Meeting of the Board
6 –8 July 2019
Songdo, Incheon, Republic of Korea
Provisional agenda item 18

GCF/B.23/12/Add.06

21 June 2019

Review of the initial modalities of the Private Sector Facility – Addendum VI

Technical notes

Summary

This document is a compilation of technical notes and supporting data, in two parts: the first part presents the methodological approach underpinning the formulation of the Private Sector Facility (PSF) strategy; the second part is a compilation of notes presenting technical details relating to the proposed new modalities recommended in the review of initial modalities of the PSF.

Table of Contents

Part I – Methodology and approach for the development of the Private Sector Facility Strategy

1. The development of the strategic roadmap for the Private Sector Facility (PSF) involved the mapping and the matching of countries' climate change priorities, needs and demands, and private sector actors' interests to engage in climate actions. These analyses underpin the development of scenarios for the identification of three key pillars of the private sector strategy, as described in the methodological approach presented below.

I. Approach for demand and supply analysis

2. A demand and supply analysis has been undertaken to understand on one hand, the need of countries represented by their NDAs and on the second hand, the interests of private sector actors to engage in climate change actions. Figure 2 presents a summary of the results of this analysis and highlights potential areas of overlap.

1.1 Approach for the demand analysis

3. The demand mapping exercise looked at the track record of accredited entities (AEs) and other bilateral and multilateral development finance institutions (DFIs) in mobilizing private finance in a sample of 36 countries, in order to assess gaps and complementarity.

4. The approach involved the building of a sample of 36 countries selected with the support of the Secretariat (facilitated by the Division of Country Programming) with particular emphasis on small island developing States (SIDS) and the least developed countries (LDCs), and a desk review of the PSF pipeline and portfolio:

(a) The sample comprises 14 countries from Asia, 11 from Africa, 10 from Latin America and the Caribbean and 1 from Eastern Europe. This sample made it possible to conduct a desk review and to engage with national designated authorities (NDAs) and collect their feedback in the margin of structured dialogues;

(b) The desk review provided access to additional information relevant to identified country demand patterns and made it possible to examine, in detail, a large set of climate policies and documents, including GCF programmes, the low-emissions development of the sample countries, their nationally determined contributions (NDCs), and their adaptation strategies, including national adaptation programmes of action, national adaptation plans (NAPs) and other major climate plans, such as the Climate Investments Funds investment plans;

(c) The assessment was completed by an analysis of information collected through an online survey shared with all 146 NDAs and the additional stakeholders consulted, of which 44 NDAs (30 per cent) provided a response;

(d) Sixteen NDAs selected from the sample countries were interviewed; and

(e) The survey, which was undertaken via telephone for the vast majority, was comprised of 22 questions focusing on private sector engagement in domestic climate actions, the hurdles identified, and the role for GCF/PSF in supporting national efforts to mobilize private sector resources for climate actions in developing countries.

5. The final demand analysis has been derived after the collation and analysis of all information gathered, as well as a cross-check of the information collected against the track record of private sector engagement by institutions comparable to GCF, mainly DFIs.

1.2 Approach for the supply analysis

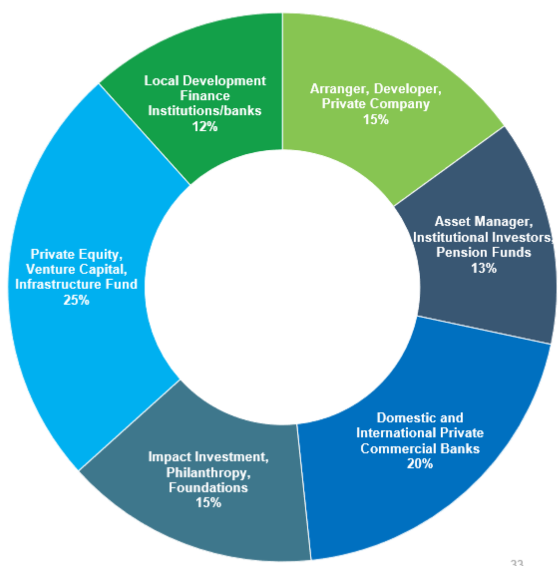
6. The supply analysis involved the identification and sampling of key sources of finance, covering a total of 441 private and public financing entities, including private sector financial entities in LDCs and SIDS, considered in the context of a macro level analysis. Figure 1 presents a broad view of the different types of private sector actors interviewed in the private sector strategy formulation process. A further analysis of a refined sample was comprised of 177 private and public financing entities from 7 different regions and subregions. The sample provided the basis to obtain information on these entities' balance sheet size, investment products and tools, as well as return target appetite.

7. Over 60 private finance actors from different regions and types were interviewed by telephone and in-person. The interviews focused on the understanding of current trends and challenges in climate finance. This approach has provided critical market intelligence across subregions and different types of private finance.

8. The final analysis was based on an evaluation of the critical market intelligence across all subregions and types of private finance sources, as well as the insights collected from interviewees on barriers, gaps, and opportunities for climate investment, as well as an assessment of the opportunities for GCF to engage with a range of private sector financial actors.

9. To complement the market intelligence on the supply side, the team also conducted additional interviews with non-financial actors, namely: the GCF Secretariat, including members of the PSF, experts and Board members of the Private Sector Advisory Group, the Currency Exchange Fund (TCX), the United States Trade and Development Agency, the Self Employed Women's Association (SEWA – India) and GCF strategic advisers.

Figure 1: Private sector actors interviewed, by type



10. The interview objectives were to gather market intelligence with consideration to the following prioritized areas:

(a) Perceptions and views of the GCF as a climate finance partner;

(b) Overview of market trends, initiatives and private investment activity that intersects GCF target areas; and

(c) Insights on the needs of financial actors, their barriers and potential GCF interventions that can be useful to catalyse private investments.

Key findings

11. **Deployment of financial instruments:** of the 177 entities interviewed, 24 per cent, mostly family foundations and philanthropic bodies, deploy grant-based instruments, 56 per cent use debt instruments, namely senior debt, project finance loans and subordinated debts and 73 per cent of these institutions finance climate investments through equity, of which 50.2 per cent provide quasi equity or mezzanine. Only 10.7 per cent, mostly DFIs, offer guarantees to borrowers and project developers;

12. **Risk appetite and return requirements levels:** 75 per cent of these institutions provide commercially oriented funding, especially for projects at investment ready status, through debt, equity, guarantee and mezzanine; 30 per cent, mostly impact funds and DFIs, provide concessional funding, including guarantee, first loss, credit enhancement, and early-stage equity. They apply softer terms through price, tenor, rank and security to reduce project risk. Finally, 22 per cent provide grant-based, philanthropic capital.

II. Methodology for scenario development

13. A five-step approach was used to develop and assess the three scenarios considered for the private sector strategy:

(a) **Step 1: identify potential scenarios:**

- (i) Reflect the consultations with stakeholders (NDAs and private financial actors): surveys, interviews, and published policies;
- (ii) Propose the principles for a country-driven and private-sector responsive approach;
- (iii) Brainstorm the seven potential key elements of the strategy with the Secretariat during mid-point meetings; and
- (iv) Identify three scenarios to develop: reflecting consultations, analysis and need for complementarity with the wider architecture;

(b) **Step 2: Further develop the three scenarios, including:**

- (i) Develop a logic model to show how different financing approaches achieve the desired impacts;
- (ii) Account for the fact that they are not mutually exclusive, but reflect different "vectors" for the private sector strategy that might not be fully inter-changeable;
- (iii) Focus on incremental activities with regard to existing PSF support; and
- (iv) Provide opportunity for the PSF to interact directly with private sector actors;

(c) **Step 3: Identify the gaps, barriers and decisions required to give effect to the three scenarios:**

- (i) Gaps in finance provision and barriers to effective engagement with the private sector or in finance provision decisions;
- (ii) Operations: suggesting change in practice the level of the Secretariat;
- (iii) Policy: signal, direction and guidance under the Board purview for partners, including countries' NDAs, AEs, private sector partners;

(iv) Business model: considerations for potential areas of enhancement or further clarity in some provisions of the Governing Instrument. These considerations could potentially involve a political or other process with relevant linkages to the Conference of the Parties (COP);

(d) **Step 4: Describe the scenario implications:**

(i) Characterize the model portfolio to illustrate the scenarios in relation to the current PSF portfolio and estimated pipeline as of the twenty-second meeting of the Board (B.22);

(ii) Illustrate impacts: such as leverage, results areas, priority countries;

(iii) Identify stakeholder concerns: does the scenario address these, including for key groups such as LDCs and SIDs;

(iv) Identify risks: financial, reputational; and

(v) Costs: both unit and aggregate; and

(e) **Step 5: Synthesize the recommendations:**

(i) Financing approaches that can be affected through operational changes, that can be implemented with a policy change at Board level, or that require changes to the basic business model that could require a review of the Governing Instrument;

(ii) Policy reforms and modalities that may be necessary for the PSF to deliver support effectively and efficiently; and

(iii) Headline recommendations and indicative business plan elements.

14. The logic model of the scenarios, as well as their potential impacts, are presented below. The logic models are not meant to be comprehensive. The scenario at the portfolio level illustrates how applying the scenario would affect key parameters of the PSF baseline portfolio, namely approved projects plus projects targeted for the twenty-first and twenty-second meetings of the Board. Finally, the impacts are broadly described with respect to fund level results, as well as implications for specific results such as carbon dioxide reductions.

