

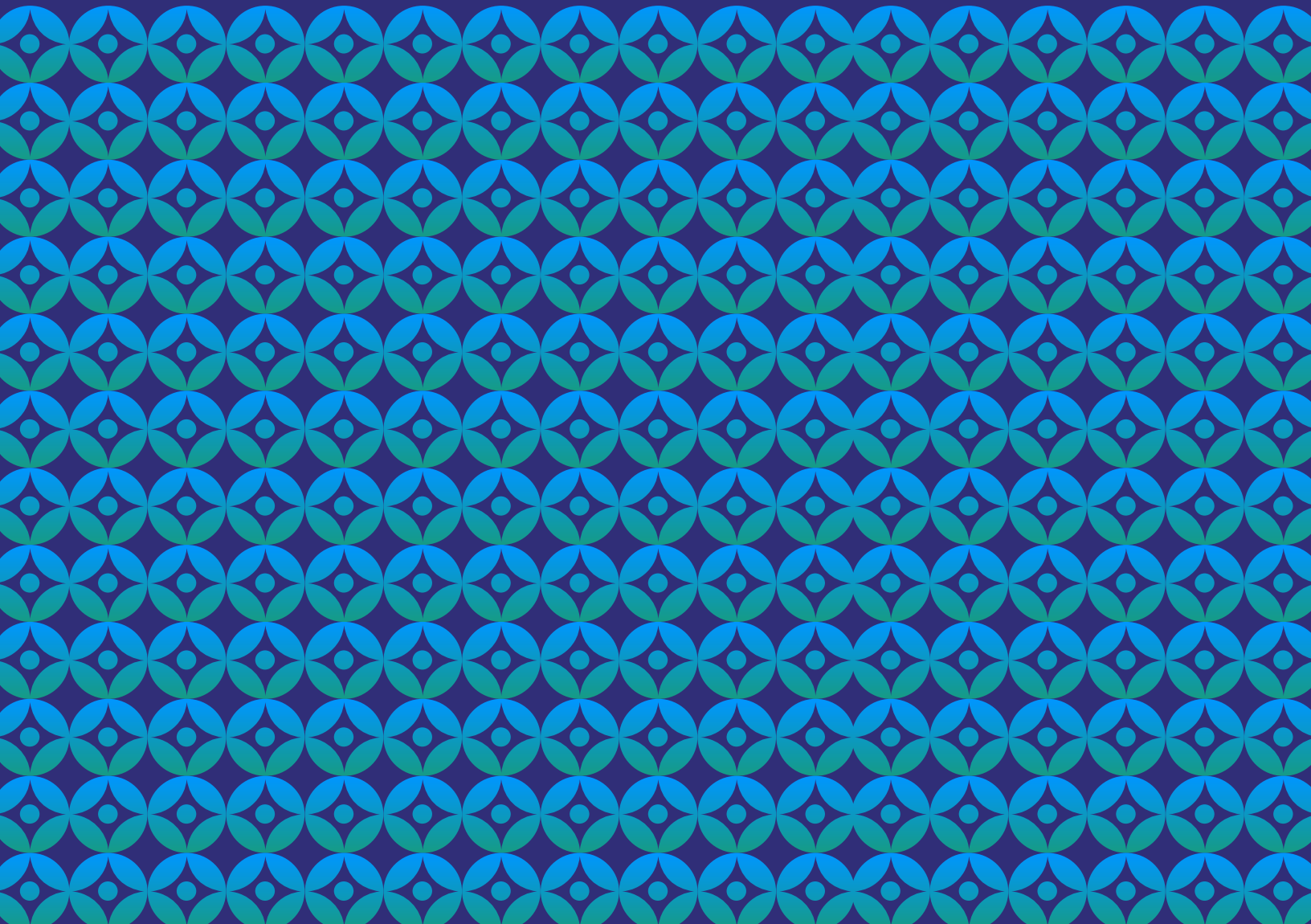


CrossBoundary
Advisory

White Paper

Remaking the global trade system **for a sustainable future**

Jake Cusack
Marilia dos Reis Martins
Kate Wharton



Introduction

In the words of WTO Director-General Dr. Ngozi Okonjo-Iweala, global trade is “a force for good for climate and part of the solution for achieving a low-carbon, resilient and just transition.” At its best, it can reduce the cost of mitigation and adaptation and accelerate the low-carbon transition by facilitating the spread of clean technologies, encouraging sustainable production and consumption, and supporting international cooperation and climate action.

Trade, however, requires capital. With heavy and increasing debt burdens – at the end of 2021 the external debt stock of developing economies reached over US\$11 trillion, more than double the amount a decade ago – many developing countries and small island states are constrained in their ability to attract capital and invest in sustainable trade infrastructure, making the transition to a low-carbon economy ever more challenging.¹

Critically, in considering the grand vision of “remaking the global trade system for a sustainable future,” we address both trade finance and investment. Trade finance is, by definition, short-term financing to enable the flow of goods and services in the market today, while investment is a longer-term financial partnership that

Remaking the Global Trade System for a Sustainable Future

Capital Availability or
Capital Absorption?
Unlocking Financing for
Sovereign and Private
Sector Trade-related
Finance for Sustainable
Climate Action in the
Global South

