Annex II: Review of the financial terms and conditions of the GCF financial instruments

I. Introduction

1. The Board, in decision B.09/04 (see annexes III and IV to this document), adopted the financial terms and conditions for the financial instruments of GCF. Through decision B.09/04, the Board also decided that the financial terms and conditions should be reviewed on an annual basis.

2. In decision B.12/15, the Board requested the Investment Committee to provide the draft terms of reference for the annual review of the financial terms and conditions for consideration by the Board at its fifteenth meeting. The terms of reference for the review of the financial terms and conditions of the GCF financial instruments, contained in annex V to this document, were adopted by the Board in decision B.15/05.

3. In decision B.17/08, the Board decided that, pending the conclusion of the review of the financial terms and conditions, the financial terms and conditions set out in annex II to decision B.09/04 should be applied in a fit-for-purpose manner, provided that such terms and conditions do not exceed the upper limits set out therein.

II. Scope and objective

4. The terms of reference for the review of the financial terms and conditions of the GCF financial instruments, as adopted by the Board in decision B.15/05 (see annex VI for the full terms of reference), specified the scope of the review, as follows:

(a) The scope of the review will include an internal component, which takes stock of the projects and programmes approved by the Board and the GCF policies related to financial terms and conditions, and an external component, which takes stock of the practices with respect to the terms and conditions of financial instruments used by other organizations with policy mandates related to those of GCF; and

(b) The review will take stock of the projects and programmes approved by the Board, including those that may be approved at its fifteenth meeting, and analyse to what extent the principles of decisions B.05/07 and B.07/06 have been followed in the assessment of the adequacy of the selected financial instruments. Such a review will take into account all the financial terms and conditions (interest rate, commitment fee, service fee, other fees if applicable, and tenor and grace period of the financial instrument). The review will also take into account whether the project/programme is public or private, the theme (mitigation, adaptation or cross-cutting) and total project/programme size category (micro, small, medium or large).

III. Linkages with other documents

5. The following documents are also relevant to the financial terms and conditions of the GCF financial instruments:

(a) "Business Model Framework: Terms and Criteria for Grants and Concessional Loans" (document GCF/B.05/07);

(b) "Investment Framework" (document GCF/B.07/06);

(c) "Level of Concessional Terms for the Public Sector" (document GCF/B.10/06);

(d) "Concessionality: potential approaches for further guidance" (document GCF/B.19/12/Rev.01); and

(e) "Risk Management Framework" (document GCF/B.19/19).

IV. General principles applied to the financial terms and conditions of the GCF financial instruments

6. By decision B.05/07, the Board adopted the following principles and factors for determining the terms and conditions of the GCF financial instruments for both public and private sector operations:

(a) Guiding principles applicable to public and private sector operations:

(i) Grant elements should be tailored to incremental cost or the risk premium required to make the investment viable, or to cover specific activities such as technical assistance;

(ii) Seeking the right level of concessionality, so as not to displace investments that would otherwise have occurred, including for private sector investment;

(iii) Levels of indebtedness capacity of the recipient should be taken into account so as not to encourage excessive indebtedness;

(iv) Structure terms on a case-by-case basis to address specific barriers;

(v) Avoid crowding out commercial financing;

(vi) Leveraging of other financing, including public and private financing, seeking to maximize leverage in the case of private financing;

(vii) Promote long-term financial sustainability; and

(viii) Apply due diligence to assess the risk to the investment;

(b) When determining terms of financial instruments applicable to both public and private operations, the following factors will need to be taken into account:

(i) The average concessionality or grant element of the financial inputs to GCF and the average concessionality or grant element of financial instruments of GCF;

(ii) The grant element of concessional finance will be tailored to provide the appropriate incentive to facilitate the implementation of mitigation and adaptation activities;

(iii) Concessional forms of finance will be designed to minimize market distortions and potential disincentives to private investment;

(iv) The expertise and capacity of financial intermediaries and implementing entities; and

(v) The risk sharing between public and private investment, when relevant.

