Voluntary Principles for the Deployment of Credit Enhancements to Support Sustainability-Linked Financing for Nature and Climate

Introduction

The technical Task Force on Sustainability-Linked Sovereign Financing for Nature and Climate (the Task Force) was established at COP28 with the objective of bringing together a group of Multilateral Development Banks (MDBs), other Development Finance Institutions (DFIs), Multilateral Climate Funds (MCFs) and international organizations, to promote increased effectiveness, efficiency, affordability, accessibility and scalability of credit enhancements to support sustainability-linked sovereign financing for nature and climate. The Task Force has developed this set of high-level voluntary principles for the deployment of such credit enhancements (these "Voluntary Principles").

Credit enhancements are financial mechanisms directed at reducing the credit risk of a debt instrument using a risk substitution instrument (most frequently a guarantee or insurance) or a combination of financial instruments. Credit enhancements can therefore improve a borrower's access to financing on more favorable terms and conditions (e.g., lower borrowing costs and longer maturities) and help attract private investment. Of particular interest is their application to new sustainability-linked sovereign financing, such as through debt conversions for nature and climate or sustainability-linked debt instruments.

Sustainability-linked sovereign financing is a forward-looking performance-based financial structure for sovereigns that incentivizes the achievement of sustainability objectives by linking the cost of the financing to the success of the country in meeting its nature and/or climate policy commitments. The purpose of providing credit enhancement for this type of financing is to increase nature and/or climate impact through greater funding and accountability of both governments and investors. At the same time, this type of financing allows a greater diversification of the investor base by attracting those institutions already committed to sustainable investments and in search of scarce high impact investment opportunities.

These Voluntary Principles are intended for a broad audience, such as MDBs and other DFIs or institutions that can provide credit enhancements for sustainability-linked financing such as MCFs, as well as other parties involved, such as governments, investment banks, insurance companies (co-insurance and re-insurance), rating agencies, institutional investors, non-governmental organizations, and others. Each institution may deploy these Voluntary Principles and credit enhancements in the context of its own mandate, objectives, and policies. The purpose of these Voluntary Principles is to: present a harmonized understanding of the criteria to consider, on a case-by-case basis, when assessing and implementing credit enhancement intervention in support of sustainability-linked financing; to facilitate collaboration among MDBs and other DFIs and other parties; and, thus to increase the scale and effectiveness of such credit-enhanced transactions.

Voluntary Principles

1. **Suitability: Credit enhancements to support sustainability-linked financing for nature and climate should be suited to the country's macroeconomic and financial circumstances**
    a. **Support nature and/or climate commitments:** Credit-enhanced transactions should seek to improve the borrower country's fiscal space over time to support nature and/or climate commitments. Credit-enhanced transactions should not substitute for necessary macroeconomic adjustments but should support such adjustment efforts for long-term debt sustainability.
    b. **Adaptation to country risk profile.** Credit-enhanced transactions should consider and be adapted to the risk profile of the country. Credit enhancements are more effective in countries that are fiscally sustainable, but not investment grade. An assessment of associated financial and economic benefits and costs of the credit-enhanced transaction should be performed and reviewed by the credit enhancer, to find the optimal combination and proportion of credit enhancement mechanisms and other structural elements. The credit enhancement, as well as the transaction supported by it, should be in the best interest of the recipient.
    c. **Mobilization objective and transaction size**. Credit-enhanced transactions should help increase a country's market access and mobilize[1] competitive private financing to allow for meaningful debt service cost reduction. Credit enhancement providers should take into consideration, the country's ability to access capital markets, the scale of the project's objectives or nature/climate targets to be financed, the private financing mobilization opportunities, and the costs of the credit-enhanced transaction. Ministries of Finance and other parties to the credit-enhanced transaction should work collectively to identify the best debt management strategy in line with the country's own targets.
    d. **Sufficient debt management capacity**. Credit-enhancement providers should ensure that governments receiving credit enhancement have sufficient debt management capacity to structure complex financial transactions with nature and/or climate objectives. Sustainability-linked financing is more complex and has stricter monitoring and reporting requirements than traditional sovereign financing. Debt management capacity needs to be accompanied by effective cross-collaboration among Ministries of Finance and other relevant Ministries for the successful attainment of the nature and/or climate targets and reporting of results. In cases where a government lacks sufficient debt management capacity, technical assistance should be provided to enhance the government's capacity.

