Fund for responding to loss and damage

FLD/B.2/12

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Second meeting of the Board

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Provisional agenda item 12

Background paper on financial instruments, modalities and facilities[1]

Summary

This background paper provides a comprehensive analysis of financial instruments, modalities and facilities that could be utilized by the Fund for responding to loss and damage to respond effectively to the growing challenges of climate-induced loss and damage. The paper draws on examples from existing climate and non-climate funds, examines the strengths and weaknesses of various financial instruments, and explores approaches to address the needs of vulnerable countries and communities affected by climate-induced loss and damage.

Expected actions by the Board:

The Board will be invited:

(a) To take note of the information provided in the background paper on financial instruments, modalities and facilities; and

(b) To initiate deliberations on the matter, including in relation to the development of a policy for the provision of grants, concessional resources and other financial instruments, modalities and facilities, and agree on next steps.

[1] This document was prepared by the Interim Secretariat for information purposes only. The Co-Chairs have not had the opportunity to review or comment on the document and have authorized its transmittal to the Board on an exceptional basis.

Abbreviations and acronyms

ADB	Asian Development Bank
AF	Adaptation Fund
ARC	African Risk Capacity
Cat DDO	catastrophe deferred drawdown option
CCRIF	Caribbean Catastrophe Risk Insurance Facility
CIF	Climate Investment Funds
CMA	Conference of the Parties serving as the meeting of the Parties to the Paris Agreement
COP	Conference of the Parties to UNFCCC
DPL	development policy loan
DREF	Disaster Response Emergency Fund
DRR	Disaster Risk Reduction
DRFIP	Disaster Risk Financing and Insurance Program
EU	European Union
GCF	Green Climate Fund
GEF	Global Environment Facility
GRiF	Global Risk Financing Facility
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFRC	International Federation of Red Cross and Red Crescent Societies
LDF	Fund for responding to loss and damage
MDB	multilateral development bank
UNFCCC	United Nations Framework Convention on Climate Change
UNCERF	United Nations Central Emergency Response Fund

I. Background and mandate

1. At the first meeting of the Board of the Fund for responding to loss and damage, the Board decided, in its workplan for the second meeting of the Board, to work on financial instruments, modalities and facilities.[2]

2. Paragraph 22 of the Governing Instrument of the Fund (annex I to UNFCCC decisions 1/CP.28 and 5/CMA.5) provides the mandate of the Board inter alia to "develop and approve operational modalities, access modalities, financial instruments and funding structures" and to "approve a policy for the provision of grants, concessional resources and other financial instruments, modalities and facilities, taking into account access to other financial resources and debt sustainability".

3. The Governing Instrument provides guidance on financial instruments in paragraph 57, that:

> "The Fund will provide financing in the form of grants and highly concessional loans on the basis of the Board's policy for the provision of grants, concessional resources and other financial instruments, modalities and facilities. In its provision of finance, the Fund will make use of, inter alia, triggers, climate impact relevant indicators, debt sustainability considerations and criteria developed by the Board, and take into account guidance from the COP and the CMA."

4. Paragraph 58 of the Governing Instrument states that:

> "The Fund may deploy a range of additional financial instruments that take into consideration debt sustainability (grants, highly concessional loans, guarantees, direct budget support and policy-based finance, equity, insurance mechanisms, risk-sharing mechanisms, pre-arranged finance, performance-based programmes and other financial products, as appropriate) to augment and complement national resources for addressing loss and damage."

5. Paragraph 59 of the Governing Instrument states that:

> "The Fund should be able to facilitate the blending of finance from different financial tools to optimize the use of public funding, especially in order to ensure effective results for vulnerable populations and the ecosystems on which they depend."

