UNEP Finance Initiative
Innovative financing for sustainability

The Green Climate Fund (GCF):
The private financial sector's perspective

A submission of the UNEP Finance Initiative[1]

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[1] This paper primarily draws on contributions from the current Co-Chairs of UNEP FI Climate Change working group Nick Robins and Mark Fulton, the former Co-Chair Armin Sandhoevel, and Sabine Miltner

Overview

The private financial sector represented by UNEP FI believes that the Green Climate Fund (GCF) presents a major opportunity for stimulating low-carbon, climate-resilient development in developing countries. By addressing climate challenges in a strategic fashion, the GCF could provide a vital stimulus to economic development, boosting local industry and building expertise. Mobilising private capital will be crucial in order to achieve the significant investment volumes in international climate finance. A stable, attractive and competitive risk-return-profile of climate investments is a prerequisite to mobilize private sector capital. This implies that the risks of any investment need to be assessable and calculable, which is only possible in a stable regulatory, political and financial framework. As a result, we believe that the design of the GCF should incorporate ways of leveraging private capital, both by supporting the necessary in-country enabling frameworks including through empowerment of the private finance sector in developing countries and by making direct investments[2].

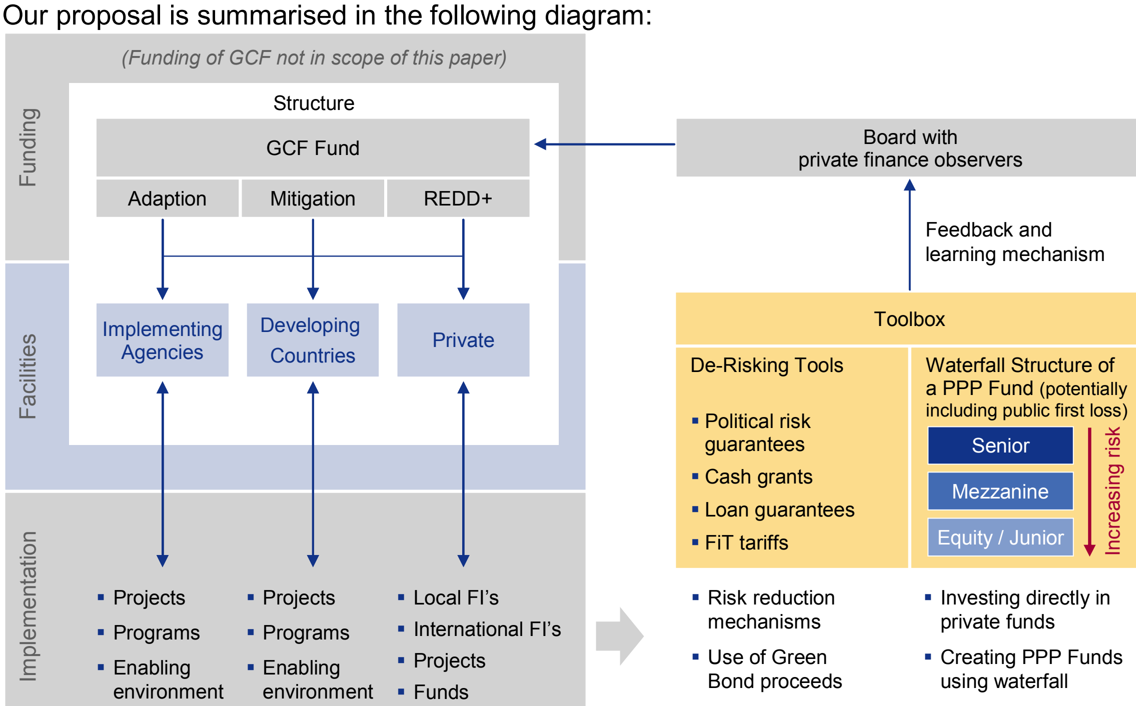
Transformational potential of the GCF can be realized through the ways in which it deploys finance to the public and private sectors for both mitigation and adaption, and through its geographical allocation, notably towards developing countries with hitherto limited access to public and private capital. To achieve this, we suggest the following:

- We propose a model which brings together three main facilities for funding mitigation, adaptation and REDD+: first, a facility for funding through implementing agencies such as IFIs, second, a facility for direct access for developing country governments, and third, a private sector facility.

- We outline a "toolbox" of measures which the private sector facility could deploy. Crucially, private sector access should be structured in a way that enables active participation from both local as well as international financial institutions.

- We suggest that private finance observers are represented on a Board as a means of providing input and expertise to the GCF, particularly on principles, governance, standards and terms.

Our proposal is summarised in the following diagram:



[2] Several discussion platforms in developing and industrialized countries with participation of local financial institutions have occurred recently: *Finance Roundtable – International Green Climate Fund*, Chatham House, London, August 2011; *Pros and Cons of Engaging the Private Sector in the Capital Mobilisation Challenge*, UNEP FI, June 2011, Gustav-Stresemann-Institut, Germany; *UNEP/AfDB Regional Private Sector Consultation to Support the Work of the Transitional Committee for the Design of the Green Climate Fund*, UNEP FI & Frankfurt School UNEP Collaborating Centre for Climate and Sustainable Energy Finance, August 2011, UNEP Headquarters, Nairobi, Kenya

Leveraging the Private Sector: A Toolbox of Options

In our proposed structure, funding could be channelled through an implementing agency facility, a facility proving direct access for developing country governments; and through a private sector facility. This facility should allow for more flexibility in order to enable domestic and foreign sources of private finance to access GCF resources for innovative projects and programmes. Clearly, all funds, projects and programmes will be subject to stringent governance and environmental standards.