About the authors

Jake Cusack

Co-Founder & Managing Partner,
CrossBoundary
jake@crossboundary.com

Marilia dos Reis Martins

Managing Director, Climate & Nature,
CrossBoundary
marilia.martins@crossboundary.com

Kate Wharton

Managing Director & Head of Natural
Capital,
CrossBoundary
kate.wharton@crossboundary

*With thanks to Graziella Kiragu for
exceptional research support*

¹ World Bank Group. (2022, December 6). *Debt-service payments put biggest squeeze on poor countries since 2000*. World Bank. Retrieved April 18, 2023, from <https://www.worldbank.org/en/news/press-release/2022/12/06/debt-service-payments-put-biggest-squeeze-on-poor-countries-since-2000>



can more dramatically shape the underlying topography of global trade. Governments and the private sector in the Global South need investment to build the industries that will power economic growth for decades to come. Trade in 2040 begins with investment today.

There is no single solution to scale climate finance in the Global South, and the most resilient systems comprise many diverse actors operating across the economy. Therefore, we take a broad approach in this paper, discussing financing for both sovereigns and the private sector in developing countries. Part I focuses on sovereign finance and centers around the funding challenges of increasing climate action costs (in particular adaptation) for sovereigns in the Global South – exacerbated by ever-rising debt burdens. Part II focuses on private sector trade finance and investment into adaptation and mitigation activities. For each, we propose recommendations to unlock finance for sustainable climate action in the Global South.

Across the board, a critical theme emerges: the challenge of capital absorption in the Global South. Much of the conversation around trade finance and investment today focuses on the issue of capital availability – which is absolutely essential. However, expanding the pool of available capital alone does not address the challenges of capital absorption. Therefore, we devote significant discussion to the transaction-level barriers faced by both governments and the private sector in attracting and deploying capital for climate action in the Global South, as well as to solutions such as investment facilitation.



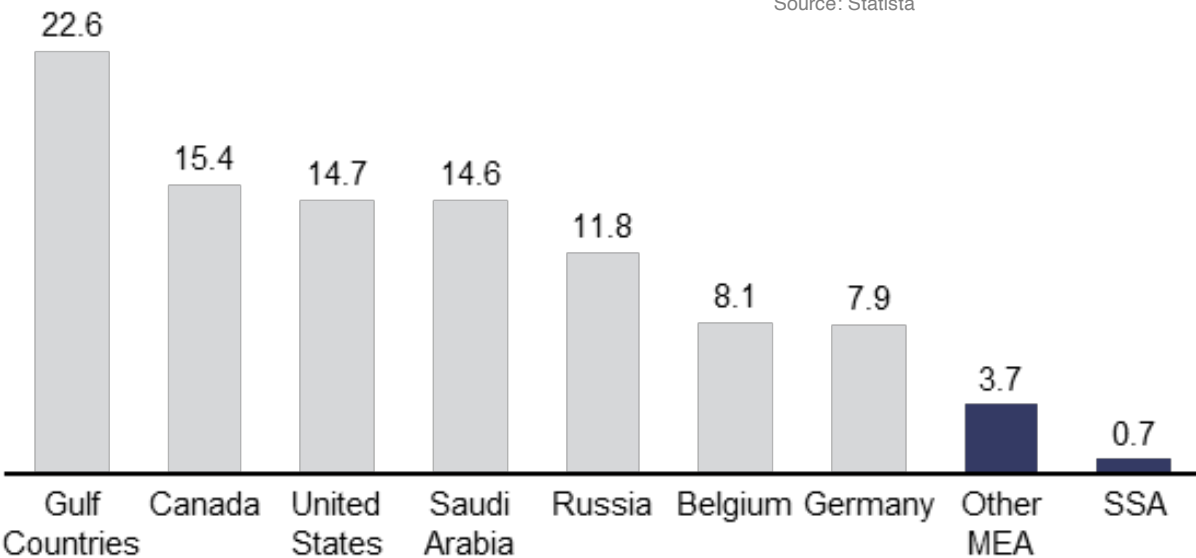
Part I: Strengthening sovereign finance for climate action

1. Climate funding challenges for developing countries and small island states

Developing countries and small island states often suffer more from the impacts of climate change than their more developed counterparts despite being responsible for a smaller share of CO₂ and other greenhouse gas emissions (Figure 1). The disproportionate effect of climate change on these economies means that rising sea levels, more frequent and severe natural disasters, changes in precipitation patterns, and other adverse symptoms of an ever-warming planet are more challenging to resolve and have longer-lasting consequences. Estimates indicate that annual climate adaption costs for developing countries could reach US\$300 billion by 2030².

Figure 01 CO₂ emissions per capita by region, 2019 (in MT/capita)

Source: Statista



² *Scaling up climate adaptation finance must be on the table at UN COP26*. UNCTAD. (2021, October 28). Retrieved April 18, 2023, from <https://unctad.org/news/scaling-climate-adaptation-finance-must-be-table-un-cop26>



The challenge faced in meeting the rising climate funding needs of developing countries is further exacerbated by other macroeconomic headwinds, such as increased political and economic instability, weak credit ratings, and higher currency risk.