III. Key findings from the assessments undertaken

15. This section summarizes the findings from the demand mapping analysis, organized around four themes and completed by a summary of key regional highlights from Africa and Latin America and the Caribbean, as well as an understanding of the perspectives of countries represented by NDAs, regarding demand from private sector actors to support climate actions in developing countries.

Understanding the role of the private sector in supporting climate actions in developing countries with a focus on the context of implementation of nationally determined contributions

16. Almost half (50 per cent) of the countries represented by their NDAs interviewed, indicated having included in their intended NDCs, which were communicated in the context of the Paris Agreement, a reference about the relevance of private sector involvement during NDC implementation. During the interview process, most of them (72 per cent) acknowledged a key role for the private sector in NDC implementation; however, most are unclear on how to mobilize the private sector from status (general frameworks and sector priorities) to a private

sector pipeline and investments. Most survey respondents (93 per cent) indicated having completed an NDC implementation roadmap that spells out the commitments and investments it would take to achieve the NDC targets, with the next step being an investment plan, including private sector engagement. However, the majority of those respondents have only general ideas about specific action to engage the private sector and how to develop a pipeline and lack a complete picture of the climate flows in their country to develop a comprehensive strategy, particularly of private flows. 18 out of 44 NDAs oversee, by themselves or in cooperation with other agencies, climate finance from GCF and from multilateral institutions such as multilateral development banks and regional development banks. However, regarding private climate flows at the domestic level, NDAs indicated not having a good picture of private investment in their countries, and private flows are still mostly unknown for NDAs.

17. In the context of NDC implementation, 35 out of 44 NDAs reported that their country is working on, or plans to develop, an NDC financing strategy that considers multiple climate finance sources, including the GCF. Lack of resources and insufficient coordination among public agencies were the most frequently mentioned reasons identified by NDAs as delaying NDC financing strategies. Over half of NDAs (27 out of 44) had undertaken an estimation of the finance gaps for NDC implementation or are working on calculating one. However, few of these NDAs (5 out of 27) report having calculated the amount of finance required from the private sector. The challenge most reported as preventing them from undertaking such a calculation is insufficient data and resources.

Challenges in engaging the domestic private sector in climate actions

18. NDAs have some awareness of the issues that are hampering private investments in climate actions. Most (86 per cent) NDAs reported a lack of awareness of business opportunities, as well as absence of attractive business opportunities, as hurdles. Low capacity of local financial institutions was also ranked high, as were private sector pipeline and project development and origination as key areas for support, as well as the limited capacity of local financial institutions. The role of direct access accredited entities in local private sector engagement is reported to be essential, as is training of local private commercial banks on risk assessment and climate change financial structures. The NDAs also identified a range of issues in encouraging private sector proposals. NDAs were concerned that AEs are not focused on high impact. Challenges of engaging the private sector and AEs were also commonly raised. They reported the need for AEs to be less focused on the “approval tendencies” of the GCF, and more supportive of innovative approaches.

19. NDAs indicated that private sector actors in many vulnerable countries have limited capacity to develop PSF proposals, except some local commercial banks, which are also the primary providers of finance for micro, small and medium-sized enterprises (MSMEs). NDAs are aware of enabling environments/policy signals to foster private investment, but more work is needed. Over half of NDAs that answered the survey reported planning to include enabling environments and signals to drive private sector decisions in their GCF country programmes.

Challenges in accessing GCF resources

20. NDAs reported challenges understanding the PSF and its role in providing necessary guidance to private sector actors: some NDAs struggle to guide the private sector on strategically tapping into GCF resources, particularly for paradigm shift/innovative investments. They expressed concerns about crowding out. When aware of the GCF, domestic private actors tend to see it only as a source of “cheaper-than-market” finance, often competing with DFIs, rather than as a financier of riskier investments. They also reported that GCF has challenges in trying to access a large segment of private sector actors operating in developing countries. The

structure of the GCF makes it difficult to reach MSMEs and those at the "bottom of the pyramid". Community organizations and MSMEs lack the knowledge, time and capacity to deal with complex proposal and approval processes. Working with MSMEs is the best option at the domestic level as economic growth opportunities in most countries depend to a large extent on MSMEs.

21. To make sure the PSF can deliver, it needs to differentiate what it can do with large, international private actors from how it can support small-size organizations that are essential to the economy. Even though the legal frameworks and incentives exist, it is difficult for small companies to enjoy them. MSMEs may know what the incentives are at the domestic level, but knowledge about developing climate projects is seriously lacking. Nearly all NDAs flagged readiness as a key issue: most NDAs that were interviewed emphasized the need for better-targeted readiness funding for private sector project development, particularly focusing on project origination and idea development prior to accessing the Project Preparation Facility or submitting a concept note. Support during the early stages is essential to build the capacity of local financial systems and the real economy Finally, they reported that the challenges to access the Project Preparation Facility are high.

Roles foreseen for the GCF and its Private Sector Facility

22. GCF readiness is needed to build the capacity of NDAs so that they will look at the right financial instruments and focus on scalability of project, for idea development prior to developing a concept note. Readiness support can help with project development.

23. Funding is needed to build capacity at the local level to develop private sector proposals, help translate what NDC commitments mean in terms of business opportunities. Most of NDAs have expressed their willingness to receive advice from the PSF on how best to target readiness resources to work with the private sector. Regarding the comparative advantage of GCF: NDAs reported that there is a need to make the comparative advantage of GCF more compelling in the climate finance landscape/DFI marketplace, as a source of capital that takes more risk to achieve greater impact.

24. The NDAs also identified a need to promoting local financial institutions' access to GCF resources.

25. Half of the NDAs reported engaging with local financial institutions with a view to nominating them as direct access entities. Many see them as a promising opportunity to channel GCF resources for the local private sector.

26. Only 8 of 43 NDAs reported engaging with other countries in south-south cooperation to support private sector engagement. As well as support, knowledge platforms were reported as potentially most useful for peer-learning and lesson sharing. The NDAs identified a need for more knowledge-sharing and understanding what has worked in other countries. There might not be too many examples for particularly innovative projects, but the PSF can help by sharing successful approaches.

27. Additional tables and data points are added below to provide further insights on the results of the analysis.

Figure 2: Demand and supply mapping for private sector investments by GCF result area

