TRANSITIONAL COMMITTEE **29 June 2011**
Second meeting **TC-2/WSIII/3**

Workstream III: Operational Modalities
Background note: Further information on financing instruments

I. Introduction

1. At the first technical workshop of the Transitional Committee (TC) for the design of the Green Climate Fund (GCF), held in Konigswinter, Germany, from 30 May to 1 June, 2011, Transitional Committee (TC) members requested the co-facilitators of workstream III (operational modalities) to collect further background information on a number of issues relating to financing instruments.

2. In particular, members requested information on three key issues:

(a) How financing instruments can promote public-private partnerships (PPPs);

(b) What financing instruments can be used to promote private sector engagement in adaptation activities;

(c) How financing instruments are combined and bundled.

3. The workstream III co-facilitators subsequently instructed the Technical Support Unit (TSU) to compile this relevant information in a background note under their guidance.

4. The background note is arranged into two chapters based on the requests received from TC members. The first chapter deals with issues 1 and 2 above, while the third deals with issue 3. It is intended as a factual basis to aid discussion among TC members on the use of financing instruments within the GCF. It will assist members in the outreach that the TC will have with the private sector by supplementing their understanding of how identified financing instruments could be integrated.

II. Instruments to Promote Public-Private Partnerships in mitigation and adaptation

A. Introduction

5. At the first technical workshop of the TC, participants considered a background note prepared by the workstream III co-facilitators on financing instruments, access modalities, and methods to manage large-scale resources from a number of sources. A number of members and participants requested further information on how financing instruments can be used to develop and promote public-private partnerships (PPPs). Background information on this topic is contained in this section of this note.

B. Role of private sector in adaptation and mitigation

6. PPPs are often used to deploy limited public funds in an efficient manner to mobilise private capital. They are specifically designed to alter the incentives for private sector actors and so redirect private investment flows, in this case toward low-emission, climate-resilient development. Investment decisions taken by private actors are based on a risk-return ratio; imbalances in this ratio can occur in environments with investment barriers and in many early market projects, thus preventing scale up of investments in both mitigation and adaptation. Major barriers to private sector action on adaptation would be the low awareness, the lack of data or the low quality of data, the absence of a trained workforce and abilities to

absorb new technologies and the overall economic uncertainty. Public funds can be used to address these risk-return imbalances. Utilising public finance instruments can help to remove barriers to private investments on mitigation and adaptation in developing countries and/or enhance access to finance for local private business. However, it is critical that public finance is used in clearly defined situations to avoid creating windfall profits for the private sector.

7. Given the fact that private investors expect a return on investments, PPPs are more common in the field of mitigation than adaptation. However, adaptation investments in climate resilient infrastructure, insurance, and agriculture can yield returns or avoided losses for investors and can be options for PPPs. The first PPPs in adaptation are being implemented on a pilot basis.

8. This section of the background note contains a number of examples in mitigation and adaptation of how different financing instruments are being used to support PPPs for both mitigation and adaptation. All these instruments are combined with public grants, which are used to mitigate the risk-return-ratio for private investments. The examples indicate that a number of financing instruments are central to promoting PPPs and are of potential relevance to the TC's work in designing which financing instruments may be needed within the GCF.

C. Instruments Used to Promote PPPs

Grants to finance technical assistance and seed capital in PPPs;

9. (Adaptation) Rural Agriculture in Sudan. In Sudan UNDP is supporting the development of regulatory and market incentives to introduce stress resistant rangeland seedling varieties to enhance rangelands productivity in the Northern Kordofan State; Gedarif State. In addition, the programme is supporting the Sudanese government to set up village level micro-finance institutions (revolving, risk absorption, livestock fund) in target communities to build adaptive capacity and livelihood resilience in Northern Kordofan State.

10. (Mitigation) MDG Carbon Facility. Here UNDP has partnered up with Fortis/BNP Paribas to provide direct access to the carbon markets for underrepresented developing countries on attractive terms. UNDP provides technical assistance to carbon projects, and Fortis/BNP Paribas purchases the carbon credits generated by the carbon projects. Projects have been supported in a wide range of countries such as Rwanda, Honduras and Uzbekistan.