6. Based on the mandates of the Board and building on the overarching principles set forth in the Governing Instrument, this paper provides an overview and comparison of financial instruments used by comparator funds (climate and non-climate funds), along with key considerations for deliberation by the Board. This paper should be read in conjunction with the background document on access modalities (document FLD/B.2/11).[3]

II. Financial instruments, modalities and facilities

7. Part A below provides a comparative analysis of the use of different financial instruments by other entities relevant for the mandate of the fund for responding to loss and damage. The comparison is based on the instruments mentioned in paragraphs 57–59 of the Governing Instrument and includes a non-exhaustive and non-prescriptive summary of potential advantages and disadvantages of each instrument, examples of their use, and potential consideration for their application in the context of the Fund. Part B is dedicated to the consideration of general principles of utilizing different financial instruments.

A. Comparison of the financial instruments of other funds and entities

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[2] Decision B.1/D.3, para. 7(vi), available from the webpage of the first meeting of the Board

[3] Available at: https://unfccc.int/event/second-meeting-of-the-board-of-the-fund-for-responding-to-loss-and-damage

Table 1: Overview of different financial instruments used by other climate and non-climate funds and entities.

Financial instruments	Green Climate Fund	Climate Investment Funds	Adaptation Fund	Global Environment Facility	UN Central Emergency Response Fund	IFRC Disaster Response Emergency Fund	Caribbean Catastrophe Risk Insurance Facility	African Risk Capacity	Pacific Catastrophe Risk Assessment and Financing Initiative	IDA Crisis Response window	Global Risk Financing Facility/ Disaster Risk Financing and Insurance Program	Contingent credit lines for natural disaster emergencies/MDB DRR products	Global Fund to Fight AIDS, Tuberculosis and Malaria	The Pandemic Fund	Migration Multi-Partner Trust Fund	Lives in Dignity Grant Facility
Grants	Y	Y	Y	Y	Y	Y				Y	Y	Y	Y	Y	Y	Y
Concessional loans	Y	Y		Y	Y	Y				Y	Y		Y			
Guarantees	Y	Y														
Direct budget support and policy-based finance										Y		Y				
Equity	Y	Y		Y												
Insurance mechanisms	Y[4]					Y	Y	Y	Y		Y					
Risk-sharing mechanisms							Y	Y	Y							
Pre-arranged finance/ contingent credit												Y				
Performance-based programmes	Y[5]											Y				

[4] For examples of GCF support for parametric insurance for climate risk through projects see: https://www.greenclimate.fund/sites/default/files/document/gcf-b34-inf16.pdf
[5] See GCF support for results-based payments under the REDD+ pilot programme: https://www.greenclimate.fund/redd

Table 2: Summary of potential advantages and disadvantages of each instrument, examples of their use, and potential consideration for their application in LDF

Financial instruments	*Example*	*Advantages*	*Disadvantages*	*Considerations for possible use in LDF context*
Grants	- GCF, CIF, AF and GEF grants for mitigation and adaptation. - UNCERF and IFRC disaster response grants	- No repayment required - Pre-arranged with triggers for immediate relief - Flexibility	- Financial sustainability issues - Limited accountability on use of funds	Grants can be a crucial component of the LDF to address urgent needs and support the most vulnerable communities. The Fund should establish clear guidelines and monitoring mechanisms to ensure accountability and effective use of grant resources.
Concessional loans	- GCF, CIF, GEF loans - IDA, UNCERF, IFRC DREF	- Encourages investment, supporting rebuilding and development efforts - Requires some level of fiscal discipline	- Creates a repayment obligation - Adds to debt accumulation - Conditionality	Careful consideration of debt sustainability in recipient countries will be needed, and to ensure that loan conditions align with the Fund's objectives and the principles of the Governing Instrument.
Guarantees	GCF and CIF guarantees	- Risk mitigation, encourages more investment - Leverages additional private sector funding	- Creates contingent liability that may be triggered - Complexity of structuring - Limited immediate impact to address urgent needs	Although an avenue to mobilize private sector resources for loss and damage, guarantees may not be the most suitable instrument for addressing urgent needs. The Fund could consider using guarantees strategically to support long-term resilience-building efforts.
Direct budget support and policy-based finance	ADB Policy based lending[6] GCF Readiness[7]	- Alignment with national priorities - Flexibility, based on national needs - Efficiency of using existing government systems	- Requires strong governance to ensure funds are used effectively - Less targeted, may not reach most affected individuals - Conditionality	Effective way to channel resources to countries facing loss and damage but requires establishing robust eligibility criteria and performance indicators to ensure that the support aligns with the Fund's objectives and reaches the most vulnerable populations.
Equity	GCF and CIF equity investments	- Potential for returns over time	- Dilution of control - Risk of failure - Complexity of structuring	May not be the most appropriate instrument for urgent needs but could be considered if the private sector is engaged.