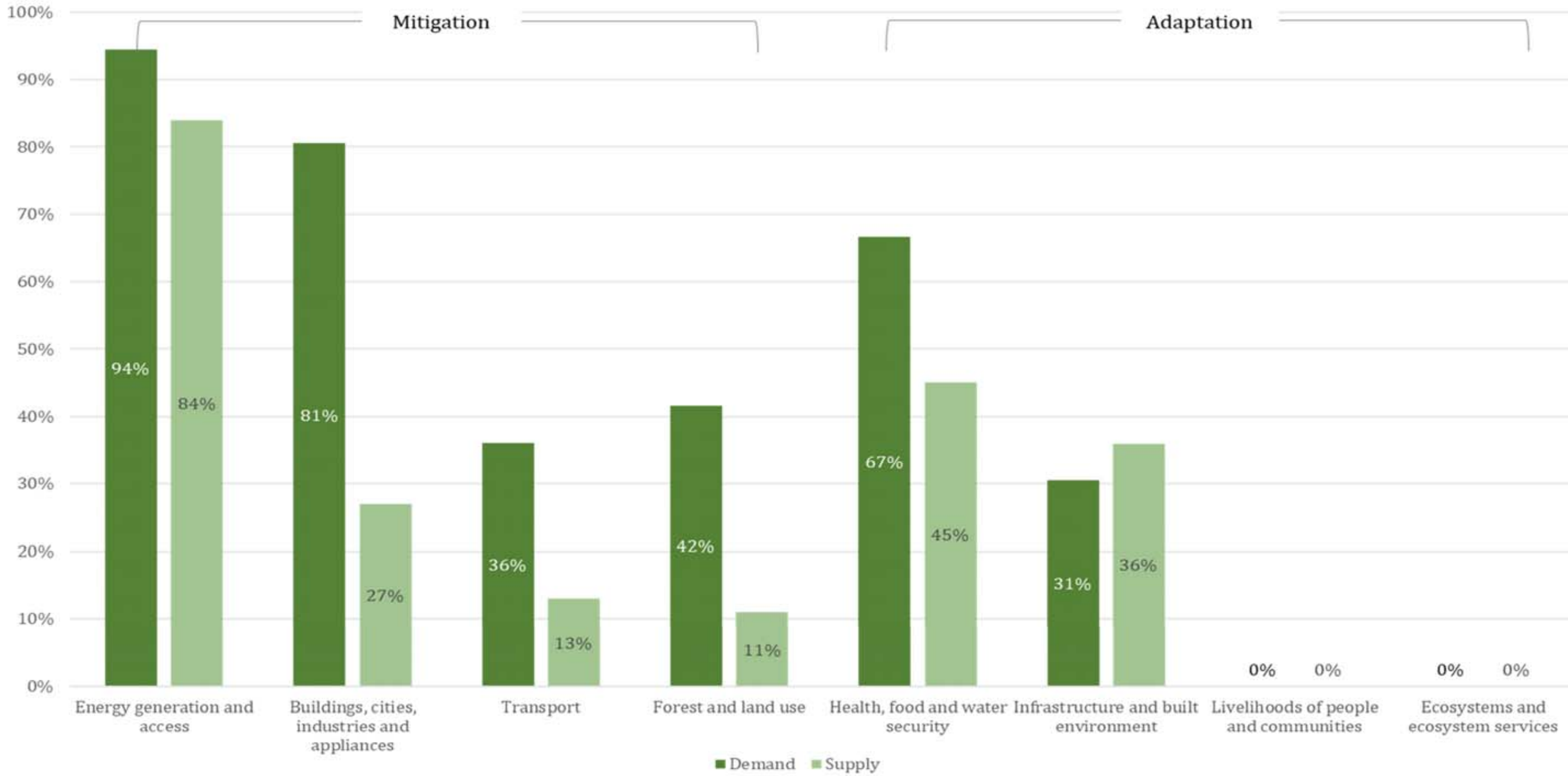


Table 1: Regional specificities: highlights of Africa and Latin America

Market highlights - Africa	
Barriers hampering access to finance to MSMEs (accounting for approximately 90% of business in Sub-Saharan Africa) to access finance for low-carbon, climate resilient investments	• DFIs are still unsuccessful in reaching MSMEs, despite attempts made through investment funds, or by channeling funds through financial intermediaries • Perceived risks associated with MSMEs, limited access to equity, and limited capacity of local financing institutions to fill the "financing gap" • High transaction and due diligence costs which make access to formal financial instruments prohibitive for MSMEs
Challenges for private sector proposal development	• Lack of awareness/interest from the private sector to engage with GCF • Difficulty finding/engaging with AEs with the capacity to develop private sector proposals in the country • Insufficient understanding of private sector needs/priorities by NDAs • Lack of staff/experts within the NDA to engage with the private sector
Focus beyond usual beneficiaries of climate finance	• Most DFIs operating in the region tend to have a couple of token projects in a limited number of LDCs • There is a gap the GCF could fill in helping build local markets for a broader set of LDCs and African States, particularly those that receive less DFI attention • Targeted readiness support to create conducive enabling environments in countries with incipient markets
Market highlights – Latin America and the Caribbean	
Middle income countries in Latin America	• High potential for systemic impact by greening domestic financial/capital markets, which GCF could support (e.g. green bonds issuances in the region have often been isolated initiatives promoted by interested champions, hence the need to generate systemic conditions for these mechanisms to take off and attract investors • Some NDAs expressed interest in having the GCF support countries in structuring green banks to develop a green local financial ecosystem, building on existing institutions
Caribbean SIDS	• Need greater support to reach MSMEs. GCF currently too far removed from local small businesses • Climate-proofing mitigation investments are a high priority in the region • Need extensive support to build/strengthen enabling environments and regulatory frameworks to promote private sector investments
Lower income countries in Latin America	• NDAs have primarily worked with international AEs geared toward the public sector and appear to have had little influence in project origination • NDAs need extensive capacity-building support and know-how to build a rapport with AEs and engage the domestic private sector

Abbreviations: AE = accredited entity, DFI = development finance institution, DMA = Division of Mitigation and Adaptation, MSME = micro, small, and medium-sized enterprise, NDA = national designated authority, NDC = nationally determined contribution, PSF = Private Sector Facility, RFP = request for proposal, SME = small, and medium-sized enterprise.

28. Table 1 above presents specific barriers, identified through the analysis, that hamper the engagement of the private sector in climate actions in Africa and Latin America and the Caribbean from the perspectives of countries represented by their NDAs.

Table 2: Private sector perspectives and considerations in different market needs

Types of barriers	Specific considerations
Latin America	
Lack of project finance	• True project finance (nonrecourse) is not readily available in some markets • Some countries have more active finance sectors, but markets are not deep • The participation of local banks is key because they are best positioned to lead consortia/syndication
Lack of longer tenor debt	• The Latin American market struggles to get longer tenors to match the length of energy and infrastructure projects • The longest possible length a local FI could offer is 7-10 years • Foreign exchange volatility is a key reason why it is difficult to get access to cross-border, longer term debt • “There are opportunities to tap local capital markets for refinancing, but suitable vehicles are uncommon”
Limited project pipeline	• Early stage equity for project development is scarce across the region. Project developers must rely on their own balance sheets, which is a limiting factor in the market • Investment lags, particularly in the earliest stages, where small infusions of capital are critical, but where the risks to investors are the highest • “Quality projects that have gone through initial development have lots of competition among banks and DFIs”
Caribbean	
Lack of creditworthy off takers	• It is challenging to find financing in the Caribbean due to a lack of creditworthy off-takers • However, market participants noted that there is a need to re-familiarize lenders with the status of off-takers (many have improved) • Notwithstanding improvements, lenders still have perceptions of inefficient and unreliable off-takers in the region
Difficulty to find bankable projects	• For RE projects, the challenge of achieving target IRRs is a mix of PPA quality (off-taker + terms) and the cost of debt • A key barrier to more RE investments in the Caribbean is low projected rates of return • Due diligence costs and lender feeds are a major issue for smaller projects • As a result, “small local banks are best situated to finance small projects – cheaper money and more reasonable terms”
Government/regulatory challenges	• Regulation is another key barrier to investment. “The timelines that the regulatory bodies build into auctions do not match with what is always realistic in terms of timing for arranging financing”

Types of barriers	**Specific considerations**
Eastern Europe	
Perceived "DFIs distort markets"	• DFIs operating in Eastern Europe are seen as a competition to local banks • DFIs are often seen as competitors rather than partners because their low rates distort financial markets and create unfair competition • In Central Asia, DFIs are one of the largest sources of capital
Price off-taker risk "DFIs distort markets"	• Price off-taker risk is one of the biggest issues limiting RE adoption in Eastern Europe. Many projects in Eastern Europe will have a guarantee for feeding power into the grid, but not for the power price • As a result, developers take on a lot of risk building projects with uncertain cash flows over 15–30 years • Additionally, RE costs have increased in recent years and the costs are passed on to consumers, which is limiting RE adoption across the region
Small/medium developers lack access to capita	• Local banks do not have the financial products to offer loans to SME (1–10 MW) developers. Consequently, local project developers struggle to get financing
Central Asia	
No capital markets	• Capital markets are limited or nonexistent in Central Asia and Eastern Europe: "Essentially no capital market in Kyrgyzstan." "Stock market in Tajikistan is tiny and difficult." "There is general excitement about Uzbekistan, where there is a stock exchange, but very little liquidity"
PPPs are limited by local stakeholder capacity	• In Central Asia, investors highlighted that "PPPs are too sophisticated for local stakeholders." There are problems around implementation and a lack of international best practice. Even with large DFIs participating in certain PPPs there have still been structural problems. "DFIs were hoping to simply implement projects from a cold start but local parties didn't understand them, and they fell apart"
Limited government support for RE	• Development of wind parks in Central Asia has not been very successful because there has not been money for grid integration. Governments are interested in reducing costs, and state guarantees are very hard to get for RE projects. Private sector-led projects in solar panels, climate infrastructure and desalinization plants have failed due to lack of government support. DFIs are the largest sources of capital in the region
Africa	
Lack of affordable long-tenor financing in local currency	• Across Africa, private sector stakeholders expressed difficulty in accessing affordable, long-tenor financing in local currency. Local banks often require 100% security even if it backed by a line of credit. Local banks frequently lend at rates that are too high for a small or medium-sized developer to access loans
Lack of bankable climate projects	• Local developers (>10 MW) are often undercapitalized and lack the capacity to develop projects that can attract investor

Types of barriers	Specific considerations
	capital. Investors lack enough pipelines of quality projects to finance
Lack of government capacity to incentivize private investment	• Governments set artificially low/noncommercial tariffs, which create negative equity IRR for project developers and deter private investment. Governments lack capacity to develop long-term energy strategies including developing and managing tenders, creating appropriate regulatory environments and building investor confidence (e.g. upholding MOUs and PPAs with developers). Developers expressed that there is often a lack of clarity from governments in terms of policy, procurement and planning around their energy strategies
Asia	
Foreign exchange volatility and capital controls	• Local currencies are volatile in many countries in Southern Asia. India's currency has depreciated by 78% in past 6 months, which causes a lot of uncertainty in projects and makes it difficult to get project and working capital debt. In Pakistan, expatriation of foreign currency is a challenge due to strong capital controls. "Can get money into the country but hard to get money out, which is a challenge for the private sector"
Sophisticated markets look for speed and additionality	• In China deals move and close quickly. Deals from due diligence to close in 2–3 months. Chinese investors need to see more than just capital; proposals must offer value added including network access, expert assistance or complimentary skills that would allow them to enter new sectors and markets
Project preparation	• Project preparation is a major gap in LDCs, including the Lao People's Democratic Republic, Myanmar and Nepal • Identified gaps in Southeast Asia include government capacity, regulatory environments, and support for local developers from project design to environmental and social inclusion
Pacific Islands	
Lack of a liquid market for project exits	• Pacific island projects lack suitable liquid markets capable of valuing and delivering appropriate risk adjusted returns. The lack of a liquid market for investment exits represents a challenge to traditional private equity exit strategies (trade sales and IPOs)
Lack of scale and volume of projects	• Renewable energy projects across the Pacific are typically in the 1-10 MW range • Private sector investors in the energy space are accustomed to structuring, modelling and investing in large projects • For their size, Pacific energy projects fail to provide adequate risk-adjusted returns
Lack of off-taker risk is a major barrier to RE development	• The state is the energy off-taker for most Pacific Islands • Except for Tonga and Fiji, these agencies often run at a loss and subsidize power • For private developers, the off-takers' payment is the biggest risk because the State may not honor its PPA

Abbreviations: DFI = development finance institution, FI = financial institution, IPO = initial public offering, IRR = internal rate of return, MOU = memorandum of understanding, MW = megawatt, PE = private equity, PPA = power purchase agreement, PPP = public-private partnership, RE = renewable energy.

