                                                                                                                                                |                                                                                                       |
|------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------|
| Debt swaps                                                                                           | Sale of a foreign currency debt to an investor or debt forgiveness by the creditor, in exchange for the debt relief being invested in climate change related activities.                                                       | Governments, public and private investors                                                             |
| Green, social, and sustainable bonds) (also known as thematic bonds) and sustainability-linked bonds | Debt instruments where proceeds are used to finance or refinance, in part or in full, new and/or existing eligible projects/assets/companies that have climate and/or environmental and/or social and/or sustainable benefits. | Public governments (national, sub-national or municipal) and private investors, banks or corporations |
| Microfinance loans                                                                                   | Small-scale financial credits to entrepreneurs, small businesses, and individuals that lack access to traditional banking services for the purpose of addressing climate change.                                               | Microfinance institutions                                                                             |
| Quasi equity                                                                                         | Debt, typically unsecured and subordinated, that raises capital base with no changes to the ownership structure for the purpose of addressing climate change.                                                                  | Public and private investors                                                                          |

|                                |                                                                                                 |                                                                                                                                                                                                                                                                          |                                     |
|--------------------------------|-------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|
| Equity instruments             | Equity securities                                                                               | Ownership interest held by shareholders in an entity—a company (including SPV), partnership (including Joint Venture), or trust—realized in the form of shares of capital stock for the purpose of addressing climate change.                                            | Public and private investors        |
|                                | Co-financing                                                                                    | Joint financing between two entities working to finance an activity with climate change objectives.                                                                                                                                                                      | Public and private investors        |
|                                | Crowdfunding                                                                                    | Funding climate change mitigation or adaptation project activities by raising small amounts of capital from many individuals, typically through an online platform.                                                                                                      | Household, companies                |
| Credit enhancement instruments | Interest-rate softening mechanisms                                                              | Lower interest rates and other subsidies to reduce financing costs below market rates to finance climate change activities.                                                                                                                                              | Governments, DFIs                   |
|                                | On-lending                                                                                      | Borrowing from external or domestic sources and thereafter passing the loan to another entity for the purpose of addressing climate change.                                                                                                                              | Governments, DFIs                   |
|                                | Refinancing                                                                                     | Replacement of an existing debt obligation with another debt obligation under different terms for the purpose of addressing climate change                                                                                                                               | Commercial banks, Governments, DFIs |
|                                | Project bond credit enhancement                                                                 | Subordinated instrument, either a loan or contingent facility, to support senior project bonds issued by a project company for low carbon projects.                                                                                                                      | Governments, DFIs                   |
|                                | Subordination of credit tranching excess spread, over collateralization, reserve accounts, etc. | Prioritization of collateralized debts, ranking one behind another for purposes of collecting repayment from a debtor. Subordinated debts are riskier than higher priority loans, transferring risk in the event the results of climate projects are not fully achieved. | Local and national governments      |

|                                                  |                               |                                                                                                                                                          |                     |
|--------------------------------------------------|-------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|
| Risk transfer/sharing instruments and mechanisms | Insurance                     | The creation of risk transfer mechanisms that provide resources for climate-related disasters and transfer loss liabilities to capital market investors. | Insurance companies |
|                                                  | Guarantees                    | A promise to repay the debt of another, in relation to a climate change activity, in the event of default.                                               | Governments, DFIs   |
|                                                  | Results-based climate finance | Funds are disbursed by the donor or investor after pre-agreed results of the climate activity are achieved and verified.                                 | Governments, DFIs   |
|                                                  | Risk capital                  | Funds (equity/concessional loans) allocated to climate mitigation/adaptation activity with high level of uncertainty.                                    | Governments, DFIs   |

The appropriate financial instrument(s) selected by the borrower will depend on the project's specific attributes, such as type of infrastructure, sector, scale, financing and co-financing needs, mitigation and/or adaptation objectives, as well as the borrower's characteristics, investor appetite for risks and returns, and the type of sources of financing available. Depending on the selected climate finance source (public or private) and financial instrument(s), the financier's key criteria will be different, with specific requirements to be followed by the climate finance proponent.