11. (Mitigation) IDB Multilateral Investment Fund (MIF). In Mexico, the Program to Promote Public-Private Partnerships in Mexican States (PIAPPEM) is a full knowledge-base operation that strengthens legal and institutional capacity of Mexican States through the South-Southeast States Development Trust Fund (FIDESUR). Due to their current fiscal conditions and PPP management capacities, the local governments of several states in Mexico are encouraged to create new mechanisms to articulate infrastructure investments. Therefore IDB's Multilateral Investment Fund allocated grants for sub-national governments' policy frameworks development and tailor-made operative manuals as part of a long-term training strategy toward increasing their institutional capacity for future PPP projects implementation in different sectors.

12. (Mitigation) Seed Capital Assistance Facility (SCAF) helps venture capital and private equity fund managers to include portfolios of early stage focused seed transactions within their overall investment holdings. The Facility aims at mobilising private investment for early stage project developments and ventures. For each seed investment that fund managers make in first-time clean energy projects, the Facility cost-shares a portion of the project development and transaction costs. Private sector cooperating fund managers to date are Evolution One Fund (Southern Africa); DI Fund (Southern/Eastern Africa); Berkeley Energy (South Asia); and Aloe Private Equity (India, China). In total these four funds are capitalised at approx. $550 million and each PPP arrangement involves ~$1 million of project development grant from SCAF disbursed against $5 million of seed financing from the fund,

and helping leverage around $200 million of construction stage financing for renewable energy or energy efficiency projects. The facility is a GEF-funded initiative of UNEP, ADB and AfDB, operating in cooperation with EIB. For more information see www.scaf-energy.org

Concessional loans and credit lines to national financial intermediaries

13. (Mitigation) Turkey Sustainable Energy Finance Facility (TURSEFF) intermediated EBRD financing for sustainable energy investments by Turkish banks. EBRD market-priced senior loans to banks combined with Clean Technology Fund (CTF) senior concessional loans to incentivise local banks to enter market. No passing on of interest benefit to end borrowers expected. Combined with EU IPA and CTF grants for technical assistance to local banks and sub-borrowers for project preparation, marketing, and policy work. US$200m disbursed.

14. (Mitigation) The Global Climate Partnership Fund facilitated by the International Climate Initiative (launched in 2008 by the German Ministry for the Environment, Nature Conservation and Nuclear Safety -BMU) is an instrument for mobilising public and private capital for investment in climate change mitigation in developing and emerging countries. The fund primarily supports commercial banks and non-bank financial institutions such as leasing companies in the target countries in their provision of funding investments in small and medium-sized enterprises and house-holds in the fields of energy efficiency, renewable.

Grants to invest in public-private green investments funds

15. (Mitigation) The Green for Growth Fund provides credit lines to financial institutions in Southeast Europe for on-lending to private households, homeowners associations, businesses, municipalities and public sector entities to finance energy efficiency measures and renewable energy projects. Initial fund volume EUR 95 m, up to EUR 350 m in five years. Asset Manager: Oppenheim Asset Management Services, Investment Advisor: Finance in Motion, Technical Advisor: MACS Management & Consulting, Investors/Donors: EIB, KfW, EC, EIF, BMZ, EBRD, IFC, OeEB.

Grants to support production and/or weather Insurance

16. Here grants are used to set up the data basis and subsidize the insurance premium on a decreasing basis.

17. (Adaptation) The World Food Programme (WFP) signed a contract in March 2006 with Axa Re for an indexed payout of 7 million USD in the event of a severe drought in the subsequent year, as measured by 23 weather stations in the region. Insurers were prepared to take on the risks because advances in technology meant it was easier to predict factors like rainfall. The premium for one year is 930,000 USD and has been met by a small group of donors, including the US, together with the Ethiopian government.