Table 3: Market feedback – breakdown for African subregions

African sub regional highlights	
South	DFIs crowd out the private markets "DFIs in South Africa do a great job of getting market and deals started but once the market is established, they do not open it up and only crowd out private sector lenders." Political risk coverage is a big issue for investors and often required for tenor extensions
North	Majority of energy and infrastructure projects are PPPs, which require sovereign guarantees. Lacks bankable project pipeline from project developers. "It is not a problem to close deals; the problem is that banks do not have enough bankable projects coming up to their desks." Strong track record of blended and project finance
West	Lack of capacity for project development. "Generally, projects in West Africa require more work because local developers are less experienced and less capitalized, and the regulatory and policy environments are less developed." Transmission lines are being built across the region to incentivize IPPs
East	Lack of project finance. There is limited upside on return; all dependent on off-taker in PPA, utility risk. Collateral is insufficient. Need a better return on RE because there is an opportunity cost for alternative loans

Abbreviations: DFI = development finance institution, IPP = Independent power producer, PPA = power purchase agreement, PPP = public-private partnership, RE =renewable energy.

Part II – Technical notes for the modalities

1. The Secretariat proposes five evolving modalities to address the challenges experienced in implementing the initial modalities of the PSF, with the aims of enhancing the business model and further engaging private sector actors for climate actions. These modalities, as indicated in table 1 below, can be categorized into two groups according to their level of Board considerations required for operationalization.

Table 4: Summary of proposed new modalities

#	Modalities	Considerations
1	Mobilizing private sector finance for adaptation via targeted endowments at the country level	To be piloted, with limitations, by the Secretariat within existing Board mandates
2	Piloting local currency funding, with particular attention to LDCs and SIDS	
3	Climate-focused centres of excellence	
4	Private sector co-investment solutions	
5	Direct investment approach	Requiring Board consideration and business model enhancement

2. The rest of this section explains the broad principles and approach, per modality. The final structures of some of these modalities will be based on a more detailed, in-depth assessment of each modality.

Modality 1: Mobilizing private sector finance for adaptation using targeted endowments at the country level

I. Description

1. In response to several vulnerable countries' requests, the PSF is considering supporting the establishment of an Endowment to support adaptation in areas with limited incentives for the private sector. The Endowment established by GCF and other contributors will invest in climate related investments, which generate revenues as well as capital gains. The income from these investments would be utilized to support adaptation projects. The principal design and structural characteristics are defined as below:

(a) The proposed Endowment could consist of multiple individual funds, which could be either (i) true endowment funds where the inflation adjusted principal value is maintained or (ii) funds functioning as endowments, where the principal value is eventually expended towards adaptation to climate change. Each endowment fund within the GCF Endowment will be established with specific climate objective:

(i) This would be jointly defined by NDAs, AEs, and any philanthropic contributor(s); and

(ii) The specificity could also determine potential country(ies) or regions where the intended use is proposed, or a specific adaptation area;

(b) The GCF contribution to the Endowment could be used:

(i) For establishing a specific endowment fund within the Endowment with a co-contribution from a philanthropic investor; or

(ii) For establishing an unrestricted endowment fund (GCF's initial contribution to the Endowment is expected to be in this form).

(c) Figure 3 below depicts how different endowment funds would fit into one Endowment.

Figure 3: Proposed structure of the Endowment

Endowment for Adaptation

	Unrestricted	Specific	True endowment	FFE
Endowment Fund -1	√			√
Endowment Fund - 2		√	√	
Endowment Fund - 3	√		√	
Endowment Fund - 4		√		√

Abbreviation: FFE = fund functioning as an endowment.

II. Strategic fit

2. GCF's support to the adaptation endowment funds will enable greater efforts towards investment in adaptation projects in the most vulnerable regions by generating constant sources of revenue by reinvesting the proceeds from the initial investments in concrete adaptation projects on the ground, with a focus on the most vulnerable communities at the bottom of the pyramid.

III. Role in strengthening country ownership

3. The proceeds from the Endowment will be invested in the most vulnerable sectors, regions and communities through national adaptation funds nominated by the countries, through the NDAs. The national adaptation funds will act as a unified pool of funds towards supporting adaptation projects in countries in line with their national priorities.

4. The proposed structure, as described in Figure 4, would provide opportunities to mobilize additional contributions through domestic, bilateral and alternative sources in the national adaptation funds, thereby promoting greater country ownership.

IV. Implementation approach

5. The Endowment, by adopting a multilayered approach, aims to mobilize and crowd in funds for adaptation at multiple levels:

(a) Endowment level – the GCF contribution is supplemented with contributions from philanthropic investors;

(b) National level – The Endowment's contribution to the national adaptation funds may be supplemented with contributions from countries themselves and from bilateral donors; and

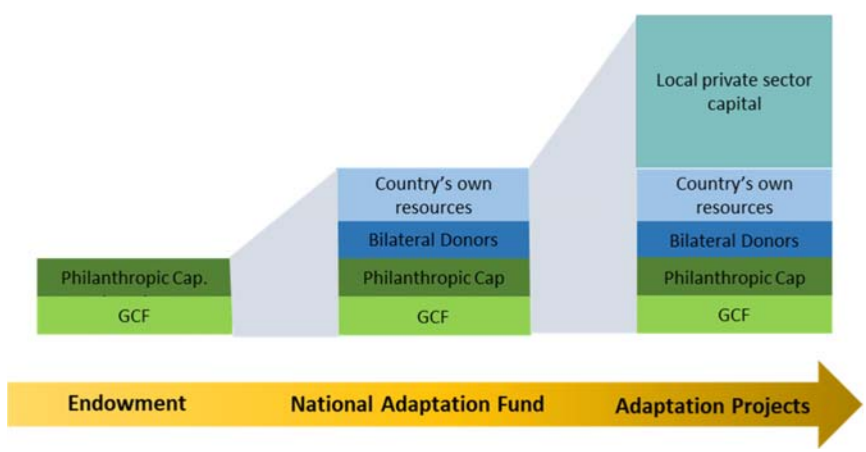
(c) Project level – the contribution from the national adaptation funds will be catalytic to crowd in private sector capital at project level.

(d) Irrespective of the intended purpose, the funds would be commingled into an investment pool;

(e) The Endowment will be built over time, and the individual endowment funds will be established over time; and

(f) The Endowment will have its own investment and spending policy;

Figure 4: The cumulative potential impact of the Endowment



6. The Oversight of the Endowment will be managed in the following ways:

(a) **Governance and reporting requirements:** The Board of the Endowment will include a representation from the GCF, besides representation from other philanthropic investors and independent investment and adaptation experts. The governance of the Endowment will be such that it ensures effective decision-making, adherence to mission of the Endowment and accountability. An appropriate monitoring, evaluation and reporting framework shall be established and reporting of the activities of the Endowment to the Board of the GCF shall be mandatory at every Board meeting. All material changes to the strategy, investment or spending policy will require GCF consent.

(b) **Approval process :** The GCF contribution to an individual endowment fund for a specific purpose will be similar to a submission of a funding proposal and would be approved by the GCF Board, on a case-by-case basis.[1] For contributions to an unrestricted endowment fund, stringent eligibility criteria using the principles of a programmatic approach shall be employed and then the funding proposal will need to be approved by the GCF Board. The Endowment would be set up in partnership with one or more philanthropic institutions and donors. Hence, a direct investment approach will be relevant, as several large philanthropic institutions are currently not accredited with the GCF.

(c) **Management:** It is preferable for the investment process and the spending decisions to be managed in-house by the Endowment. However, initially, owing to inadequate staffing, the investment process may be managed by a reputed climate investment manager. These details would be worked out in due course as detailed assessment is done on the modality.

[1] The mechanics of working with different AEs in the Endowment would need to be further detailed as the funds may be commingled into a common investment pool.

