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Enhancing Climate Finance in EMDEs through Prudential Regulatory Clarification and Reform

- **Private climate finance to EMDEs is falling**, despite these countries representing 25% of global GDP and requiring an additional \$450–550 billion annually in external climate investment by 2030.
- **Basel III rules, as currently interpreted, unintentionally discourage EMDE lending**, including by unnecessarily limiting recognition of robust credit enhancement tools.
- **Project finance is treated highly conservatively under Basel capital calculation approaches**, despite strong data showing lower-than-expected default rates and high recovery rates over time.
- **Country risk ceilings often overstate risk for EMDE exposures**, limiting bank participation even in high-quality, co-financed projects – thus driving up the cost of capital.
- **Targeted clarifications and reforms to the Basel framework could unlock significant volumes of private investment** in high-impact, climate-aligned EMDE projects – without compromising financial stability.

INTRODUCTION

Emerging market developing economies (“EMDEs”) have a critical role to play in achieving global climate goals under the Paris Agreement. Yet, these countries face a persistent shortfall in climate finance, with private capital flows declining over recent years.

In line with the ambition of COP29 and the New Collective Quantified Goal (NCQG), external finance from all sources—including international public, private, and other channels—must contribute approximately \$1 trillion annually by 2030, rising to around \$1.3 trillion by 2035, to meet total climate investment needs in EMDEs.¹

Despite accounting for roughly a quarter of global GDP, EMDEs (other than China) attract just 14% of global climate finance flows. According to the Independent High-Level Expert Group on Climate Finance, these economies currently receive only around \$30 billion of external private finance and will require an additional \$450–550 billion per year in external

¹ <https://unfccc.int/topics/climate-finance/workstreams/baku-to-belem-roadmap-to-13t>

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finance by 2030 to remain on a net-zero trajectory, an increase of 15 to 18 times². Mobilizing this scale of investment is essential to global climate outcomes and financial stability alike.

In this context, policymakers have repeatedly emphasized the importance of mobilizing much higher levels of private investment in EMDEs – most recently as part of the Baku to Belem Roadmap at COP29. Moreover, multilateral development banks (“MDBs”) and development finance institutions (“DFIs”) have introduced a range of enhanced tools to address prevailing market gaps.

However, this collective effort is hindered by aspects of the Basel III prudential framework that unintentionally deter bank lending to EMDEs. Banks within the ICC network report severe difficulties in meeting capital efficiency thresholds for projects in EMDEs – while some have exited or actively avoid emerging markets entirely. Others report passing on additional risk costs to EMDE borrowers – in effect negating the intended pricing impact of concessional finance.

This note summarizes key barriers within the prudential framework and outlines recommended actions to align capital regulation with climate and development goals while maintaining financial stability.

BARRIERS TO EMDE CLIMATE FINANCE

Insufficient recognition of public risk mitigation tools

MDBs and DFIs play a vital role in reducing the risk profile of EMDE investments through credit guarantees and co-lending structures. While the Basel framework permits the use of MDB/DFI guarantees for capital relief, strict operational requirements limit their applicability:

- **Unconditionality requirements:** guarantees must be unconditional, yet widely used MDB products, such as MIGA's non-honoring guarantees, include standard (but rarely used) exclusions that render them ineligible for capital relief purposes.
- **Timeliness requirements:** key instruments like political risk insurance (“PRI”) or breach of contract protections must pay out promptly after a default to qualify for capital relief, but most instruments used in EMDEs involve processes (e.g. arbitration) that render them ineligible – even if they effectively reduce credit risk.
- **Treatment of partial risk insurance:** Basel III grants capital relief only for the guaranteed portion of a loan, creating a cliff edge where even a 49% guarantee offers no more benefit than a much smaller one. This severely limits the usefulness of partial guarantees commonly used in EMDEs to share risk and support lending.

² Independent High Level Expert Group on Climate Finance (2023): A Climate Finance Framework <https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2023/11/A-Climate-Finance-Framework-IHLEG-Report-2-SUMMARY.pdf>

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- **Incomplete recognition of MDBs:** the Basel framework list of MDBs eligible for favorable risk weights is static and excludes newer institutions with strong credit ratings and mandates aligned with climate finance.³
- **Treatment of blended finance structures:** current rules do not recognize the risk-reducing benefits of blended finance structures, preventing banks from receiving capital relief even when public or concessional partners absorb first-loss risk.

Moreover, although the Basel framework permits credit mitigation from private insurers, in practice most private PRI does not qualify for capital relief because of structural and legal conditions in standard commercial contracts. As a result, banks cannot obtain capital relief for exposures backed by established private PRI providers, even when it significantly reduces credit risk.