2. Strategies for mobilizing sovereign finance for climate action in the Global South

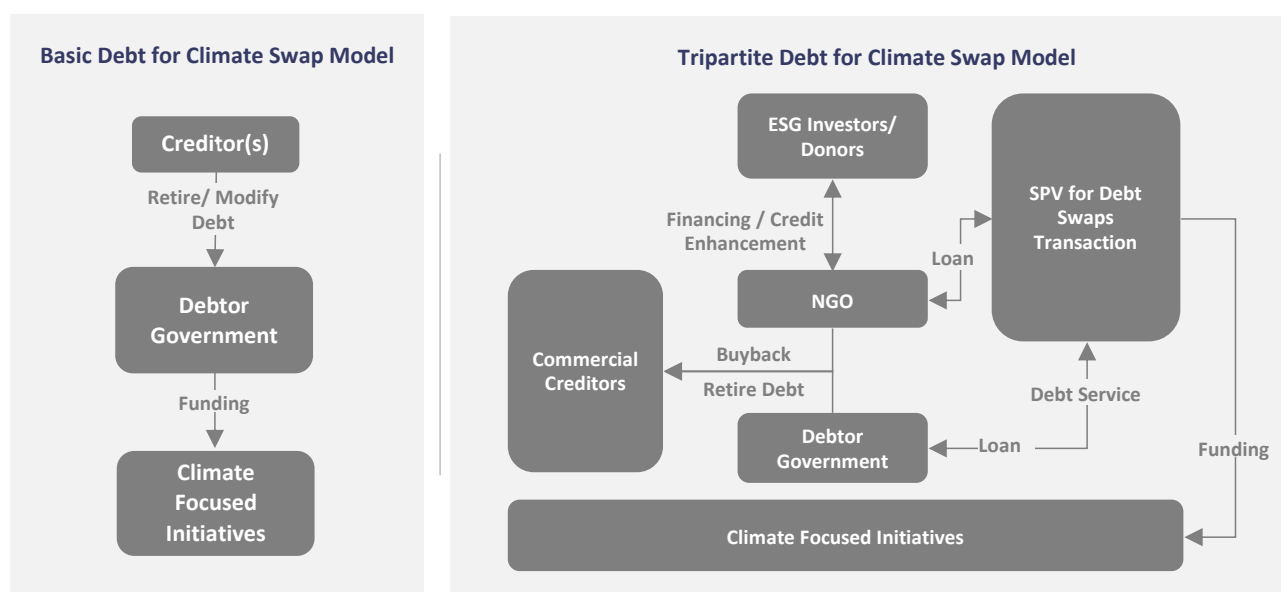
Addressing these challenges requires a comprehensive approach that includes greater international cooperation, improved access to finance, and stronger institutions in developing countries. We discuss (1) debt for climate swaps – a financial tool that could be deployed to increase climate and nature efforts while improving sovereign debt profiles; and (2) avenues for strengthening credit rating assessments in the Global South – a crucial element for increasing capital inflows.

Debt for Climate Swap

Debt for Climate Swaps are a type of financial arrangement that offers some relief to countries that are constrained by fiscal challenges, in exchange for their commitment to support climate and nature-based initiatives.

Figure 02 Debt for climate swap models

Source: Debt for climate swaps – CrossBoundary Sovereign Advisory Viewpoints



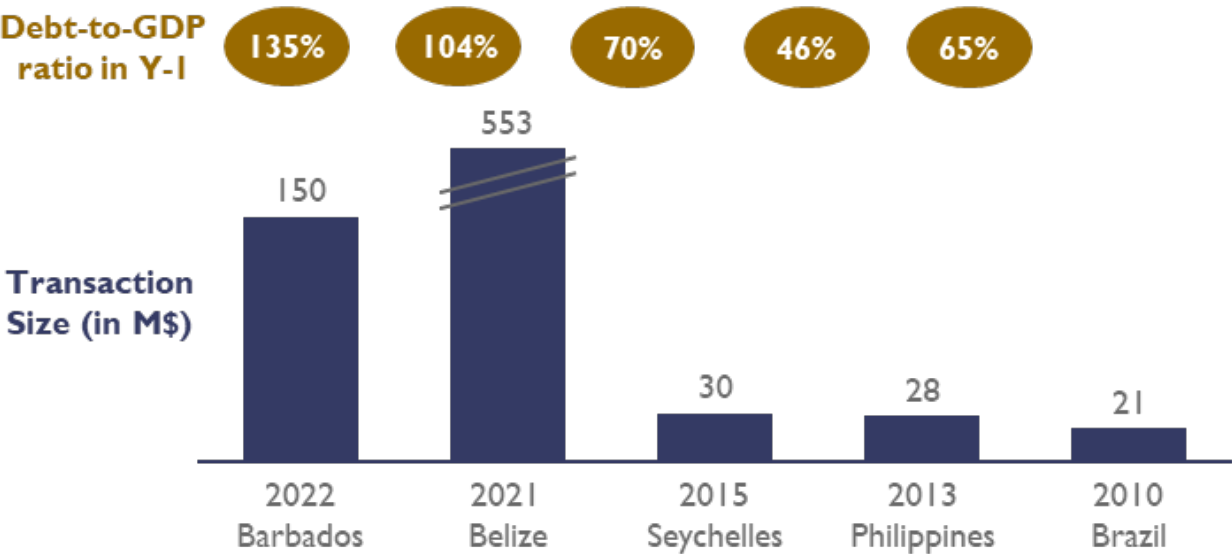
These swaps can cover both commercial and bilateral debts and can be structured in different ways, either directly between a borrower and a creditor as bilateral swaps, or with the involvement of multiple stakeholders in multi-party swaps.