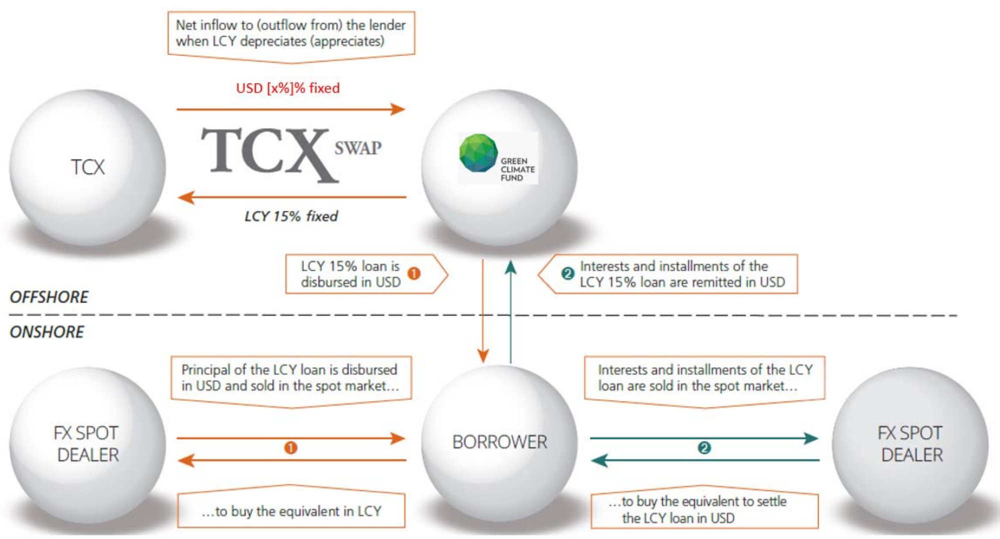
Modality 2: Piloting local currency funding for least developed countries and small island developing States

I. Description

1. Two complementary approaches are considered by the GCF to pilot the local currency funding modality.

2. The first proposed approach to local currency financing is to enable GCF to hedge against potential currency fluctuations by transferring the foreign exchange risk to the Currency Exchange Fund (TCX), which is a fund specialized in non-commercial hedges. TCX covers more than 70 currencies and is used by many DFIs. TCX has invited GCF to be an affiliated member to supply hedges in local currencies. GCF will explore up to three hedging solutions and confirm the benefits to its clients who need local currency products. This pilot is a part of larger initiative by the Secretariat to explore local currency instruments that can expand GCF's catalysing role, as illustrated in figure 5.

Figure 5: Illustration of the pilot's proposed local currency hedging mechanism



Abbreviations: FX = foreign exchange, LCY = local currency.

3. The second approach aims at establishing local currency climate investment vehicles to de-risk and make available domestic institutional capital denominated in local currency. Through this approach, GCF will seed local investment vehicles along with existing AEs and other Financial Institutions through equity and equity-like instruments. The AEs will have local and regional experience and established track record in the climate space.

4. The vehicle would initially be seeded by GCF, the AE and opportunistically other domestic or international Financial Institutions. Over a period of time, the vehicle would have the potential to supplement its initial capital with additional capital from domestic capital markets and domestic institutions like pension funds. While some of the domestic institutions have capital, they have experienced challenges in investing directly in the climate space on account of regulatory challenges and lack of capacity to invest in the climate space.

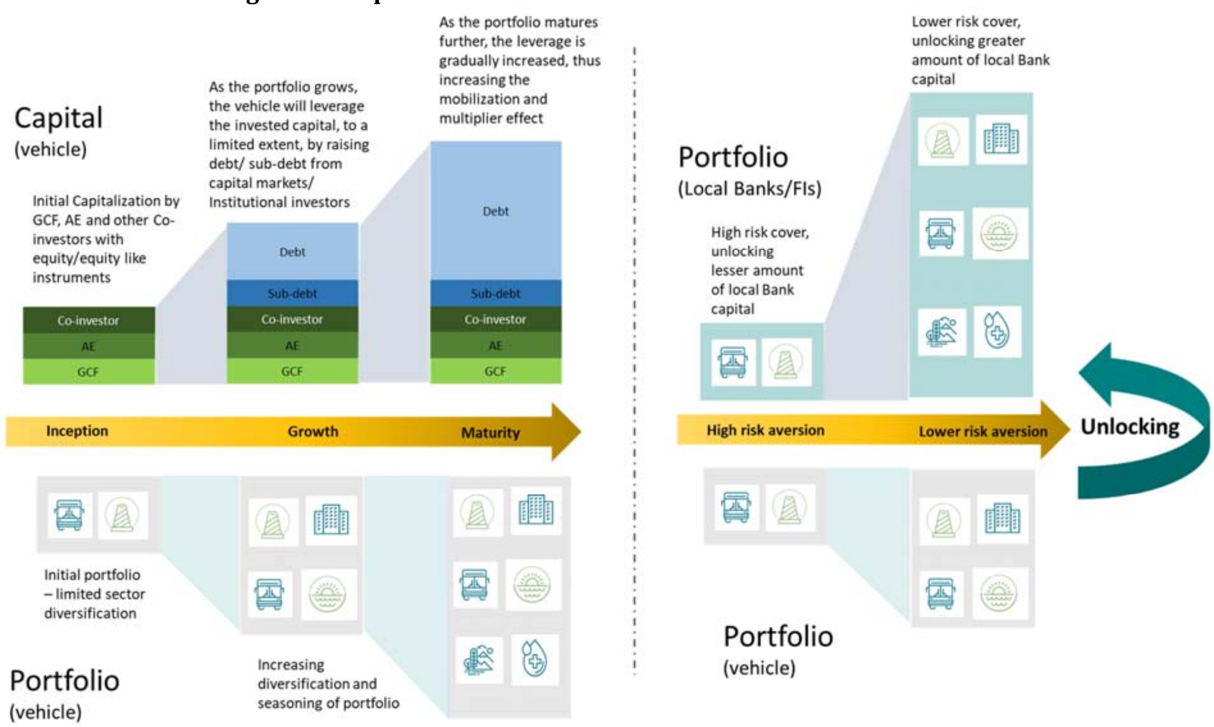
5. The approach presents potential to increase the risk-absorption capacity and significantly unlock and mobilize financing from local banks and Financial Institutions by addressing specific financing barriers, besides lacking capacity to finance projects in the climate space. The banks typically face barriers which include limitations of tenor, which is a constraint in all markets due to the inherent asset–liability mismatch of banks; requirements of additional collateral and security; and general high-risk perception towards climate projects.

6. Since the vehicle will raise long term local currency "patient capital", it will have a significantly higher risk tolerance relative to the domestic banks. Consequently, this will enable the vehicle to offer tailor-made de-risking instruments such takeout guarantees, long tenor credit guarantee and subordinated instruments. This effectively overcomes the challenges domestic banks experience.

7. Over a period of time, as banks get familiar with climate investments and enhance their internal capacity, the risk perception of climate investments will reduce, thus reducing the requirement of support or risk cover from the climate investment vehicle. This will have a multiplier effect on mobilization of capital for climate projects and can thereby produce a greater climate impact.

8. The evolution of the vehicle and the unlocking effect of the vehicle are depicted in figure 6.

Figure 6: Proposed structure of a local investment vehicle



Abbreviation: AE = accredited entity.

9. GCF's involvement in governance of the vehicle from the inception stage will ensure availability of finance for critical areas like climate adaptation, which are currently unable to attract finance otherwise in a business as usual scenario.

II. Strategic fit

10. These modalities will advance the PSF mission to engage local private sector actors to support climate change adaptation and mitigation interventions and business opportunities in developing countries, thereby addressing currency fluctuation risks associated to funds provided in hard currencies as lending instruments to local investors.

III. Role in strengthening country ownership

11. The local currency funding modality strengthens country ownership in various aspects:

(a) GCF will be able to support the country's climate ambitions by ensuring GCF concessionality is not eroded by foreign exchange fluctuations. It will also address a risk that is particularly prevalent for direct access entities, thereby empowering them to submit proposals, while reducing the associated transaction costs;

(b) This modality supports the participation of local financial institutions in the capitalisation of the vehicle. It also encourages their investment alongside the vehicle in de-risked projects, while facilitating credit enhancement for climate actions;

(c) By helping to crowd in capital from local markets to support transformative projects in the country, the vehicle acts as an enabler and makes a compelling business case for local investors. Over the longer term, as transformative business models are proven and general risk aversion subsides, access to local capital, which is structurally aligned with project needs, will gradually cease to be a principal constraint that prevents climate investment.

IV. Implementation approach

12. For TCX: The GCF pilot will be driven by a cross-divisional team, which will manage the programme, obtain legal clearance, sign an International Swaps and Derivatives Association Account Control Agreement, and open any related accounts. This requires GCF to confirm its capacity for the implementation, and to provide counterparty collaterals from time to time. GCF will select three projects – both public and private sector – for the pilot programme. After three hedging transactions are completed, the cross-divisional team will evaluate the pilot programme and report to the Board for its consideration and any necessary follow-up actions.

13. For the local currency investment vehicle: this modality will catalyse co-participation of local banks – by de risking their participation either through takeout guarantees or credit enhancements through sub-debt, junior debt positions or credit guarantees. The specific implementation approach for this modality is presented below:

(a) **Implementation:** The proposal to establish the vehicle will be submitted under a regular submission window by an AE. If needed, the GCF Project Preparation Facility will be used to prepare a robust funding proposal, which will include details about the market and the sectors, as well as the proposed structure and co-investors. It may be pertinent to note here that a direct investment approach may be appropriate in countries/cases where the anchor investor is not an existing AE but a strong financial institution that has a solid track record of investing in the local markets. Using the principles of a programmatic approach, stringent eligibility criteria shall be employed, and such eligibility criteria to screen climate projects will be ingrained in the constitutional documents of the vehicle.

(b) **Governance and reporting requirements:** The investment will be monitored and reported as per existing policies of the GCF. Additionally, the Board of the vehicle may include representation from the GCF, besides climate experts and local financial experts. Further, certain rights may be enshrined in the charter of the vehicle, as this will be detailed in the term sheets of the proposals.

(c) **Prospective**: Over a period of time (i.e. 3-5 years), these investment vehicles will develop a mature portfolio of exposures in different areas and sectors, thus leading to risk reduction through diversification and seasoning. This, along with the equity-heavy capital structure, will potentially lead to a superior investment grade credit rating, enabling these vehicles to raise funds by issuing local currency climate bonds in the local markets.