While the types of instruments available are those typical of any project finance transaction, climate finance instruments can further be categorised by the results the funds are lent against. Specifically, some climate finance is based on the greenness of the investment to be financed, i.e., the focus is on the proceeds are used. Other climate finance is linked to predefined, improved climate results that must be achieved by the borrower – either the interest rate goes down if the borrower meets the climate target, or the interest rate goes up if it does not. These two distinct approaches to climate finance are summarized in the figure, below.

| Item         | "Use of Proceeds" - Green/Social/Blue/Sustainable                                                                                                                                                                                                                                                                                        | "Target Driven" - Sustainability-Linked Financings                                                                                                                                                                                                                                                                                                                                                                          |
|--------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Description  | <ul style="list-style-type: none"> <li>Financial instruments with a <b>dedicated use of proceeds</b> focused on eligible categories, including: <ul style="list-style-type: none"> <li>✓ Climate adaptation</li> <li>✓ Climate mitigation</li> <li>✓ Social</li> <li>✓ Ocean conservation</li> <li>✓ Biodiversity</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>Pricing linked to achievement of <b>ambitious targets</b></li> <li>Target <b>compliance is verified at an agreed point in time</b> and generally no rebates apply</li> <li>Targets are normally <b>corporate ESG metrics</b></li> <li>Targets need to be <b>material</b> – i.e., relevant to the business; and <b>ambitious</b> compared to "business as usual" and peers</li> </ul> |
| Pricing      | <ul style="list-style-type: none"> <li>Normally priced as conventional instruments</li> <li>Market demand has led to a <b>"greenium"</b> for borrowers/issuers</li> </ul>                                                                                                                                                                | <ul style="list-style-type: none"> <li>Interest rate and fees <b>indexed to performance on targets</b>: <ul style="list-style-type: none"> <li>For bonds, at least 25 bps step-up if targets are missed</li> <li>For loans, up to 25 bps step-down if targets are met</li> </ul> </li> </ul>                                                                                                                                |
| Verification | <ul style="list-style-type: none"> <li>Implementation and validation methodology laid out in a <b>Sustainable Financing Framework</b></li> <li><b>Second Party Opinion</b> usually required</li> </ul>                                                                                                                                   | <ul style="list-style-type: none"> <li>Target rationale, ambitiousness and validation methodology laid out in a <b>Sustainability-Linked Financing Framework</b></li> <li><b>Second Party Opinion</b> usually required</li> </ul>                                                                                                                                                                                           |
| Standards    | <ul style="list-style-type: none"> <li>Aligned with ICMA or LMA's Green Loan Principles and Green, Social and Sustainability Bond Principles.</li> </ul>                                                                                                                                                                                 | <ul style="list-style-type: none"> <li>Aligned with ICMA's Sustainability-Linked Loan / Bond Principles</li> </ul>                                                                                                                                                                                                                                                                                                          |

Green bonds may be particularly attractive to issuers because they can benefit from a "greenium," or a premium for bond issuers experienced through lower interest rates than conventional bonds. A recent systematic review of the available literature estimates that an average greenium ranging from -1 to -9 basis points exists for green bonds on the secondary market.<sup>6</sup> Green bonds appear particularly advantageous for emerging markets, with an average emerging market greenium of -3.4 basis points as compared to conventional bonds by the same issuer, though a relatively small sample size cautions against drawing firm conclusions.<sup>7</sup>

Nevertheless, given the high yield nature of this segment of the market, there could be potential for the emerging market greenium to widen. The negative premium is mostly a result of the imbalance between the supply of green bonds and investors' demand.<sup>8</sup> In addition, a greenium may be a part of the overall discount factor (or the required rate of return). That is, assuming the sustainability factor associated with a thematic bond is a credit positive, such that the issuance of the bond is perceived to improve sustainability, this in turn should result in lower overall risk of the issue (issuer) and thereby warrant a lower yield (higher price) relative to the normal curve (i.e., greenium).<sup>9</sup>

As the "greenium" becomes wider, issuers will have greater incentive to issue green bonds, which should support the "greening" of the emerging market debt market. Overall, the green bond market presents a promising opportunity for organizations, and in particular those operating in emerging markets, to finance largescale sustainable investments across a wide variety of industries and green technologies, potentially at a lower cost of debt.

The yield of these bonds is typically dependent on the degree of green investment that they are financing, but certain instruments allow for the interest rate to be adjusted based on the degree of improvement in the sustainability of the organization. Green bonds are particularly popular in emerging markets and their contributions to the global market have grown significantly, increasing by 21% in 2020. China is currently the leading issuer of green bonds in emerging markets; other countries that have seen growth include Armenia, Egypt, and Saudi Arabia.

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Footnote 6: S. MacAskill, E. Roca, B. Liu, R.A. Stewart, O. Sahin. 2021. [Is there a green premium in the green bond market? Systematic literature review revealing premium determinants.](#)

Footnote 7: Amundi Asset Management and International Finance Corporation. 2021. [Emerging Market Green Bonds Report 2020: On the Road to Green Recovery](#).

Footnote 8: *Ibid.*

Footnote 9: United Nations Development Program. 2022. "[Identifying the 'greenium'](#)".

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