Although debt swaps have gained popularity in recent years, they have generally only resulted in limited debt relief. This is in part due to small transaction sizes, the need for buy-in from multiple stakeholders (and reticence at times from donors and potential transaction sponsors), as well as lack of legal and regulatory frameworks.

As shown in the figure below, debt for climate swaps have been relatively small in scale, with only a handful of transactions being successfully launched to date. For example, in 2013 Belize entered into a debt for nature swap with the United States, which reduced its debt by US\$10 million (0.5% of GDP at the time), in exchange for the protection of its reefs. Similarly, in 2015, Seychelles worked with The Nature Conservancy to reduce its debt by US\$21.6 million, in exchange for the establishment of a marine conservation trust fund. While these transactions were significant landmarks, they represent only a small fraction of the debt held by developing countries and limit the potential for swaps to provide meaningful debt relief and funding for climate initiatives. Still, debt for climate and nature swaps

Figure 03 **Examples of previous Debt for Climate Swaps**

Source: Debt for climate swaps – CrossBoundary Sovereign Advisory Viewpoints



are beginning to grow in size as well as frequency, with the largest ever debt conversion announced in May for Ecuador for the protection of the Galapagos – backed with political risk insurance from DFC and a guarantee from IDB, and over \$1.126B in savings expected to be realized by Ecuador. A \$500M debt swap for marine conservation is also expected to be announced in July 2023 for Gabon.

For Debt for Climate Swaps to be effective and result in meaningful progress towards mitigating and adapting to climate change, they typically require the involvement of multiple stakeholders – debtor and creditor countries, multilateral development banks, civil society organizations, private sector entities, and international organizations. That coordination can take time and effort. Donors, governments, and international organizations may have different goals, time horizons, and risk tolerance levels, which can affect their willingness to participate and their expectations for outcomes. For example, donors may be more focused on promoting sustainable development and addressing climate change, while governments may prioritize debt relief and fiscal stability. In addition, there may be differences in approaches to risk assessment and management, legal and regulatory frameworks, and institutional capacities among stakeholders, which can complicate the process of structuring and implementing swaps.

Finally, the effectiveness of Debt for Climate Swaps also depends on the existence of supportive legal and regulatory frameworks – both at local and at international levels. Given the infancy of this instrument as a tool for climate action, there is currently no standardized framework or best practices for structuring, and implementation can require changes to existing laws and regulations.

Debt swaps present an opportunity to incentivize investment in climate and broader collaboration and partnership between developed country creditors and developing country borrowers to ensure the latter are not shouldering the burden of climate action (and in particular adaptation) alone. In light of increasing connection between climate vulnerability and sovereign debt, and the decreasing availability of concessional financing for vulnerable countries, debt swaps can serve as an important financial mechanism for climate action.



To scale, we suggest three key actions:

- 1. Broader participation from donors and creditors for increased scale:** Expanding the involvement of developed country governments, donors, and multilateral development organizations, such as the World Bank, can not only increase the amount of funding available for debt for climate swaps but also encourage broader market participation in such mechanisms. Developed country governments who are creditors could play a significant role by establishing funds and programs to provide increased support for debt for climate swaps. For instance, the US government's Tropical Forest and Coral Reef Conservation Act, which offered eligible developing countries the option to alleviate certain official debt owed to the U.S. Government in exchange for supporting tropical forest or coral reef conservation activities, serves as an example of such initiative (albeit with few recent examples of executed agreements).
- 2. Building partnerships and coalitions to support swaps:** Partnerships and coalitions that bring together stakeholders from different sectors and countries can help build support for Debt for Climate Swaps and improve their effectiveness. For example, the World Bank could help convene and facilitate discussions to help build consensus and buy-in from actors across the public and private sectors.
- 3. Support the development of legal and regulatory frameworks:** multilateral organizations – in particular the World Bank and the IMF – can play a key role in supporting the development of legal and regulatory frameworks that support the design and structuring of Debt for Climate swaps. This could involve the provision of technical assistance, capacity building, and financial support to developing countries. Creating more standardization around the structure and terms could help increase investor confidence and reduce perceived risks.

Strengthening Credit Ratings Assessments

While there are numerous factors that limit the flow of private capital into developing countries, credit ratings represent a major impediment. Sovereign credit ratings are used by investors as a benchmark for the risks associated with extending credit to government borrowers, and they allow investors to compare



countries' creditworthiness both within and across continents. As such, global Credit Rating Agencies (CRAs) have become gatekeepers to an important source of development – and climate – finance³. An unfavorable credit rating, or a negative rating outlook, has the potential to impede growth and undermine economic stability.