Modality 3: Climate-focused centres of excellence

I. Description

1. The proposed climate-focused centres of excellence[2] focus on addressing the need for early-stage incubation and acceleration. They place a strong emphasis on the need to strengthen policies for an enabling ecosystem at the country level. This is to be supported with adequate funding and appropriate commercial structuring of early-stage incubators and accelerators which will result in greater impact. The proposed modality is expected to support the work that is currently being undertaken by the Secretariat for the development of a targeted RFP as requested by the Board in decision B.18/03. It is expected to do so by removing bottlenecks and barriers in the market that are otherwise thought to hinder the level of impact expected from issuing an RFP. They will provide a learning experience through the deployment of an initial pilot programme that could demonstrate GCF's additionality and its crucial role in removing market barriers for climate investments – a model that is both replicable and scalable.

II. Strategic fit

2. Accelerating innovation and access to technologies in developing countries requires a strong enabling environment and ecosystem, backed by adequate funding for an effective response to climate change. The GCF is strongly positioned to bridge the gap through the variety of financial instruments available, the strong country reach and the wide pool of partners by which the desired impacts can be achieved. Through the PSF, GCF is also positioned to play a catalytic role that would open markets to new investments in climate change as well as mobilizing private capital at scale. Through the climate-focused centres of excellence, the PSF will be able to unlock the potential for private sector capital to flow into what is foreseen to be a rather risky market and provide innovative solutions that would de-risk private sector investments for early-stage climate innovations and technologies. By working closely with AEs, NDAs, the Climate Technology Centre and Network, the secretariat of the United Nations Framework Convention on Climate Change, the private sector, fund managers and others, GCF aims to accomplish an impactful solution to early-stage climate innovations and technologies.

III. Role in strengthening country ownership

3. Country ownership is key in coordinating GCF engagements within countries. The proposed modality will enable local developers to drive projects throughout the lifecycle of the incubation and acceleration of climate innovations and technologies. Therefore, the Secretariat, through the PSF, has been engaging with and consulting NDAs on their involvement and input since the early design of the pilot programme targeting early-stage climate innovations and technologies. By addressing the lack of local private sector funding at scale for early-stage

[2] The COP of the UNFCCC invited the Board of the GCF by decision 7/CP.21 to consider ways to provide support for facilitating access to environmentally sound technologies in developing country Parties, and for undertaking collaborative research and development for enabling developing country Parties to enhance their mitigation and adaptation action. Responding to this, the Board at its eighteenth meeting took note of the options outlined in document GCF/B.18/12 for the GCF to support collaborative research, development, and demonstration projects including (1) climate technology innovations systems; and (2) targeted climate technology research, development and demonstration support. Related to this, the Board, by decision B.18/03, also requested the Secretariat to develop terms of reference for a request for proposal (RFP) to support climate technology incubators and accelerators for consideration by the Board. As part of a wider institutional effort to address the request by the Board, a working group within the Secretariat was established to address the matter through a holistic approach, covering policy and country needs, as well as operations-related matters.

climate innovation and technologies and creating a strong ecosystem for enhanced country ownership, these centres will ultimately enable developing countries to enhance and accelerate innovation and climate technologies to support adaptation and climate change resilience, reduce greenhouse gas emissions, and promote economic growth and sustainable development.

IV. Implementation approach

4. The GCF proposes a two-stage approach in order to test the market through an initial pilot programme, then document learning and follow up with a direct investment modality:

(a) **First stage:** establish climate-focused centres of excellence, following the already established GCF funding channels:

 (i) The PSF is exploring, with interested NDAs and AEs, a potential structure for climate-focused centres of excellence, with the purpose to source early-stage climate innovations and technology start-ups from developing countries around the world, with a specific focus on SIDS, LDCs and African States. The climate-focused centres of excellence will focus on start-ups operating in areas consistent with the GCF's eight strategic results areas. The potential structure is as follows:

  (1) Regional incubator: To be established in the form of hubs to strengthen country ownership, and stimulate participation by local stakeholders (universities, the private sector, government agencies and others) in the building of a strong enabling ecosystem;

  (2) Global accelerator: To be established with industry partners who have experience in the early-stage start-up cycle. The accelerator aims to provide greater technical support and accommodate the different investment needs, with a strong focus on start-ups originated through the country-based incubators;

  (3) Global growth fund: As start-ups progress, larger investment needs are to be accommodated for. The global growth fund, therefore, aims to address these investment needs and to fill in some of the financing gaps linked to the growth of climate innovations;

 (ii) A funding proposal supported by an AE, targeting the twenty-fourth meeting of the Board, will offer a first opportunity to present a scheme under this pilot programme. It would enable the GCF to learn from this experience with the view to replicate and scale at a later stage;

(b) **Second stage:** Establish modalities that will enable the PSF to consider a dedicated approach to early-stage climate innovations and technologies, based on the lessons learned.

5. A direct investment modality would enable the PSF to bridge the financing gap required to nourish early-stage climate innovation and technologies through incubators and accelerators around the world. This will also enable the PSF to leverage current efforts by other international development institutions in the area of incubation and acceleration of climate-related start-ups and scale up the size of opportunities available in this sphere. Under such a modality, the GCF could establish a dedicated team within the PSF through fund-type structures to work with incubators/accelerators around the world and subsequently support the identification and development of early-stage start-ups and climate technologies.

6. General challenges that are often experienced in the implementation of early-stage climate innovations and technologies include:

(a) The scarcity of funding at scale: due to the high risks associated with early-stage funding in general, and climate innovation and technologies in particular, it has been observed that there is immense difficulty in attracting capital to invest in this line of business. Therefore, private sector funding has been more focused on both later and growth stages. In addition, due to high costs and the lengthy incubation and acceleration process, facilities around the world struggle with the availability of capital to carry their operations;

(b) High-risk perception by investors: the perception of high risk is a barrier to private capital investments for early-stage technologies and incubation and acceleration of start-ups in general. Therefore, GCF intervention would enable investors to have enough comfort, in terms of risk mitigation, to enable them to deploy capital in this area; and

(c) Lack of institutional frameworks and weak ecosystems: the lack of institutional frameworks and incentives to encourage the development of new climate innovations and technologies are among the main barriers that need to be addressed. The GCF is well positioned to have a combination of both public and private interventions that would enable countries to build a stronger ecosystem in relation to early-stage start-ups and climate technologies.

7. Limitations relating to the GCF business model are as follows:

(a) Accreditation model: the current business model requires the GCF to work only through AEs. As a result of the perception of high risk associated with early-stage incubation and acceleration (and start-ups in general), as well as liquidity, it is difficult under the current business model to have an effective approach that would improve the ecosystem for early-stage incubation and acceleration; and

(b) Non-objection letters: the efforts of GCF in working with incubators and accelerators for the development of early-stage climate technologies and start-ups would strengthen country ownership. However, because NDAs require visibility on the pipeline and fund managers before issuing non-objection letters, this requirement represents a barrier for the GCF to be able to work with early-stage climate technologies and start-ups.

Modality 4: Private sector co-investment solutions

I. Description

1. The GCF private sector co-investment solutions aim to bring institutional investors into climate investment opportunities that they typically would not be involved in, with the risk mitigation they seek, and the investment return they look for in developing countries with strong growth prospects. The co-investment solutions are envisioned to achieve the following objectives:

(a) Fulfil a key mandate of PSF by mobilizing institutional investors at scale for climate action;

(b) Unite like-minded institutional and impact investors to join efforts into climate investment themes in developing countries;

(c) Provide institutional investors with the opportunity to co-invest in climate investment projects, along with the GCF, by de-risking and deploying concessional and blended finance tools;

(d) Eliminate barriers to invest in climate-related asset classes by institutional investors in emerging and developing countries; and

(e) Establish a solid investment track record that would position climate investments in developing countries as an attractive asset class for investors.

II. Strategic fit

2. A key pillar in the strategy of PSF is mobilizing capital from institutional investors to co-invest in GCF private sector projects and accelerate climate action in developing countries. Institutional investors including pension funds, sovereign wealth funds, insurance companies, family offices, endowments, philanthropic investors and foundations have expressed a growing appetite for climate investments. It is estimated that over USD 131 trillion is administered by these institutional investors, yet only a negligible portion is channelled into climate investments in developing countries due to the following barriers: (a) High-risk perception; (b) Lack of investment access and vehicles; (c) Information asymmetry; and (d) Lack of capacity, origination bankable opportunities, and market knowledge. This presents an opportunity where the PSF can help bridge the gap by creating investor-led co-investment initiatives that will connect institutional investors to climate investment opportunities in developing countries.

III. Role in strengthening country ownership

3. This modality will contribute to fostering country ownership and supporting the mobilization of private capital, thereby helping developing countries in meeting their NDCs, providing visibility on opportunities to mobilize capital at scale to drive long term and transformational low emission and climate resilient development, based on national priorities.

IV. Implementation approach

4. PSF has undertaken a significant amount of groundwork in developing effective modalities that would enable institutional investors to co-invest with the GCF. PSF has engaged with several institutional investors including pensions funds, insurance companies, sovereign

wealth funds and asset managers who have expressed strong interest in partnering with the GCF on strategic initiatives as outlined in this proposal.

5. Two key initiatives where a strategic partnership could be established between the GCF and institutional investors are described below.