V. Review findings and recommendations

7. Based on the terms of reference adopted by the Board in decision B.15/05, a consulting firm (Nodalis Conseil) was engaged to support the work of the review. The executive summary

of the review from the consultant is attached as annex VII. The scope of the review covered funding proposals approved by the Board up to and during the seventeenth meeting of the Board. The key findings of the review are provided below.

8. For public sector projects:

(a) The portfolio-level review demonstrated that Board guidelines have broadly been met in terms of adaptation allocation for vulnerable countries, geographical balance and engagement with the private sector;

(b) While a larger share of nominal GCF resources went to private funding proposals, in grant-equivalent terms a larger share went to the public sector proposals;

(c) Board decisions do not provide guidance to accredited entities (AEs) preparing funding proposals, neither on how to choose between grants and concessional loans, nor on how to choose between the two types of concessional loans; and

(d) Due to a lack of quantitative analysis for the selection of a specific level of concessionality, the lack of a clear rationale for the GCF-level of concessionality requested, and the rare use of arguments related to the level of indebtedness of the recipients, the project-level analyses indicate potential issues with Board-approved guidelines ("principles") on the choice of instrument and on instrument terms and conditions.

9. For private sector projects:

(a) The review did not identify issues of non-compliance with Board-approved guidelines on the choice of instrument and on instrument terms and conditions; and

(b) Risks stemming from the lack of mechanisms to ensure that GCF concessionality is effectively transferred down to the intended beneficiaries.

10. Practices at other institutions:

(a) Most development financing institutions rely solely or at least partly on country-based criteria, such as the level of indebtedness or the gross domestic product of the recipient countries to determine the types of instruments that can be extended, and the terms and conditions of their instruments or a mixed approach combining country and other criteria;

(b) Financial institutions such as the Global Environment Facility (GEF) and the Clean Technology Fund (CTF) adopt a project-specific barrier-based approach;

(c) GCF, GEF and CTF loans are similar for the highest level of concessionality, but the low level of concessionality of GCF loans is slightly lower than the International Development Association standard conditions for blend countries, and lower than the low level of concessionality of other institutions;

(d) Several private sector-focused development finance institutions determine financial terms and conditions and concessionality in a similar fashion on a case-by-case basis, following an analysis of the barriers preventing private investment in the project with margin spreads, which are usually based on internal ratings that include a country risk and a project risk element; and

(e) The International Finance Corporation has instituted since 2012 an independent Blended Finance Committee to review projects that request the use of concessional instruments.

11. The Secretariat notes that the following main recommendations arising from the review have already been implemented/are under implementation:

(a) Development of a grant equivalent calculator with a clear methodology to measure the level of concessionality needed;

(b) Adoption of a uniform approach to measuring concessionality that would also allow for better comparability between private and public sector projects;

(c) Clearer differentiation of policies and guidelines to enhance the readability of policies and guidelines for AEs;

(d) Provision of more guidance by GCF to AEs to enhance process predictability for all types of projects;

(e) Adjustment of the proposal review process, including the timing of intervention by the independent Technical Advisory Panel, so that basic design issues can be raised and resolved earlier;

(f) Implementation of a phased approach for large one-off proposals of a programmatic nature; and

(g) Continuation of the determination of the financial terms and conditions of private sector projects on a case-by-case basis.

12. In addition, based on the review, the Secretariat considers that the following recommendations require further consideration:

(a) Definition and communication of a set of criteria to assist AEs in choosing the level of concessionality granted to a project or programme proposal; and

(b) Differentiation of the level of scrutiny required on concessionality between pilot, scale-up and one-off funding proposals.

VI. Conclusion

13. The Secretariat will continue to review the financial terms and conditions of the GCF financial instruments, as set out in annex II to decision B.09/04, based on the terms of reference to be agreed with the Investment Committee.

14. The Investment Committee proposes to update the terms of reference of the review of the financial terms of conditions of the GCF financial instruments. In updating the terms of reference, the committee also took note of the review of the financial terms and conditions and recommends that the Secretariat continue to review the financial terms and conditions of the GCF financial instruments as set out in annex II to decision B.09/04 based on the updated terms of reference as set out in annex I to this document.