While sovereign rating methodologies are designed to allow for consistent risk assessments across the globe, they may put emerging economies at a disadvantage by failing to incorporate key characteristics or alternative data. Some have argued that the metrics used – including in ESG scores – may be biased towards developed countries, as the data used to assess those factors are often more readily available for developed economies. In the African context specifically, research indicates that CRA methodologies might be systematically overestimating sovereign credit risk. Tennant and Tracey (2016), for example, demonstrated that S&P and Fitch have upgraded African countries considerably less frequently than other developing regions, after accounting for improvements in governments' ability and willingness to service their debt.⁴

Most institutional investors face exposure limits to sub-investment grade rated ('BB' / 'Ba' or lower) securities, which make up the majority of African Sovereign debt instruments (and many other sovereigns in the developing world). As such, this represents a major impediment for accessing larger pools of capital. In particular, CRAs limit a corporate or project issuer's ability to obtain a rating higher than that of their respective Sovereign. As such, a deterioration in Sovereign credit ratings can result in a direct downgrade for corporates in the country, negatively impacting private sector financing conditions.

To tackle the challenges highlighted above, we suggest three key actions:

- 1. Collaborate with CRAs to identify opportunities to strengthen credit rating analyses:** Institutions like the World Bank and the IMF could play a crucial role in engaging and collaborating with

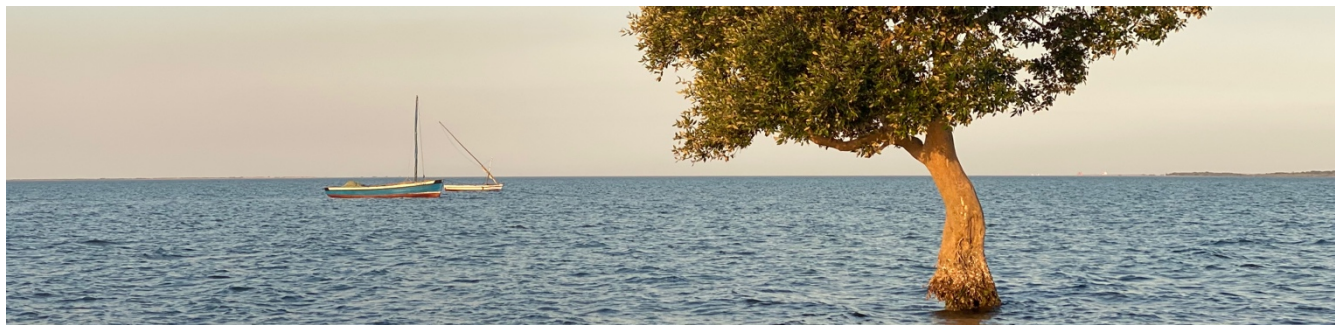
³ Environmental, Social, and Governance (ESG) scores are also increasingly being used as core factors in CRAs' creditworthiness assessments.

⁴ Tennant, D., and Tracey, M., *Sovereign Debt and Credit Rating Bias* (2016), Palgrave Macmillan.



CRA and/or financial regulators to identify opportunities to strengthen credit rating methodologies and better capture credit risks where data quality asymmetries exist. In particular, CRAs should continue to develop methodologies to incorporate climate-related risks into sovereign credit ratings, making it easier for investors to identify and invest in countries committed to climate action. By incorporating climate risk metrics into credit rating methodologies, rating agencies can provide a more comprehensive assessment of a country's creditworthiness and its vulnerability to climate change.

2. **Support more robust reporting, improved accuracy, and broader collection of governance indicators:** Asymmetry of data quality and availability across the continent may result in certain standardized indicators, such as the World Bank's Worldwide Governance Indicators, not always being the best source of information to assess risk in every country. Considering the broadening of the scope of sources used to assess governance risks could help more accurately capturing the reality of developing economies.
3. **Design interventions to reduce sovereign ceiling constraints on corporate ratings:** Sovereign rating ceilings constrain private sector access to affordable and diversified sources of financing. For transactions that are pivotal to successful climate action, institutions such as the IMF and the World Bank could leverage their influence, credit quality, and balance sheet to enable corporates in these markets to access both market and credit risk enhancements necessary to attract a broad investor base on terms more favorable than the applicable sovereign credit ceiling would otherwise allow. It is vital that the private sector is given the incentives necessary to fully participate in funding climate and nature initiatives, and blended finance structures that surpass the credit ceiling of the sovereign would be welcomed by both domestic and international investors.



Part II: Strengthening private sector finance for climate action

3. Gaps and challenges in financing private sector climate projects in the Global South

The challenges to financing climate projects in developing countries can be categorized as macro-level, sector-level, and firm- or transactional-level constraints. Macro-level constraints – lack of quasi-public goods, worsened by sub-optimal policy and decisions and legal barriers – represent broad disincentives to investment, for which traditional interventions, such as policy reform, have been developed. Firm – or transactional-level – constraints such as lack of capital for risk/return and transaction costs, are often left unaddressed and prevent mutually beneficial transactions from occurring. These barriers create gaps and challenges within private sector finance for climate projects in the Global South, as seen in the figure on the next page.

In this paper, we focus on three firm-level constraints on availability of climate finance in the Global South, which center on the key issue of capital absorption: (1) perceived risk and pioneer/first mover challenges leading to disproportionately higher cost of capital; (2) structural risk/return challenges and timing/liquidity mismatches leading to lack of available capital; (3) and high transaction costs relative to deal size, leading to difficulty reaching SMEs and deploying capital in underserved markets generally. While we focus on trade finance, these challenges are broadly applicable across other instruments and sources of private capital in developing countries.