4.1 The GCF co-investment vehicle (the "Vehicle" or "Fund")

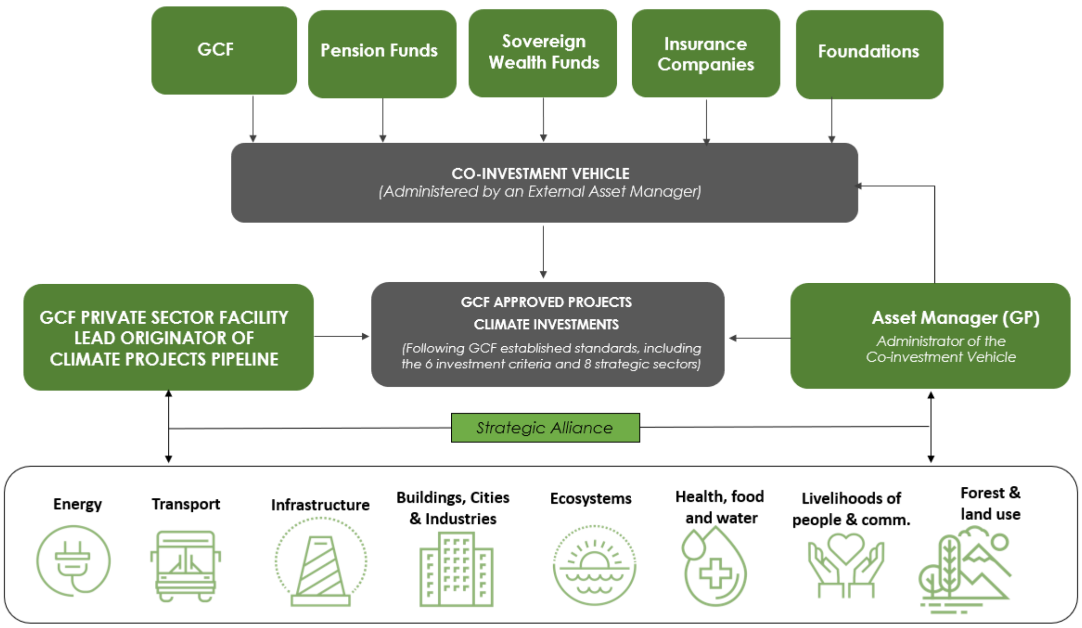
6. The first strategic initiative is envisaged to be a co-investment vehicle seeded by the GCF and other institutional investors including pension funds, insurance companies, and sovereign wealth funds. The participation of GCF in the Fund will be structured to de-risk institutional investors using innovative blended finance instruments such as subordinated equity and debt, and first loss catalytic capital to mobilize institutional investors at scale for climate investments in developing countries. The co-investment vehicle will target the mobilization of at least 4–5 times the catalytic capital seeded by the GCF.

7. The GCF co-investment vehicle will primarily invest in projects or subprojects of programmes approved by the GCF and climate projects that are in line with GCF investment criteria in all aspects. The Co-investment Vehicle will bring together like-minded investors around a renowned asset management firm that will be selected to manage the co-investment vehicle in coordination with a dedicated co-investment team within the PSF (see figure 6 below). The asset management firm will run a separate and independent investment decision-making process to invest alongside the GCF, owing its fiduciary duty to its investors and aiming to build a diversified portfolio of climate investments in developing countries.

8. The PSF will play a key role in originating, de-risking and coordinating the sharing of its pipeline of climate projects with the co-investment vehicle to attract co-financing at scale. A dedicated co-investment team within the PSF will manage the investment process and work closely with the designated asset manager, following the GCF investment criteria and other project screening criteria established by the GCF.

9. The asset manager may be an AE with strong asset management expertise, track record and fiduciary standards. Therefore, the funding commitment of GCF into the vehicle could take the form of either: (1) a dedicated funding amount to be approved by the Board to seed the co-investment vehicle; or (2) a special funding proposal to be approved by Board for the capitalization of the co-investment vehicle.

Figure 7: Structure of the proposed GCF co-investment vehicle



Abbreviations: GP = General partner

4.2 GCF syndication platform for climate investments

10. The second strategic initiative aims to establish a syndication desk or platform as part of the PSF. The syndication desk is envisaged to be a powerful origination hub for climate investments supported by a technology or cloud-based platform to facilitate the sharing of climate projects between the GCF and interested partners and investors. The syndication platform is intended to be an effective marketplace for origination and syndication where the GCF can share innovative and transformative climate projects in its pipeline with investors to attract co-financing at scale.

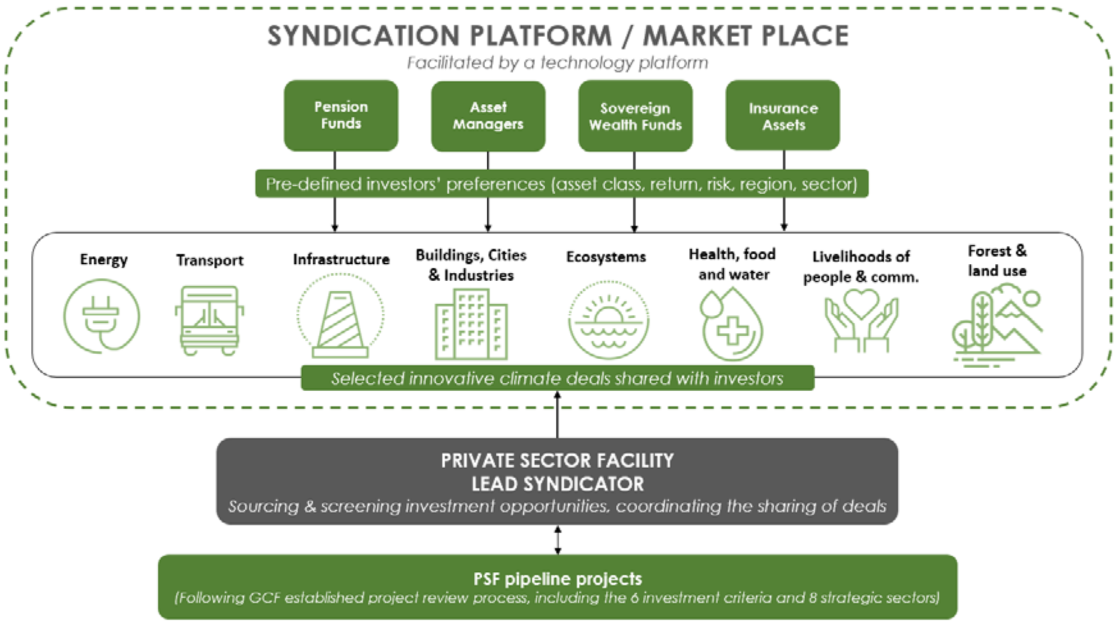
11. The GCF will play an intermediary role as the lead syndicator through its syndication desk, sourcing and screening investment opportunities following GCF investment criteria, and coordinating the sharing of deals and knowledge with investors that are members of the syndication platform. A dedicated PSF syndication team will oversee the management of the platform and work hand in hand with investors and AEs in the investment and syndication process (see figure 7 below).

12. Only investors who meet a set of pre-defined selection criteria and have expressed strong interest in co-investing with the GCF will be selected as members. Investors are expected to participate in transactions on a deal by deal basis. Prior to joining the club of investors, members of the syndication platform will pledge soft commitments and inform GCF of their investment preferences including asset class, return, risk, region and sectors. Investors will have access to innovative climate projects matching their preferences and would be responsible for their own due diligence and decision-making.

13. Investors will benefit from access to the GCF pipeline of innovative climate projects in many ways. First, the risk profile of all projects presented to investors will be enhanced by GCF participation, which can feature innovative blended finance instruments. The GCF contribution will de-risk direct investments in climate projects in emerging and developing countries for

members of the syndication platform, thus facilitating their participation. GCF concessionality can be used to de-risk climate projects through innovative structuring using instruments such as concessional senior and subordinated long-term debt, subordinated equity, first loss credit enhancement and guarantees. Therefore, the GCF is uniquely positioned to provide investors with transformative climate projects and offer innovative financial instruments to overcome the barriers that usually hinder their investments into climate projects in emerging and developing countries.

Figure 8: Structure of the proposed GCF syndication platform



14. The operationalization and implementation of the proposed co-investment solutions by PSF could potentially commence in the second quarter of 2020.The Secretariat will seek approval by the GCF Board of a dedicated funding commitment to seed the co-investment vehicle in 2020. With support from the GCF Board, PSF will advance its work on the proposed co-investment solutions and develop a fully-fledged implementation plan for operationalization. PSF will continue to engage institutional investors to secure their commitment for the capitalization of the GCF co-investment vehicle.