To provide a flavor of the instruments that the GCF could provide to the private sector, we recommend four areas based on our experience and background:

- **Political risk reduction mechanisms**: Private investors expect transparency, longevity and certainty ("TLC") and a clearly defined, long-term investment horizon. If these prerequisites are not fulfilled, tailor-made risk reduction mechanisms need to be set up in order to ensure a "fair" return. One possible risk reduction mechanism would be to mandate GCF to provide political risk insurance for climate related investments in developing countries, in a similar fashion as the Multilateral Investment Guarantee Agency (MIGA) does for conventional investments into these markets. Coverage may go beyond pure political risk and may include for instance currency and legal risks. In this way, the GCF could help overcome a fundamental early-stage barrier that forces investors to exclude certain markets from their investment radar and therefore nips FDIs in the bud.

- **Further risk reduction mechanisms**: Instruments which are widely used in de-risking today include: cash grants, loan guarantees and concessional financing[3]. More recently there has been discussion of how to integrate these into a Feed in Tariff regime including grants or guarantees[4].

- **Waterfall structure**: An appropriate approach to attract private capital is to combine both private and public capital in a public-private partnership (PPP) by setting up a tiered risk-sharing structure, or "waterfall". The liabilities of a waterfall-structured fund consist of several types of tranches with different degrees of risks. While private investors could invest in less risky senior tranches, donor countries may hold more risky junior tranches. First loss provisions for the public sector can also be considered. This type of structure mitigates risk for private investors, thereby helping to leverage private capital for what may be considered high-risk investments[5].

- **Climate Bonds:** Climate (or Green) Bonds could be guaranteed by the GCF in a later step as a part of a waterfall structure and in this way support the financing of the projects. Climate bonds are designed to have comparable credit risk and returns as conventional bonds, and therefore represent an important instrument to attract mainstream fixed income investors (e.g. insurance companies, pension funds). Although guaranteed by the GCF, the bonds would need to be backed by real assets with sufficient cash flows to provide returns. These climate bonds could be one possible example of a senior tranche of a PPP fund. [NB This use of bond finance is separate from the issuing of bonds as a source of GCF funding, for example, in a similar manner to Immunisation Bonds by IFFIM].

[3] For further discussion, please see *Scaling up Renewable Energy in Developing Countries: finance and investment perspectives*, Chatham House, April 2010, http://www.chathamhouse.org/publications/papers/view/109324; and *Catalysing low-carbon growth in developing economies – Public Finance Mechanisms to scale up private sector investment in climate solutions*, UNEP and Partners, October 2009
http://www.unepfi.org/fileadmin/documents/catalysing_lowcarbon_growth.pdf

[4] For further discussion, please see *GET FiT Plus: De-Risking Clean Energy Business Models in a Developing Country Context,* Deutsche Bank, April 2011, http://www.dbcca.com/dbcca/EN/_media/GET_FiT_Plus.pdf

[5] For further discussion, please see the Global Climate Partnership Fund website http://gcpf.lu/

Structuring the GCF: A multi-access fund

In order to fulfil its goals and fully integrate the private sector into the process, we believe that the GCF should comprise a multi-access Fund that serves as a distribution point for public monies and then leverages the private sector and other public development banks towards the $100bn target. Key design features include:

- A facility that implementing agencies such as IFIs, including development banks, United Nations and other agencies, can apply to at the programmatic and individual project level. This should include "enabling environment" funding.
- A facility for developing countries to access directly.
- A facility that the private sector can apply to for fund investment, creation of public-private partnership (PPP) funds, and projects that satisfy GCF criteria. Instruments may comprise both equity and debt capital, and should be designed in a way that removes existing barriers to private foreign investments and be characterized by fair and competitive risk-return profiles.

A particular priority to ensure that these three facilities are focused on currently under-serviced developing countries, with the aim of avoiding the crowding out of both private and public sources. Programmes and projects on the ground could be provided with debt capital and could be implemented by existing development banks.

We also believe that the GCF should have the ability to raise capital at some point.

Already many development banks (IFC, WB, KfW, etc.) co-invest with other public and private entities. The design of the GCF should deploy the best practices and lessons learned from these existing examples. We have identified the following strengths and weaknesses of this structure:

Strengths:

- Gaining investor confidence and mobilizing large volumes of private capital.
- Targeting market access to developing countries so far under-serviced by international investors and by existing IFI programmes.

Weaknesses:

- The volume of capital transfer is essentially limited to public funds, since private FDI is (intentionally) not attracted under this model – except as co-investors. Ultimately, the success of this model will depend on the availability of public funding.

Finally, we suggest that the private finance sector is invited as permanent and active observers to the board of the GCF. This would enable expertise and know how to be provided at a strategic level – and not just through the private finance facility. Financiers could share experience and could identify investment requirements at both the policy and project levels. Given the innovative nature of the GCF, this participation could play an important role in feedback and learning, as well as providing input on overall principles, governance, standards and investment criteria.