Higher cost of capital due to perceived risk and pioneer/first mover challenges

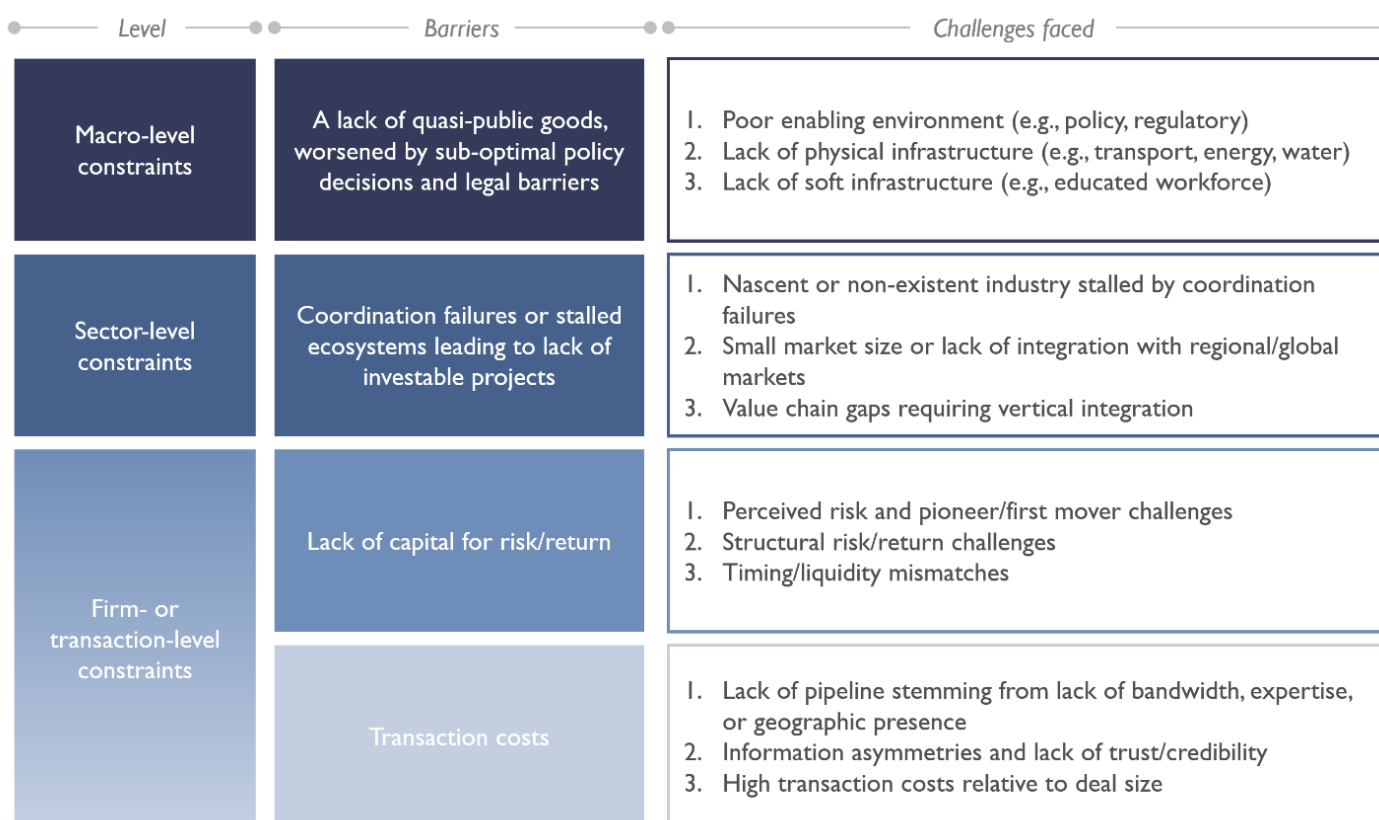
Where it is available, trade finance – like other types of capital – in developing countries is more expensive than in developed countries, which reduces the number of viable climate projects.



While this is often due to actual higher risks in these geographies, it is also the result of high *perceived* that result from information gaps, lack of expertise in the market or sector, and lack of on-the-ground presence by the capital provider. Related to perceived risk is the first mover challenge, whereby (contrary to developed markets) the first mover faces a “pioneer penalty” including higher costs to overcome the lack of hard and soft infrastructure, time, and costs to navigate local regulations, and higher perceived risk for investment.⁵ The pioneer generates valuable public goods for which it is not compensated by the market. This generation of public goods can justify public or philanthropic subsidy of first-movers on both sides of pioneering transactions.

Figure 04

Macro, Sector, and Firm constraints for Financing Climate in the Global South



⁵ Collier, et al. Pioneering Firms in Fragile and Conflict-Affected States Why and How Development Finance Institutions Should Support Them, Policy Research Working Paper 8774. World Bank and International Finance Corporation, 2019. <https://openknowledge.worldbank.org/handle/10986/31400>

Lack of available capital due to structural risk/return challenges and timing/liquidity mismatches

While there is an abundance of capital potentially available for climate action, it may not be suitable for the projects that are seeking funding in developing countries. This can be because of ticket size, payback period, risk and return profile, liquidity, or other factors. For example, a native reforestation project in Sierra Leone would not be suitable as a direct investment for a pension fund until it has been fully de-risked, with trees replanted, a long-term blue-chip buyer locked in for the purchase of carbon credits, and proper insurance or other protections in place – and even then, it is highly unlikely that a pension fund could directly invest rather than going through a fund in which it is a Limited Partner. Particularly for smaller projects, higher-risk projects, and those in underserved markets generally, there are a dearth of fit-for-purpose climate investment vehicles that can offer patient capital at the appropriate ticket size.