2. **Accountability and effectiveness: Credit enhancements are valuable, scarce resources and the credit-enhanced transaction should ensure their efficient and transparent use, promoting accountability, transparency and replicability of the transaction.**
    a. **Ensure debt transparency.** Countries should provide the highest level of transparency in terms of the structure of credit-enhanced transactions and, and where relevant, related costs, to increase accountability. Market-facing documentation should be made available to the public at the appropriate time.

[1] In line with the definition of private investment mobilization agreed by MDBs in this reference guide

b. **Credit-enhanced financial instrument.** The financial instrument supported by credit enhancement should adhere to established principles, best practices and standards, as issued or published by relevant, dedicated and reputable institutions.
c. **Ensure competition and efficient use of the credit enhancement.** Investment banks and other advisors should be engaged through a competitive process that allows the country to select the best offers in terms of structure, resource mobilization, price, and transaction costs. The terms should be transparent, subject to compliance with non-disclosure agreements and relevant laws.
d. **Dedicated governance by providers of credit enhancements.** Institutions providing credit enhancements should have professionalized units and teams to adequately manage the design, execution and monitoring of the provision of credit enhancements.

3. **Nature and/or climate impact: The credit-enhanced transaction should involve ambitious commitments from the country's national climate and nature plans that are aligned with the goals of the** Paris Agreement **and/or the** Kunming-Montreal Global Biodiversity Framework**, with relevant and material key performance indicators and coherence between capital mobilization and policy efforts.**
   a. **Definition of ambitious climate and nature commitments with high-level leadership and strong stakeholder engagement.** Policy commitments should be developed by the government, through an inter-ministerial coordination mechanism, including Ministry of Finance or Planning, in consultation with relevant stakeholders, including local civil society and, where relevant, indigenous communities, and in line with the government's international commitments to National Determined Contributions (NDCs), National Adaptation Plans (NAPs), National Biodiversity Strategies and Action Plans (NBSAPs), Land Degradation Neutrality and/or Long Term Strategies (LT-LEDS), amongst others.
   b. **Strong performance indicators and ambitious targets.** Achievement of the country's nature and/or climate commitments should be tested against performance indicators that are material to the country's core climate and/or nature policies; measurable or quantifiable on a consistent methodological basis; based on science; externally verifiable; and able to be benchmarked. Targets should be ambitious and should represent a material improvement in the respective indicator versus a baseline and be additional to "business as usual."
   c. **Financial incentives for achievement of the climate/nature policy commitments, indicators and targets.** Incentives can be structured as step-ups (penalties) in financing pricing, as step downs (rewards), or in some other way or a combination of both. Financial incentives should be commensurate and meaningful relative to the financial characteristics of the country's original debt, size of new financing and funding unlocked to introduce sufficient incentives for the government to achieve the climate/nature commitments and targets**.** The incentive structure should focus on achievement of commitments, include consideration of interim targets and avoid benefiting upstream investors if the government fails to meet its commitments.
   d. **Coherence between credit enhancement mobilization and commitments.** The funding allocated to the necessary activities to meet the nature and/or climate targets or

commitments should be commensurate with the size of the credit-enhanced transaction. Funding enabled by the transaction should aim to cover the additional and unfunded total cost of the nature/climate commitments made under the transaction. The commitments should be costed, and the ambition adjusted based on expected financial resources. For nature commitments, costing should be in line with the country's Biodiversity Finance Plan or equivalent, when available.

e. The scale of the overall transaction and the savings should be taken into account when assessing the adequate allocation.

4. Governance structure: Credit-enhanced transaction structures should adhere to best practices and standards on use of resources and provide robust reporting and verification.

a. **Ensure adequate capacity and mechanism for the use of the funding.** A robust governance structure responsible for the use of funding obtained from the credit-enhanced transaction is key to ensuring transparency and accountability. For instance, this governance structure could include a Conservation Trust Fund, consistent with international best practices, to manage disbursements to support achieving the biodiversity and climate commitments. Notwithstanding the governance structure chosen, the mechanism should ensure the highest level of compliance with environmental and social management, procurement, financial management and disclosures, standards of conduct, and transparency.

b. **Inclusive governance structure.** The selection and/or creation of a governance structure should follow best practices for community engagement, openness, transparency, equity, and inclusiveness

c. **Data transparency and integrity, reporting and verification.** The relevant country should publish an *Annual Report* regarding progress against climate and/or nature commitments, including selected indicators and targets to enable monitoring of performance. Moreover, the relevant country should publish an *Impact Report* consisting of evidence that the policy commitment and/or the climate/nature target has been met. Audits and evaluations should be mandatory and be led by independent external verification agents.