Annex V: Summary of Local Currency Financing Approaches

The review identified several options for the Green Climate Fund (GCF) to facilitate local currency debt. These options include providing a local currency loan (Approach A) or offering a USD loan with a grant to cover the associated hedging costs (Approach B). While each approach is effective on its own, they can also be combined to achieve a balanced and impactful outcome (i.e., Option A.2+). Figure 1 below outlines these base options.

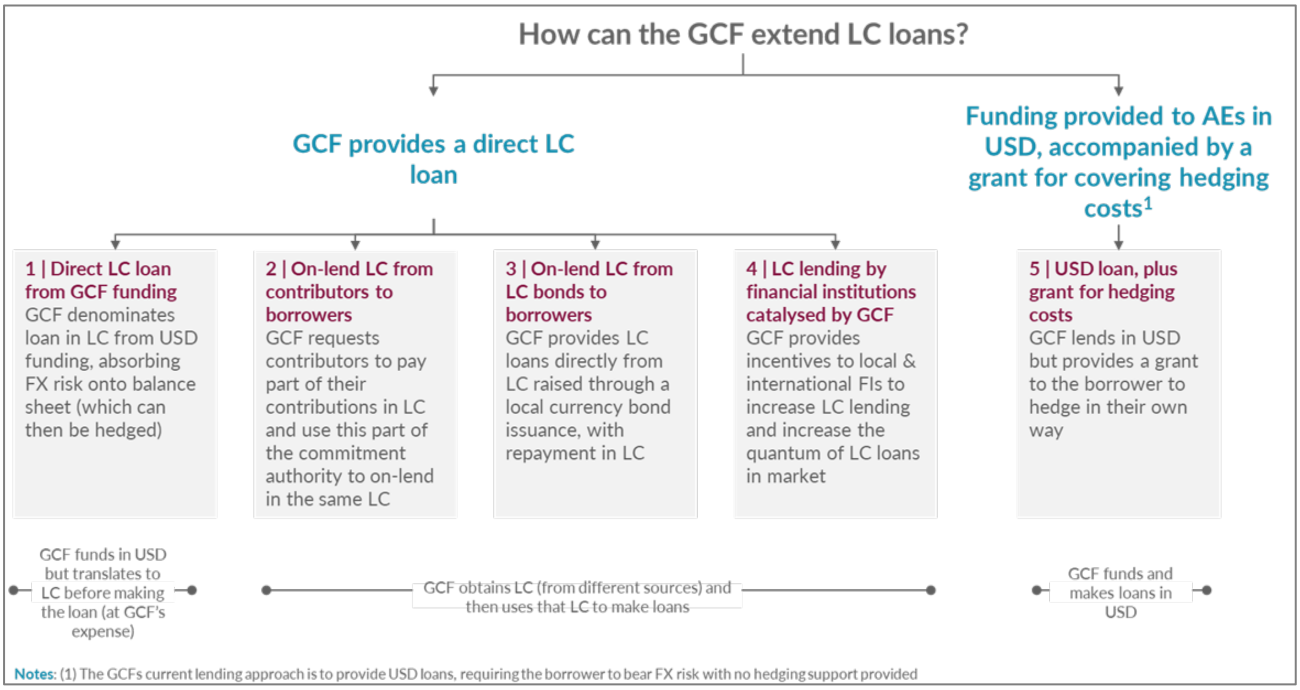
Approach A – GCF provides a local currency loan: Provide direct LC loan: By denominating its loans, both principal and interest, in LC, GCF shifts the FX risk onto its own balance sheet. Consequently, GCF assumes risk associated with having an open FX position on its balance sheet and can use a hedge to manage its balance sheet exposure (where available).

To avoid having to bear hedging costs when offering an LC loan, additional options exist:

- On-lend from GCF contributors: GCF requests contributors to pay part of their contributions in LC and uses to on-lend in the same LC.
- On-lend LC from LC bonds: GCF provides LC loans from LC raised through a local currency bond issuance, with repayment in LC.
- Catalyze LC lending by local financial institutions (FIs): GCF provides incentives[1] to local and international financial institutions (FIs) to increase LC lending.

Approach B – Provide a USD loan plus a grant to cover the AE's hedging costs: GCF has the option to maintain its loan offerings in USD, thereby keeping the FX risk off its balance sheet. In this scenario, the GCF provides a grant to the AE to cover their hedging costs.

Figure 1: Five base local currency options



[1] Incentives include leveraging LC funding of existing banks through de-risking instruments (e.g., SBLC)

Figure 2 highlights the implications of each option on AE needs, market suitability, and GCF impact.

	LCF Option	Description	AE Needs	Market Suitability	Impact on GCF [1]
A.i	**Provide a direct LC loan**	GCF denominates loans in LC from USD funding, absorbing FX risk onto its balance sheet, which can be hedged.	Provides the greatest flexibility to meet AE funding size needs at a moderate cost by leveraging its size.	Suitable in developing or established FX markets.	High impact on GCF, given the need to absorb risk onto its balance sheet and develop capabilities for hedging, deploying LC, and managing risk. However, there will be a high degree of control over funding decisions.
A.ii	**On-lend LC from contributor**	GCF requests contributors to pay part of their contributions in LC and use this part of the commitment authority to on-lend in the same LC.	Provides flexibility to meet high funding size needs at a low cost. However, the speed of delivering LC can be slow, if it has not already been obtained from contributors.	Suitable for countries with a strong presence of GCF's contributors.	Although the FX risk can be transferred to the contributor country, it has minimal impact on GCF. This is because the GCF experiences low FX risk because of limited currency translation and a reduced need for operational adjustments. However, GCF may have to share control over funding decisions with contributors.
A.Iii	**On-lend LC from LC bond**	GCF provides LC loans by raising an LC bond, with repayment in LC.	This model is not conducive to meeting high funding amount needs, has very high costs, and has a very low speed of delivery to AEs.	Suitable for countries with mature financial markets for AEs to raise funds. This is the best way to support local financial markets.	High impact on GCF because there is a need to build bond issuance capabilities and governance oversight. This will be a change and not something GCF seeks to do immediately. However, the FX risk is low, and the level of control over funding is high.
A.iv	**Catalyze LC lending by financial institutions**	GCF provides incentives to local & international FIs to increase LC lending and increase the quantum of LC loans in the market.	This model is not conducive to meeting high funding amounts needs and has very high costs. However, the speed of funding delivery to the AEs is high.	Suitable for countries where there is an availability of local banks that can offer LC loans.	Moderate impact on GCF because while this model requires low internal operational investments and has low FX risk, GCF will have a lower degree of control over funding.
B	**Provide a USD loan plus a grant to cover hedging costs**	GCF lends in USD but provides a grant to the borrower to hedge FX risk.	This model is not conducive to meeting high funding amount needs and has high costs. However, the speed of delivery is very high.	Suitable in countries where AEs have existing FX capabilities (e.g., local bank account/ experience with translation/ hedging).	Low impact on GCF due to a low need for operational investments, low FX risk, and a high degree of control over funding decisions.

[1] Impact at GCF is an evaluation of 3 parameters – i) extent of operational changes needed; ii) risk on GCF's balance sheet; and iii) degree of control by GCF