18. (Adaptation) Caribbean Catastrophe Risk Insurance Facility (CCRIF) offers parametric insurance products that provide coverage for hurricane and earthquakes and will be offering coverage for excess rainfall by November 2011. Currently 16 Caribbean countries are CCRIF members. The World Bank acts as Trustee. CCRIF mission is to serve Caribbean governments and their communities in reducing the economic impact of natural catastrophes. CCRIF provides immediate liquidity through a range of affordable insurance products in a way that is financially responsible and responsive to their needs. The CCRIF Team is composed by a Facility Supervisor, an Insurance Manager, a Reinsurance Broker, an Asset Manager (there are two asset management companies) and a Communications Manager. In the fiscal year 2009/10 CCRIF funding was divided into capital raised from donor contributions (USD 67.5 m), annual premium income (USD 21.5 m) and participation fees from members countries (USD 22 million).

III. Combining Financing Instruments

19. To meet the objective of scaling up financing for climate activities in developing countries many funds combine and sequence funding from a range of sources, both public and private. In some instances funds are combined in one instrument and in other instances they may be employed through an instrument that operates in parallel with other instruments and funding sources.

20. In addition to direct combinations, the sequencing of funds invested by different parties may be coordinated to varying degrees. The operational modalities of GCF funds will impact on its ability to combine effectively a range of sources. Different financing instruments (grant, concessional, market) can be blended on different levels (e.g. special purpose vehicle, project/program, national institution). One possibility is to create a special purpose vehicle and combine public and private funding in one single instrument (Example 1). An alternative would be to combine grants and loans in parallel in one specific project. This type of blending is showed in Example 2. Further, national developments banks can blend different international financing sources (e.g. donors, climate funds, IFIs) with national funds to finance climate investments (Example 3).

21. With the right operational modalities GCF funds could help to catalyse a significant scaling up of financing from other sources. With the wrong operational modalities GCF funds might crowd-out other public or private sources, for instance by offering financing terms that are more concessional than needed and than other sources are able to provide.

22. A starting point for considering the issue of combining funding is to consider past experiences, which is the purpose of this note. Included herein are the following three examples:

Example 1: Public Private Investment Funds

23. A widely used mechanism to leverage public and private funds to finance climate investments are "Specialised Climate Investment Funds" designed as public-private partnerships. These funds can provide win-win benefits for both public and private investors with successful examples relying on transparent governance, the alignment of interests between public policy goals and the private sector, and a return on private investment. .

24. Normally, the public investor defines the broad investment criteria and the target region. The advantage for the public investor is that its scarce grant funds are leveraged. The incentive for private investors is the layered risk/return structure which enables them to invest in climate projects that normally would be considered too risky from a purely commercial perspective. Attracting the interest of private sector in specific public policy initiatives has enabled a faster roll out of investments due to its flexibility and its agility to react to the right incentive structure.

25. Examples of public private investment funds are the Green for Growth Fund, the European Fund for Energy Efficiency and Renewable Energy Projects and the Global Climate Partnership Fund. These funds provide dedicated finance to local financial intermediaries, businesses, and private households. Some of them also incorporate technical assistance components. As for instance the technical assistance facility of the Green for Growth Fund serves for capacity building and training to partner institutions (both financial institutions and non-financial institutions), awareness raising and market enabling activities and validation and monitoring of energy savings and CO2 emission reductions.

26. Technically these funds utilise a tiered risk-sharing structure. Its liabilities consist of three types of securities bearing different risks: Senior A, Mezzanine B, and Junior C Shares. Private investors invest in the Senior Tranche with the highest return, international financial institutions invest in the Mezzanine Tranche, donor agencies in the Junior Tranche. The

Junior Tranche represents a first-loss tranche, fully subordinated to all other classes of securities issued. The returns for each tranche are fixed at appropriate risk return levels.