[6] Available from [Public Sector Financing: Financial Products and Modalities | Asian Development Bank (adb.org)]
[7] GCF can provide budget support through its Readiness and Preparatory Support Programme. See: https://www.greenclimate.fund/readiness

Insurance mechanisms (parametric insurance, catastrophe bonds)	African Risk Capacity (ARC), Caribbean Catastrophe Risk Insurance Facility (CCRIF), and similar EU support to subsidize premiums for CCRIF	- Transfer risk to insurers - Potential for rapid payouts	- High premium costs, especially for the most exposed (high risk) communities and countries - Coverage limitations - Potential for moral hazard, limiting incentive to guard against risk - Limited flexibility and availability to smaller entities - May not be suitable for slow onset events	Could be valuable tools particularly in terms of providing rapid financial support to countries/communities affected by climate-related disasters. The example from disaster response management could be adopted, including partnership with the existing regional facilities. But disaster response versus loss and damage criteria need to be distinguished.
Risk-sharing mechanisms	Umbrella stop-loss mechanisms, regional risk pools.[8] GCF equity and guarantee mechanisms[9]	- Shared responsibility - Encourages participation	- Complex arrangements - Coordination challenges - Potential inefficiency	Could be further explored to foster collaboration and burden-sharing among different stakeholders.
Pre-arranged finance/ contingent credit	IBRD DPL with Cat DDO	- Preparedness, enhances capacity to plan for and manage crises - Provides advance certainty of borrowing capacity - Flexibility, based on national needs - Alignment with national priorities, policy engagement	- Upfront costs in preparation - Maintenance of agreement over extended time period - Creates a (contingent) repayment obligation	It can be a useful instrument to ensure timely availability of resources for rapid response to climate-related events. The Fund should consider the balance between the costs of maintaining pre-arranged finance and the benefits of having a reliable source of funding for climate change emergencies.
Performance-based programmes	GCF results-based payments under REDD+ pilot program	- Incentives for results - Efficiency - Transparency	- Complex monitoring - Potential for misalignment - Risk of non-compliance	Could be considered to incentivize the achievement of specific objectives and ensure the effective use of resources. Potentially complex design performance indicators need to align with the needs of vulnerable communities and maintain flexibility to adapt to changing circumstances.

[8] As discussed at: https://www.cisl.cam.ac.uk/news-and-resources/publications/risk-sharing-loss-and-damage-scaling-protection-global-south

[9] GCF enables risk-sharing with other investors through first loss equity financing and guarantees.

B. General principles for financial instruments

8. As an entity entrusted with the operation of the Financial Mechanism of the UNFCCC and the Paris Agreement, the Fund will be both accountable to, and function under the guidance of the COP and CMA. The Fund will also hold a broad remit as a new channel for multilateral finance, including recognizing that the climate impacts faced so far by some climate-vulnerable countries have already exacerbated their debt challenges.

9. The selection of financial instruments for the LDF is a critical aspect of ensuring its effectiveness in addressing the needs of vulnerable countries and communities affected by climate change impacts. Not all possible additional financial instruments may have the same degree of attractiveness for use in the context of the Fund. The principles outlined here could be considered in guiding the selection process and ensuring that the Fund operates in a manner that is responsive, equitable and sustainable.