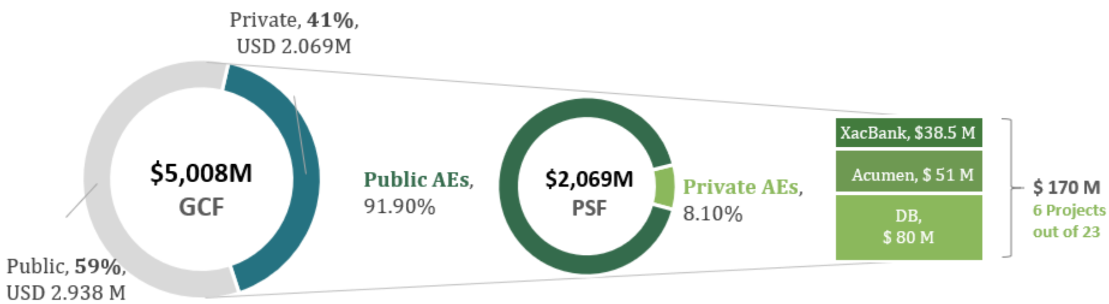
Modality 5: Direct investment approach

I. Description

1. As outlined in the private sector strategy, the experience of GCF during the initial resource mobilization period highlighted the importance of potential enhancements of the GCF access modalities to enable the GCF to fully realize its catalytic potential. This is particularly the case with respect to private sector interventions, which require speedier and more efficient due diligence as well as a clear pipeline of transactions.

2. During the initial resource mobilization period, only about USD 170 million in GCF funding has been directed to private sector AEs, representing less than 4 percent of the Fund's total portfolio post B.22 (see figure 9).

Figure 9: Proportion of private sector AEs within the GCF/PSF portfolio



Abbreviations: AE = accredited entity, DB = Deutsche Bank.

II. Strategic Fit

3. The Board has indicated, in decision B.04/08, that PSF "may over time work directly with private sector adaptation and mitigation actors at the national, regional and international levels". The PSF has evolved into a mature investment team of seasoned climate finance specialists with a strong investment track record, therefore, complementing the current modalities with such a direct access approach seems relevant, necessary and timely.

4. At present, the accreditation framework is in place to assess whether partner institutions have the institution-wide systems, policies and procedures in place to safeguard projects and programmes from fiduciary, environmental, social and gender-related risks. Although GCF performs secondary due diligence of funding proposals, it relies on the AEs to perform the first level due diligence. Under a direct investment approach, the Secretariat itself would conduct the primary due diligence and lend or invest directly into projects and programmes on the ground. This will require the PSF investment team to undertake a rigorous due diligence on all aspects of the projects, including financial, technical, environmental, social and gender-related risks and climate impacts, fiduciary and integrity related issues (see figure 9 below).

5. As the GCF Board is considering the review of the initial modalities of the PSF, it is important to clearly outline any implications for putting in place such a modality and to assess the benefits as well as the barriers of its implementation. The modality has the potential to offer an access modality complementary to the current accreditation process that will effectively and immediately address private sector entities' challenges.

III. Role in strengthening country ownership

6. The proposed modality presents the potential to significantly enhance the ability of the PSF to support local private sector actors engagement in climate actions in line with national priorities. By investing directly, PSF has a better ability to facilitate access to credible local partners, hence allowing them to be more effective and decisive in supporting climate actions. The merits of the direct investment approach relevant to strengthening country ownership include the following:

(a) Enabling PSF to directly engage with the private sector and enhancing the origination of transformative climate projects in line with countries' NDC priorities;

(b) Supporting the GCF's high-risk appetite to achieve impact;

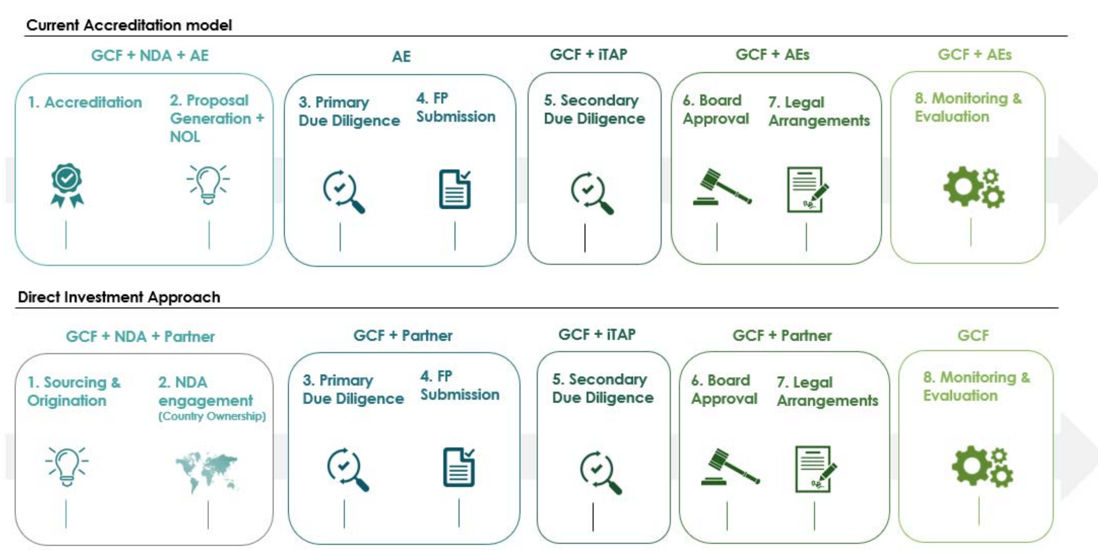
(c) Ensuring a robust, speedier and more efficient due diligence process, as well as better clarity of transactions from conception to implementation, monitoring and evaluation;

(d) Allowing more visibility over disbursements and thus enabling quicker realization of impacts;

(e) Opening up new opportunities to position GCF as a climate knowledge and investment hub; and

(f) Significantly improving the ability of GCF to respond to future RFPs. This is crucially important considering the experience of the mobilizing funds at scale RFPs, through which the GCF originated more than 350 requests for funding totalling more than USD 40 billion.

Figure 10: Current (secondary due diligence) versus a direct investment approach (primary due diligence)



Abbreviations: AE = accredited entity, FP = funding proposal, NDA = national designated authority, NOL = no-objection letter, TAP = Technical Advisory Panel.

IV. Implementation approach

7. In order to support the operationalization and implementation of the direct investment approach, the Secretariat would need to:

(a) Set a portfolio target and limit (e.g. up to USD 500 million) for piloting direct investments in specific sectors with high innovation and transformation potential;

(b) Map key sectors and country priority areas (country programmes, NDCs and NAPs) that will support the delivery of high-impact mitigation and adaptation interventions;

(c) Establish a detailed list of eligibility criteria for the direct investment approach that may include "medium" environmental and social safeguard risks; funding limit per transaction; participation alongside an experienced and credible co-financing partner; appropriate sponsor credentials including, but not limited to, compliance; and credible technical and financial expertise. The criteria will be targeted to innovative climate investments that can trigger systemic transformation, such as investments in climate focused field platforms (direct equity), as well as support to underrepresented thematic areas within the GCF portfolio;

(d) Discuss with countries the best way to operationalize country ownership in the context of direct investing, including non-objection letters or any suitable alternatives. Direct access is essential to maximize the potential of the PSF to catalyse both domestic and international private sector actors to finance transformative climate change projects in line with developing countries' NDCs and priorities;

(e) Implement, in partnership with one or two co-financing partners with a strong local presence and track record;

(f) Create a roster of independent experts to undertake the integrity, fiduciary, environmental and social safeguards and technical due diligence; and

(g) Ensure GCF's streamlined business practices and approaches are applied to investment opportunity due diligence, including through improved systems and processes (see table 2 for the role of units within GCF).

Table 2: Enhanced Secretariat-wide collaboration to support the direct investment approach

Unit	Role
Private Sector Facility	• PSF climate investment specialists need to become the transaction leads and focal points from start to finish • At some stage a stronger representation on the ground might be necessary
Division of Country Programming	• To develop country programmes that can be easily translated into an investment programme of mitigation and adaptation impacts • To map key entities, both domestically and internationally, able to deliver country programmes and articulate the direct investment approach
Procurement	• To create a roster of independent experts for undertaking the integrity, fiduciary, environmental and social safeguards and technical due diligence (based on industry best practice) • Roster to include top accounting firms able to conduct a portfolio quality analysis of complex banks
Finance and Accounting	• To ensure that there is a robust accounting system in place to adequately facilitate the due diligence process
Human Resources	• To oversee the expedited hiring of investment professionals with investment track record and other support unit capacities
Office of the General Counsel	• To establish a roster of external firms, both local and international, that could support the legal due diligence and legal documentation • Dedicated lawyers with principal investment experience

Unit	Role
Office of Risk Management and Compliance	• To ensure that checks and balances are in place (counterbalance) • Dedicated experts of multiple industry groups with a track record of risk in these areas and the requisite officers to undertake checks and balances
Division of Mitigation and Adaptation	• To provide sectoral guidance notes on the eight GCF performance areas and ensure a good understanding of these thematic groups (communities of practice)
Information Communication Technology and Systems	• To put in place the required systems, processes and capacities (e.g. end-to-end systems based on grouping of industry) • Systems that could support the accounting for all the financial instruments
Office of Portfolio Management	• To ensure adequate project monitoring and financial reporting capacities • The team may also be required to handle the role of recovery in potential stressed situations unless a separate unit/division is created
Environmental and Social Safeguards	• Dedicated environmental and social safeguards and gender team to provide hands-on support to the investment team supported by a roster of experts

8. The operationalization and implementation of the proposed direct investment approach by PSF could potentially commence in the second quarter of 2020. The Secretariat will seek approval by the GCF Board of a dedicated funding commitment to pilot this modality in 2020. With support from the GCF Board, PSF will advance its work on the proposed direct investment modality and develop a fully-fledged implementation plan, as part of the implementation of the private sector strategy.

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