Conservative treatment of project finance

Project finance is central to climate and infrastructure investment in EMDEs, yet the Basel framework assigns conservative risk weights to this form of financing:

- **Standardized approach:** Risk weights for project finance are set at 130% in pre-operational phases and 100% during operation – compared to 100% for unrated corporates. Even high-quality projects (with cash flows, reserves and credit protections) face stringent criteria for an 80% risk weight. This is despite data from Moody's and the GEMs Consortium demonstrating that project finance in EMDEs outperforms corporate loans, with higher recovery rates and default rates comparable to investment-grade corporates after five years.
- **IRB approach:** The internal ratings-based maturity adjustment assumes linear risk growth over time. In practice, the experience of banks is that project finance exhibits decreasing risk as projects stabilize and generate revenue.
- **Embedded protections:** Basel does not currently recognize borrower-level mitigants in project finance transactions (e.g. FX hedging, purchase agreements).

Impact of country risk calculations

³ Examples include: GuarantCo (AA-, UK-backed) and the Central American Bank for Economic Integration (AA, S&P).

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While the Basel Framework does not explicitly assign capital charges based on country risk per se, it does so indirectly through **country ceilings and risk-weight floors** applied to non-sovereign exposures (e.g. corporates or projects) in lower-rated jurisdictions. For example, exposures to a corporate in a country with a sovereign rating of B or below may receive a 100% or higher risk weight, even if the underlying project or borrower is highly secure.

Illustrative example:

A commercial bank considers lending to a solar energy project in a Sub-Saharan African country rated B-. Despite having:

- A long-term power purchase agreement with a multilateral-backed utility,
- MIGA PRI against currency inconvertibility and breach of contract, and
- Co-financing from a MDB (A-loan),

...the exposure still attracts a 100%+ capital charge due to the country's sovereign rating. This undermines the effect of risk mitigants and disincentivizes the bank's participation.

RECOMMENDATIONS

Climate change presents a systemic risk to financial stability, especially in EMDEs. As countries and financial institutions mobilize to support net-zero transitions, prudential regulation must evolve to avoid unintended obstacles to climate-aligned investment.

Given the urgency of the financing challenge faced by many EMDEs we encourage policymakers to consider a two-step approach to macroprudential reform – starting with low-hanging fruit that could yield an immediate boost to climate finance flows, before considering broader structural reforms.

Step 1: Technical adjustments and clarifications

Small, targeted adjustments to the Basel framework could unlock substantial additional investment – either by way of new guidance from the Basel Committee on Banking Supervision or, failing that, coordinated action from national regulators. Such steps could include:

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- i. **Updating credit risk mitigation guidance** to accommodate the real-world mechanics of MDB/DFI and private credit enhancement tools, including PRI. At a minimum, such guidance should allow guarantees or insurance to qualify if exclusions are: standard market practice (e.g. nuclear or war clauses); and statistically remote or immaterial to the exposure in question.
- ii. **Clarifying time limits for credit risk mitigants** by recognizing that contracts with defined arbitration periods (e.g. under 180 days) or subject to the established claims procedures of MDBs/DFIs can provide functionally timely payouts and should qualify for capital relief.
- iii. **Allowing the application of blended risk weights to exposures covered by partial guarantees** to reflect the real risk reduction offered by these tools.
- iv. **Allowing for automatic recognition of credit enhancements provided by all MDBs/DFIs** with credit ratings at or above AA-.
- v. **Providing clear guidance on the treatment of borrower-level risk mitigants** in project finance transactions (both during pre-operation and operational phases) – including interest rate or currency hedging, purchase agreements, reserve accounts and performance bonds.

Step 2: Structural reforms

Building on these initial measures, we recommend that Basel Committee is mandated to establish new work programs to:

- i. **Refine the treatment of project finance** to reflect its proven performance based on available market data; introduce dynamic risk weights that adjust over a project's lifecycle (particularly between pre-operation and operational phases); and consider recognizing project finance as a distinct asset class within the prudential framework.
- ii. **Review Basel's approach to country risk to better differentiate between sovereign and project-level risk.** This should permit risk weight adjustments where exposures are highly secure or mitigated by credible guarantees/involve MDB participation.
- iii. **Consider the potential introduction of a scaling factor for high-quality, climate-related investments in EMDEs** – similar to the existing Supporting Factor for Small and Medium-Sized Enterprises under Basel III or the Infrastructure Supporting Factor within the European Union's Capital Requirements Regulation.
- iv. **Review potential modalities to recognize well-structured blended finance arrangements** – notably those with public or concessional first-loss tranches – as eligible credit risk mitigation where they provide transparent and reliable risk absorption.

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ICC calls on governments and financial standard-setters to initiate a structured dialogue—under the Baku to Belem Roadmap at COP30—with the engagement of the Basel Committee on Banking Supervision, to explore targeted prudential adjustments that can be implemented in the near term. These “quick fixes” can help unlock urgently needed capital flows to EMDEs can unlock the capital needed to meet global climate goals – while ensuring the continued soundness of the global financial system.

We further encourage the establishment of a clear pathway for longer-term regulatory reform that aligns capital rules with global climate and development goals. ICC stands ready to support this effort and contribute technical input and private sector expertise to accelerate progress in this important area.