

Credit Risk in ERC Finance Transactions

Full Description

Credit risk is a major, fundamental consideration in every ERC finance transaction. Lenders to ERC activities or developers may incur losses if the borrower fails to repay a loan, provide a pre-determined financial or ERC return, or otherwise meet their contractual obligations. Around 100 project developers account for about two-thirds of all historical ERC issuance but most developers and projects are small, and there is a surge of new developers and projects in recent years.¹ That is good for market growth but means many developers may not have sufficient creditworthiness to borrow due to a lack of experience, physical assets, and other factors such as project viability and liquidity. Even with protection against other ERC risks, a lender fundamentally will always face the risk that the counterparty borrower defaults. As ERC markets continue to grow across the world, new entrants may lack the knowledge, expertise, and track record necessary to attract financing from commercial investors without credit enhancement. This can be achieved through a variety of approaches, including innovative structuring, insurance, and first-loss and subordinated capital, which in an EMDE context may be provided by a donor government or DFI.

1. Credit guarantees

Credit guarantees can be a highly effective tool used to mobilize ERC finance. Typically provided by governments, DFIs, or other multilateral institutions, guarantees are an obligation for the guarantor to (partially) compensate lenders in the event that the borrower defaults. In doing so, loan guarantees lower the cost of capital for ERC projects, enabling them to access a wider pool of capital on better terms. Credit guarantees are broadly considered one of the most effective blended finance tools for mobilizing private sector finance for climate action or other sustainability goals² and that holds true for ERC finance. For ERC activities, credit guarantees can and have been provided at the issuer or fund level, directly covering investors' return from the bond issuer or ERC fund. For example, USAID's Development Credit Authority (DFC) supported the Althelia Climate Fund by providing a 50% loan guarantee on losses of the fund's lending activity up to \$133.8 million.³ Credit guarantees can also be provided at project level, protecting cash flows from the ERC activity to the developer or financial intermediary.

2. Principal protection

Principal protection can be used to insulate repayment of all or part the loan principal from certain ERC risks meaning lenders expose their expected returns, but not the underlying capital, to ERC risks. In the context of ERC markets, principal protection has been most notably used through principal-protected ERC-backed bonds issued by AAA-rated supranationals (e.g., WB ERLB, IFC Forests Bond), where interest payments only were linked to delivery of ERCs by underlying ERC projects. Principal protection is not risk free but puts the principal and interest at different risk levels. It is highly effective at mobilizing ERC finance when the issuer is highly rated, but expanding use of principal protection across the ERC market would require relying on a broader set of issuers beyond AAA supranationals. This broader set of issuers is unlikely to be so highly rated, but the general approach could still be applied particularly for a public issuer, where the principal is used to finance other public investment (e.g., renewables or grid infrastructure) and only the interest payment is linked to ERC activities.

3. First-loss or subordinated capital

Integrating first-loss or subordinated capital into ERC funds or structured financial products can help mobilize a wider range of lenders and investors. This type of capital can take several forms, including junior equity, subordinated debt, and repayable or non-repayable grants. Incorporating these types of capital into an investment structure or at the project level can help encourage more risk-averse investors to participate.

Subordinated capital can also serve to fill temporary financial gaps created by low ERC prices, which could then be reimbursed when market prices increase and senior debt has been repaid. Integrating first-loss and subordinated capital into funds, financial instruments, and large projects has been widely used in climate finance, where public or philanthropic investors provide the first-loss or subordinated capital to enhance the risk-return profile for private sector investors and so mobilize private climate finance. This approach is expected to continue to be an important blended finance vehicle for climate objectives but has yet to be applied to ERC financing on a large scale.⁴

Footnote 1: Abatable, [The State of the Carbon Developer Ecosystem](#), 2023.

Footnote 2: Institute of International Finance, [Scaling Blended Finance for Climate Action: Perspectives from Private Creditors](#), 2023

Footnote 3: USAID, [“U.S. Government, Althelia Climate Fund Mobilize \\$133.8 Million for Forest Conservation and Alternative Livelihoods”](#), 2014.

Footnote 4: Convergence, [State of Blended Finance 2022: Climate Edition](#), 2022.

Additional Resources

[Further Readings on Financing and Risk Mitigation](#)
[Climate-Smart PPP Legal and Regulatory Framework](#)
[How PPPs Are Financed](#)
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