SSDH BRIEFING:

Decoding COP27 Climate Finance Talks on KPI-linked Sovereign Debt

November 2022

THE MOST IMPORTANT COP SINCE PARIS

The 27th Conference of Parties (COP27) of the United Nations Framework Convention on Climate Change ended a day late on Sunday November 20th, 2022.

Within the context of fractious geopolitics, made more fraught by spiralling energy costs, food insecurity and escalating debt levels- achieving consensus either on fossil fuel reductions or nationally determined contributions (NDCs) was always going to be a challenge. Given the additional challenge of limited official development assistance (ODA) available for non-Ukraine targeted programmes, it was a noteworthy achievement that COP 27 concluded with agreement on the creation of an international Loss and Damage fund to assist low and middle-income (LMICs) countries in covering the costs of climate change impacts.

The sovereign debt crisis was the thread that ran through every discussion. It was acknowledged that all African countries and most LMICs are either already in, or imminently facing, a debt crisis. Many panels highlighted the need for, and examples of, debt restructuring linked to climate and nature key performance indicators (KPIs).

The recent deal by Uruguay provided an important example of the benefits of KPI-linked sovereign debt: highlighting a country's commitment to its climate policies and NDC targets, reducing the cost of capital, increasing transparency, improving risk mitigation and fiscal management - and increasing the pool of private investors.

The multiple panels on nature and finance made it clear that nature has a permanent place in financial conversations. According to Simon Zadek, Convenor of the Advisory Board of the SSDH:

> *COP27 was the most important COP since Paris. It was much harder but much more real, and it achieved little because it was about the right subjects. Importantly, it inaugurated a new way of thinking about finance as nature was the unexpected VIP at Glasgow last year and it now has a permanent seat at the high table.*

Several COP27 delegates also made the link between sovereign debt and nature investment. Andrew Deutz, Director of Global Policy, Institutions and Conservation Finance at The Nature Conservancy and a member of the SSDH Advisory Board, observed that:

> *We are on the cusp of a sovereign debt crisis, and there is an opportunity to restructure USD$2 trillion of that debt and link it to climate and conservation KPIs – again if the IMF signals direction, and MDBs provide greater de-risking.*

THE LOSS AND DAMAGE AGREEMENT: IMPORTANT CONTEXT

Noting the incremental progress of COP27 as a result of the loss and damage fund, three reports provided critical context and framing for the Loss and Damage discussions:

- The UN High Level Group on Net-Zero Commitments from Non-State Actors, chaired by Catherine McKenna, critiqued the pronounced tendency for green-washing among the private sector
- The High Level Expert Group on Climate Finance, chaired by Nick Stern and Vera Songwe, called for $1trillion p.a. of climate investments by 2030
- The UN Adaptation Gap Report, that stated that countries are only providing 20% of the adaptation financing commitments made at COP26.

There was some (last minute) progress on agreeing to work towards the development of the framework and metrices to support a Global Adaptation Plan.

KPI-LINKED DEBT AND THE MANY SHADES OF GREEN

A number of COP 27 sessions focused on the new Nature and Finance market.

The UNECA session with Egypt, Gabon and Uruguay discussed how performance-based financing allows countries to plan forward, thereby signalling the strengthening of fiscal management. It was agreed that the differences between financial tools such as KPI-linked bonds, the application to Loss and Damage and insurance and the implications for macro financing still require careful thought and analysis.

Notably, sovereign issuance expanded faster than the wider green bond market in 2021 with a growth rate of 103%, raising cumulative issuance to USD$193bn compared to the USD$95.2bn raised in 2020. In Q3 2022, the green, social, sustainability, sustainability-linked (SLB) and transition bond (GSS+) volumes reached USD$152.3bn, a decline of 35% compared to Q2 2022, and 45% compared to Q3 2021. According to the Climate Bonds Initiative, sovereign sustainability bonds originated from 11 emerging markets issuers to the value of USD$14.8bn, so providing some evidence that sovereign green, social and sustainability (GSS) issuance would help propel the market towards the 2025 USD$5tn target. This growing appetite for ESG fixed-income strategies has led to the rise of sustainability-linked bonds (SLBs) in recent years. Progress on sustainability performance by SLB issuers is measured through Key Performance Indicators (KPIs) and assessed against Sustainabili-ty Performance Targets (SPT).

Unlike green and other sustainability-labelled bonds, the proceeds of SLBs are not ring-fenced for particular projects or spending; rather, the pay-out to investors in the bond depends on whether the issuer meets agreed-upon perfor-mance indicators. Like the Green Bond Principles and the Social Bond Principles, the Sustainability-linked Bond Principles (SLPB) are voluntary and constitute recommended market best practice in order to promote market integrity and transparency in sustainable finance.

KPI-linked bonds offer governments multiple benefits including lower-interest rates and investor diversification, and they contribute to national climate targets. The benefits of KPI-linked bonds exceed the direct impact of individual sovereign green or sustainability issuance because they enhance long-term commitment to environmental and social policies.

SOVEREIGN SLB ISSUANCE: CHILE AND URUGUAY EXAMPLES

Unlike the corporate SLB space, sovereign SLB issuance is less developed, with only two countries having launched such instruments so far: Chile and Uruguay.

While speaking at a COP27 panel session, Herman Kamil, Head of the Sovereign Debt Management Office at Uruguay's Ministry of Economy and Finance, highlighted the importance of SLBs in helping countries meet their environmental commitments. Mr. Kamil noted that his department had seen:

> *A compelling opportunity and urgent need for a sovereign* sustainability-linked bond *that links the cost of capital to success in enhancing its environ-mental credentials.*

CLIMATE INVESTMENT: A DANGEROUSLY LAGGING INDICATOR

Despite the progress in developed markets, overall green and climate investment (both sovereign and private) in emerging markets remains a dangerously lagging indicator of climate action. As Sean Kidney, a member of the SSDH Advisory Board, observes:

> *The twin COPs in Egypt and UAE are a bridge to more sovereign issuance from emerging markets. We should be looking to a post-COP28 environment where green, social and sustainable sovereign debt from developing nations has been supported and is multiplying with new deals on horizon. Sovereign issuance is an indicator of action from policymakers and financial regulators in facilitating north to south climate investment. Finance for mitigation, adaptation and resilience remains dangerously inadequate. The next two years of COPs are a springboard for policymakers to turn commitments into trillions, directed where it's needed most.*

Given the triple crisis of debt, climate change and biodiversity, there is emerging consensus on the need for IFIs to reform procedures and instruments as articulated by the Bridgetown Agenda.

Embedding results-based KPIs into debt and insurance instruments has great potential to support, and attract public and private investment into mitigation, adaptation and even Loss and Damage programmes.

It will be important to ensure that the expectations of policy discipline, monitoring, reporting and verification (MRV) are supported by adequate technical assistance to help vulnerable countries that are the most indebted, most affected by environmental crises, and least able to respond adequately to KPI requirements.

PROGRESS – WITH RESERVATION

In 2021, wealthy nations vowed to provide USD$40 billion per year by 2025 to help poorer countries with adaptation, but a new UN report estimates that this amount is less than one-fifth of what developing nations need.

One frequently cited study on Loss and Damage estimated that developing countries could suffer between USD$290 billion to USD$580 billion in annual climate damages by 2030, even after efforts to adapt. Those costs could rise to USD$1.7 trillion by 2050.

Nonetheless, in a first for a climate COP, the final text of the loss and damage fund also backs reform of giant lenders such as the International Monetary Fund and the World Bank.