Debt sustainability

10. Financial instruments of the Fund must consider the debt sustainability of recipient countries, ensuring that support does not lead to unmanageable financial burdens. The LDF could prioritize grant-based financing as its primary mechanism to avoid increasing the debt burden on vulnerable countries. This includes providing full cost grants that cover the entire expense without distinguishing between baseline development costs and additional costs incurred due to climate change. By emphasizing grants, the Fund can ensure that countries can address loss and damage effectively without exacerbating their financial challenges.

Equity and fairness

11. Ensuring equitable access to the Fund's resources is critical. The resource allocation system, to be developed by the Board in line with paragraph 60 of the Governing Instrument, could consider aspects of preventing overconcentration of funds in any one region, country or thematic area, guaranteeing a distribution that reflects the diverse needs and vulnerabilities of all developing countries, while considering the allocation floor outlined in the Governing Instrument. This principle ensures that resources can reach the most impacted countries effectively.

Speed of disbursement

12. For rapid onset events, quick consideration, approval and disbursement will be important. Given the need for the Fund to be able to disburse funding quickly, the LDF Board could consider creating mechanisms by which such individual decisions could be devolved, such as through a trigger mechanism, while maintaining the overall responsibility of the Board for funding decisions.

13. For slow onset events a programmatic approach to evolving long-term needs may be appropriate, including direct budget support and flexible grant instruments, but also concessional financing for specific targets.

Data and knowledge integration

14. Utilizing a comprehensive approach to data and knowledge will enhance the relevance and effectiveness of the Fund's interventions, addressing the real needs and conditions of vulnerable communities. Triggers and selection criteria for disbursement should apply rigorous data sources such as scientific data, community-based knowledge and participatory assessments. This support will ensure that funding decisions can be timely and accurate. The approach should include bridging data gaps through capacity-building, collaborations and technology integration. Clear and actionable triggers, such as specific climate event thresholds and impact indicators, will need to be determined to guide funding release. The framework can remain dynamic, with updates and feedback mechanisms, and leverage the Santiago network for technical support and capacity enhancement.

Complementarity and coherence

15. The selection of instruments for the LDF could be informed by consideration of how the Fund could work synergistically with relevant bilateral, regional and global funding mechanisms and institutions, including existing climate finance mechanisms and other funds, while recognizing that the specific targets of the LDF are unique and distinct. Instruments could be adopted to ensure that they complement and fill gaps in the architecture, and avoid additional administrative burdens on recipients. The LDF could implement targeted approaches, such as alternate funding windows for rapid response and long-term planning, to address unique needs. Sharing data and approaches across the climate funds may help to provide consistency for affected countries to navigate the mosaic of funding sources, and support reliability in funding decisions. Facilitation of coordination and complementarity under the funding arrangements, including through the high-level dialogue, as outlined in annex II to decisions 1/CP.28 and 5/CMA.5 may also inform this work.

III. Possible next steps

16. Based on the review of financial instruments used by other funds and relevant entities provided in this paper and considering the mandate and principles of the Fund outlined in the Governing Instrument, in particular paragraphs 22 and 57–59, the Board may wish to initiate deliberations on the use of different financial instruments, including in relation to the development of a policy for the provision of grants, concessional resources and other financial instruments, modalities and facilities, and agree on next steps.

17. To meet the mandate of the Fund’s operationalization in a timely manner, the Board could potentially consider, among other options, establishing funding windows that address: rapid response, in relation to quick release of funds post-disaster; slow onset events, considering the need for long-term planning and transformative programming; and small grants, ensuring access to support communities, Indigenous Peoples and vulnerable groups and their livelihoods.

18. In terms of potential sequencing in rolling out financial instruments, the Board could initially consider prioritizing grants and simple financial instruments, potentially expanding to more complex tools at a later stage as its programming capacity develops.

References

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