Difficulty reaching SMEs and deploying capital in underserved markets due to high transaction costs relative to deal size

Transaction costs are the costs of doing a deal, above and beyond the investment itself. This includes the time and resources to originate, diligence, negotiate, and structure the deal. Transaction size is typically dictated by the overall fund size and the number of deals the management team can close and support on a limited budget. Larger funds must do larger deals. A rule of thumb is that a large deal takes roughly the same effort as a smaller deal, and so in practice there is a structural disincentive for investors to do smaller deals. This is exacerbated for deals in new geographies or sectors, which face even higher transaction costs and will therefore be deprioritized in favor of more familiar and opportunities with lower transaction costs elsewhere. As a result, while climate finance, including trade finance, is more accessible in developing countries for large, now-familiar climate projects such as wind or large hydropower, it is largely inaccessible to SMEs who also play a key role in climate solutions, or for more novel project types such as ecosystem restoration funded by carbon credits.

As just one example in trade finance specifically, from CrossBoundary's own experience as a renewable energy developer and investor across Sub-Saharan Africa, export credit has been



effectively inaccessible for several reasons. First, distributed or small-scale projects such as solar minigrids or commercial and industrial solar systems rarely surpass minimum funding hurdles. A minigrad in rural Zambia, for example, may only need US\$200,000 per system, requiring significant aggregation to reach a reasonable size for a commercial bank or ECA to consider the deal. And where credit insurance is not available, trade financing structures can be especially challenging as banks often require 100% cash-backed Letters of Credit, making the project more expensive without the cash benefit. In Sub-Saharan Africa, distributed renewable energy trade financing remains nascent, and the working capital implications for contractors and developers has slowed market growth.

4. The global architecture for private sector trade finance

Finally, we dive deeper into trade finance as a critical enabler of climate action for projects involving the import and export of climate technologies. Trade finance is an umbrella term used to describe financial products and instruments that help companies manage the payment and supply risks associated with international trade, through reconciling the divergent needs of importers and exporters – importers prefer to pay for goods after receiving them to avoid the risk of non-delivery, while exporters prefer to pay for goods upfront to avoid the risk of non-payment.

Commercial banks remain the primary providers of trade finance, accounting for 43% of global trade finance transactions.⁶ Export Credit Agencies (ECAs) and Development Finance Institutions (DFIs) account for 10% and 9% of global trade finance transactions, respectively.⁷

ECAs can fill gaps in the trade finance market where private capital is unwilling to provide financing; they typically provide credit insurance to large global commercial banks who originate the loan. Today, ECAs are collectively among the largest sources of public financial support for foreign corporate involvement in industrial projects in the developing world.⁸ Most ECAs support exports from developed countries; developing country corporates looking for support for exports, on the other hand, must rely on private sector financing, which is limited by high perceived risk.

⁶ *Global Survey*. International Chamber of Commerce. 2020.

⁷ *Ibid.*

⁸ *What are ECAs?* eca-watch.org. (n.d.). Retrieved April 18, 2023, from <https://www.eca-watch.org/node/1>



Lastly, trading houses act as intermediaries between buyers and sellers in global commodity markets and provide financing to producers and suppliers in emerging markets that have difficulties accessing traditional financing channels. While this works well for commodities, it does not work for most other products, including many of those critical for climate action, which are not as easy to seize and liquidate if needed.

The WTO prohibits members from providing financing at rates lower than the member state's cost of borrowing, with the view that this could distort trade. The restrictions on subsidies limit the availability of concessional export finance for developing countries. The WTO Agreement on Subsidies and Countervailing Measures (ASCM) includes a carve-out that allows WTO members' ECAs to offer below-market interest rates if they comply with the provisions of the OECD Arrangement on Officially Supported Export Credits ("Arrangement"). This Arrangement specifies financing terms and conditions for different countries and sectors, including a set of softer sector-specific financing terms and conditions.⁹ Climate change projects, for example, have a longer maximum repayment term.¹⁰ An important modernization of the Arrangement was the 2021 decision to raise maximum local cost provisions to 40% of export contract value for high-income OECD countries and 50% for all other countries. This means that in addition to receiving financing for imported products, beneficiaries can also receive more financing to cover locally sourced products and services. In geographies where long-term lending is scarce, and where there are high costs for local labor or construction – such as in many developing countries – this change should help to accelerate the growth of climate projects and associated local benefits.

5. Reform proposals and path forward for unlocking private sector finance for climate

There is no single solution that will unlock and accelerate trade finance and investment for climate projects in developing countries. We discuss a set of recommendations for three primary actors: (1) Concessional capital providers, including DFIs; (2) Donors; and (3) the WTO and OECD in the context of trade finance policy.