Example 2: Blending Platforms

27. Blending platforms introduced by the European Commission, European donors and European Financing Institutions are an innovative financial mechanism aimed at mobilising additional funding to cover the investment needs of specific countries and projects. As a financing platform the approach generates a high grant/loan leverage ratio. Further, they make use of existing finance delivery mechanisms of the eligible European Finance Institutions. For recipient countries the advantage is the high finance volume for capital intensive infrastructure at concessional rates.

28. Each EU blending platform has a strategic body providing policy direction, a decision-making body deciding which projects should receive grants and a group of financiers screening proposals and providing technical analysis before forwarding select proposals to the decision-making body.

29. An example for a blending platform is the Neighbourhood Investement Facility (NIF). The NIF has been designed to finance capital-intensive infrastructure projects in partner countries covered by the European Neighbourhood Policy (ENP) as well as to support their private sector. The facility promotes key infrastructures in the transport, energy, social and environment sectors with a particular focus on climate change mitigation and adaptation and on growth of the private sector. The Facility brings together grants from the European Commission and the EU Member States with loans from European public Finance Institutions, as well as own contributions from the partner countries. To date, the NIF has contributed €277.4 million in grants to infrastructure and private sector projects, leveraging a total project volume of more than €10 billion.

30. The decisions on NIF's operations are taken by the NIF Board. The Commission presides the NIF Board, which is composed of representatives of the Commission, Members States and other donors. The NIF Board sets the overall strategy and takes operational decisions. The Board is served by a Secretariat managed by the Commission. The Finance Institutions Group which also acts as Secretariat prepares and gives technical advice on the pipeline of the operations proposed by the Finance Institutions.

31. The Lead Finance Institution for each project follows their own internal policies and procedures in the execution of the tasks that have been delegated to it by the Commission or by the Co-financing Institutions. The Eligible Finance Institution has to be accredited by the European Commission.

Example 3: National Development Banks - catalyzing funding sources for national climate investments

32. In recent years, there has been a growing realization that national development banks (NDBs) have a crucial role to play in channelling funds towards low-carbon projects and programs. NDBs are strategically placed to address market failures faced by private sector actors seeking to invest in these types of projects by facilitating access to medium and long-term financing at attractive rates. Thus, by integrating NDBs into the public policy framework against climate change in their respective countries and by making use of their capacity to blend different types of finance, these institutions could become key actors for scaling up financing of low-carbon projects in line with the priorities articulated in national climate and development plans.

33. NDBs catalyze international climate finance from different donors, climate funds and IFIs by combining these funds in accordance with the national climate financing priorities. They actively blend grants, concessional loans, market loans and own budgetary funds and

direct them to specific green investments. They have an array of traditional financing instruments and facilities at their disposal and have the capacity to develop new mechanisms as needed. NDBs though are playing an active role as a financing institution within the public policy framework against climate change in their countries.

34. As public development institutions, NDBs enjoy a high visibility and a clear leading role in fostering climate investments in the market. Therefore the promotion of climate investment products and services by NDBs will be perceived by local market players as a policy and market shift towards these types of investments. Second, in their role as second-tier banks, NDBs are well positioned to mainstream investments throughout the entire financial sector. The NDBs can therefore promote innovative financing for climate-friendly investments, as well as facilitate such investments through offering technical assistance products and services to their clients.

35. Third, due to their unique nature, NDBs are not only obliged towards profit-oriented investment decisions, but also towards delivering national development goals, including those relating to poverty reduction. In this capacity, national development banks are well positioned to initiate the transformation of the local financial sector and economy towards low carbon development. Through innovative finance and guarantee programs, the national development banks are often better positioned than commercial banks and sponsors to bear certain risks which the private market is yet not ready to take. Going forward, the role of NDBs will be important in mobilizing private sector investment, thereby expanding the pool of available capital to low carbon projects.

36. Examples of NDBs playing an important role in financing climate investments in their countries are the BNDES in Brazil, the Bancoldex in Colombia, the DBSA in South Africa, the BOAD in West Africa, the IREDA in India, and the CDB in China.

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