

Green Climate Fund

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# Business Model Framework: Financial Instruments

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**GCF/B.04/06**

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## Recommended action by the Board

It is recommended that the Board:

- (a) Takes note of the information presented in document GCF/B.04/06 *Business Model Framework: Financial Instruments*;
- (b) Provides guidance on the policy matters and options regarding the financial instruments of the Fund; and
- (c) Adopts the draft decision presented in Annex I to this document.

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# Business Model Framework: Financial Instruments

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## I. Introduction

1. At its March 2013 meeting in Berlin, Germany, the Board requested the Interim Secretariat to undertake work on a number of documents on the Fund's business model framework, with the assistance of consultants (decision B.01-13/06). One of the documents to be prepared for consideration at the June 2013 Board meeting was to address financial instruments, including an *"assessment of the range of financial instruments the Fund could utilize, their benefits and disadvantages and applicability."*

2. Decision B.01-13/06 *"noted convergence that the Fund should also:*

*"(ii) Commence as a fund that operates through accredited national, regional and international intermediaries and implementing entities;*

*(iii) Focus initially on grants and concessional lending, and employ additional financial instruments, as necessary, to effectively achieve the objectives of the Fund".*

3. The purpose of this document is to present to the Board an assessment of options for financial instruments that the Fund could employ to attain its objectives. This document should be read in conjunction with the other five documents on the business model framework.<sup>1</sup>

4. The Governing Instrument for the Fund provides specific guidance on several key financial instrument-related features of the Fund:

Paragraph 54: *"The Fund will provide financing in the form of grants and concessional lending, and through other modalities, instruments or facilities as may be approved by the Board. Financing will be tailored to cover the identifiable additional costs of the investment necessary to make the project viable. The Fund will seek to catalyse additional public and private finance through its activities at the national and international levels."*

5. The Governing Instrument also articulates several other principles directly relevant to the financial instruments of the Fund, including:

Paragraph 55: *"The Fund may employ results-based financing approaches, including, in particular for incentivizing mitigation actions, payment for verified results, where appropriate."*

Paragraph 56: *"The financial management practices and financing agreements will be in keeping with the Fund's fiduciary principles and standards and environmental and social safeguards to be adopted by the Board. The Board will develop an appropriate risk management policy for funding and financial instruments."*

6. This guidance and principles from the Governing Instrument, as well as the considerations put forward by the Board, have been fully reflected in the options for the Fund's financial instruments presented in this document.

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<sup>1</sup> GCF/B.04/03 to 05 and 07 to 08.

## II. Financial instruments and modalities

7. There are four basic instruments that can be used through different modalities and at various stages of the financing cycle: grants, concessional loans, guarantees and equity investments.

8. Such instruments may be supplied through either simple or more complex and sophisticated modalities or structures for projects and/or (policy-based) programmes and in the context of sector-wide approaches. Provision of financing may involve debt swaps, advanced market commitments, performance-based payments, public-private partnerships and a range of other innovative arrangements involving co-financing and leveraging resources on capital markets.

9. Annex II contains a matrix of instruments and modalities and their advantages and disadvantages, with examples.

10. Annex III presents an overview of the instruments and activities supported by the main multilateral funds and special programmes for climate change financing to date.

### 2.1 Instruments

11. The following options for financial instruments that could be utilized by the Fund are not mutually exclusive and can be phased in as the Fund evolves. The Board could choose for the Fund to utilize some or all of them.

#### 2.1.1 Option 1: Grants

12. Grants are resources generally channelled to fund investments without the expectation that the money be repaid. Such resources can be used, inter alia, to:

- (a) Cover all or part of the cost of the externality when the abatement cost is not covered by the internal revenue generation of the investment;
- (b) Cover the incremental cost of climate change investments;
- (c) Provide technical assistance and capacity building;
- (d) Undertake feasibility studies;
- (e) Offer capacity building to financial intermediaries to leverage resources through other instruments.

13. Often, grants are used to complement other instruments, such as concessional loans, to maximize the impact of investments. Grants can be provided up-front or disbursed through an incentive-based schedule after achieving specific goals.

14. Grants can: contribute to information generation, data analysis, development and dissemination of knowledge products; enhance the capacity of national institutions for a robust policy reform and priority setting; and build a strong and sustainable pipeline.

15. There are numerous examples of technical assistance provided through grants to increase awareness of climate change and to transfer the skills and knowledge to undertake actions to combat it. For example, in 2012, the Asian Development Bank (ADB) provided a technical assistance grant, financed by the Japan Fund for Poverty Reduction, to help the Government of Indonesia to build strong capacity so that it can continue developing good climate change policies that can be turned into planning and programme implementation at the national and local levels.