⁹ *Arrangement and sector understandings*. OECD. (n.d.). Retrieved April 10, 2023, from <https://www.oecd.org/trade/topics/export-credits/arrangement-and-sector-understandings/>

¹⁰ In April 2023, the Climate Change Sector Understanding (CCSU) scope was expanded to include sustainable energy production; CO2 capture, storage, and transportation; transmission, distribution, and storage of energy; clean hydrogen and ammonia; low-emissions manufacturing; zero and low-emissions transport; and clean energy minerals and ores.



1. **Concessional capital providers, including DFIs, can expand the volume and ensure strategic use of concessional capital to mobilize private investment:** Blended finance – the use of concessional public or philanthropic capital to either lower the risks or improve the returns of a deal to crowd in private investment – can address firm-level constraints related to the lack of capital for risk/return. It is most sustainable when used to overcome risk/return challenges stemming from perceived risks and first-mover risks, where there is a long-term commercial return but investors need to see proof points in the sector or geography, and thus it is a one-time subsidy unlocking private finance at scale. When there is a structurally sub-market risk/return profile over the long-term, as is often the case for climate activities like rural electrification, then there is a role for government subsidy to make the sector attractive for private finance. We also need to see greater risk-taking from DFIs for climate projects in order to ensure a change from business as usual. DFIs can (1) create pockets of funding specifically allocated for risk-taking for climate projects (e.g., no senior debt positions, longer grace periods and tenors, or deliberately lower return requirements); (2) expand on-the-ground staff for deal origination and diligence; and (3) ensure strong messaging from leadership alongside performance incentives related to deployment of catalytic climate capital, as often the constraint is not a mandate constraint but a cultural one.
2. **Donors can complement macro-level reform programming with support for investment facilitation to overcome firm-level barriers to climate investment:** While there is certainly a climate funding gap, there is also a capital absorption gap. There is significant capital available that can be channeled to climate deals in the Global South today, but its deployment is hindered by high transaction costs. Donors can achieve high leverage on limited development funding through investment facilitation activities that subsidize the additional costs to get these deals over the line. This includes supporting capital seekers to prepare the necessary investment materials, identify and credibly connect with relevant investors, navigate the due diligence process, and negotiate fair terms. It also includes supporting capital providers to identify, diligence, and structure deals in markets where they have less familiarity and may not have an on the ground presence. Alongside other positive externalities, pioneering deals have the important effect of building momentum in a market or sector and encouraging other investors to follow suit – thus justifying public subsidy of transaction costs. Investment facilitation can also apply to



sovereigns to support their access to capital markets, e.g., a green bond issuance or debt for climate swap in a smaller economy where the commercials of the deal will not entice strong advisors and investors without some level of donor support. Finally, donors can fund the design and establishment of new blended finance vehicles that have potentially prohibitively higher costs for set-up and fundraising but also achieve higher impact. Critically, this support should extend to middle-income countries that are often otherwise excluded from donor programming yet are critical for enhancing competition in manufacturing of climate and environmental goods and services; as well as to adaptation-related finance for small island nations.

3. **The WTO and OECD can modernize the OECD Arrangement to enable ECAs to provide more concessional support for climate finance:**

ECAs are currently constrained from providing more concessional financing by the agreed financing terms and conditions including maximum repayment term, Commercial Interest Reference Rates, and minimum premium rates. If these constraints were relaxed, ECAs could be motivated to act on them for multiple reasons, such as ensuring competitiveness with other ECAs, providing more favorable support to their country's exporters (which can have knock-on effects such as supporting economic growth through job creation), and encouraging innovation through making trade finance more accessible. Participants of the Arrangement could consider lowering the minimum interest rates and premium rates as part of the softer terms of the Climate Change Sector Understanding (CCSU). They could also consider increasing the minimum concessionality thresholds for tied aid to climate projects, which would similarly provide a competitive advantage to climate related projects. More broadly in developing countries, ECAs should be playing a critical role in providing coverage where the private sector cannot. Specifically, ECAs should be encouraged to:

- Make balance sheet investments to support climate projects in the Global South and small island states where commercial banks do not operate at scale
- Lower local content requirements for climate projects to accelerate deployment
- Coordinate closely with DFIs, MDBs, and other partners to offer comprehensive financing packages in a timely manner
- Set up specific initiatives to better serve SMEs in developing countries
- Provide portfolio or supplier-level ECA borrowing structures as an alternative to project-by-project



Conclusion

Ultimately, there is no single solution that can address the range of factors that limit developing country governments and the private sector from accessing capital for climate action. Rather, what is required is a series of coordinated actions designed to help countries improve their credit fundamentals and ensure near term access to improved financing terms while addressing the structural challenges in the medium to long term.

In this paper, we discussed sovereign finance solutions including debt for climate swaps and improved sovereign credit ratings, and the specific actions required to unlock each. We also discussed the vital role that private sector finance and investment play in scaling climate action in the Global South, and solutions to address risk/return challenges, transaction cost challenges, and policy related to provision of trade finance by ECAs. A uniting theme that emerges is the need for solutions that address capital *absorption* challenges alongside expanded capital *availability*.





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At the core of
CrossBoundary
is our purpose
**We unlock capital
for sustainable growth
and strong returns
in underserved markets**

For more information please contact
communications@crossboundary.com