16. Global Environment Facility (GEF) funding, which is provided to implementing agency partners in the form of grants, has the flexibility to be used in a variety of manners. Typically, these grants are used by the agencies as resources to support policy development, enabling activities, technology demonstration, and capacity building. However, in many innovative projects and programmes, the intermediary or implementing agency will use GEF funding for a non-grant purpose, meaning that grants are turned into other, non-grant instruments through blending with other funding. The range of non-grant applications of GEF funding is virtually unlimited. Agencies have good experience with concessional loans, equity investments, performance guarantees, revolving loan funds, structured financing, and risk-sharing facilities, to name a few. Examples include the GEF/International Finance Corporation (IFC) risk-sharing facilities that help to "crowd-in" local financial institutions for energy efficiency and renewable energy investments. Another recent example is the Inter-American Development Bank (IADB)/Multilateral Investment Fund (MIF), where the GEF will invest as a limited partner in equity funds promoting clean energy and natural resource protection in Latin America. A recently approved programme with the European Bank for Reconstruction and Development (EBRD) will use GEF funding for junior shares in a structured financing deal to promote energy efficiency investments in Northern Africa.

17. There are also performance grant modalities, which may be launched through prizes/payments that reward innovation, quantified mitigation results or quantified generation of non-fossil fuel energy generation and other special grant modalities, which involve a conditional repayment obligation.

#### 2.1.2 **Option 2: Concessional lending**

18. The up-front transfer of resources from one party to another with the agreement that the money will be repaid on conditions more favourable than market terms is known as concessional or soft lending. This lowers the cost of capital and reduces the risk to all participants by offering low or no interest rates, longer repayment and/or grace periods, or a combination of these features. Intrinsically, concessional lending includes a grant component that can be quantified based on how favourable the lending terms are (the "grant element" of the loan).

19. Concessional lending is used when financing at market terms is not available or would make the investment unviable. In the absence of concessional funds, the resulting cost increase might create pressure on fiscal subsidies, burden consumers if additional costs are passed on to them via prices or tariffs, or make projects or programmes unviable.

20. Concessional lenders generally consider the existing debt levels and capacity to repay of the loan recipient before extending financing to them. An example of concessional lending is the IADB loan to Trinidad and Tobago to strengthen and modernize the regulatory, institutional and policy framework to develop and promote instruments to assess and reduce vulnerability and risks associated with climate change and to promote carbon markets and policies to reduce greenhouse gas (GHG) emissions.

#### 2.1.3 **Option 3: Guarantees**

21. Some investments entail inadequate risk-adjusted returns to investors or governments and fail to attract capital through debt on terms that could ensure the feasibility of the project. Guarantees help to mitigate or manage such risks. Guarantee instruments are commitments in which a guarantor undertakes to fulfil the obligations of a borrower to a lender in the event of non-performance or default of its obligations by the borrower, in exchange for a fee. Guarantees can cover the entire investment or just a portion of it.

22. Risk mitigation instruments focus on reducing key default risks at various points in the financing cycle. They can help mitigate specific counterparty risk in a project or provide cover from changes in policy or regulatory frameworks. They can help address project-specific increases in operations and maintenance costs above estimates and where the operator has refused to guarantee additional cost coverage because of a new technology, or degradation of performance beyond the operator's guarantees.

23. The IFC has been using GEF grant funding to support financial institutions with guarantees in seven countries (Brazil, Colombia, Guatemala, Mexico, Russian Federation, South Africa and Thailand), with partial credit guarantees in order to provide financing to various segments, including residential, commercial, municipal and energy supply. Over time, the guarantees from the IFC can be phased out as familiarity with these sectors improves and risk perceptions decrease. This form of guarantee allows leveraging US\$ 12-15 of commercial investment for each US\$ in GEF funds, when effectively structured.

#### 2.1.4 **Option 4: Equity investments**

24. Equity consists of an investment into a project or asset to leverage debt and achieve better returns. Some projects have significant risks and financial requirements that investors are not necessarily willing to take. In such cases, it is possible to make equity investments, which directly inject capital to grow the operation of a project or a firm and allow it to leverage further resources, as they mitigate the risk for other investors. Equity investors own part of the company or assets and therefore depend on the results of the project to secure a financial return on their investments; they do not have any guarantee of repayment or return. In the case of failure of a project, the debt holders involved in the project have priority on any available returns over the equity investors. Equity is used when the probability of failure of the investment is high, but there still remains a probability of success and, therefore, of return to the equity holder.

25. An example of equity investments is the IFC/GEF Photovoltaic Market Transformation Initiative designed to accelerate the sustainable commercialization and financial viability of energy services, based on solar electricity technology, in India, Kenya and Morocco.

26. It is important to note that two or more instruments can be blended, with more than one instrument being used by the Fund itself on a particular project, or a Fund instrument or instruments being combined with instruments from other sources of financing.

## 2.2 Modalities

27. The following options for modalities to employ the financial instruments described above are not mutually exclusive. The Board could choose for the Fund to utilize some or all of them.

### 2.2.1 **Option 1: Adaptable programme loans (APL)**

28. An APL is a form of concessional lending that provides phased support for long-term development programmes with a long-term perspective in specific sectors.

### 2.2.2 **Option 2: Development policy loans (DPL)**

29. A DPL is also a form of concessional lending that provides non-earmarked financing aimed at helping a borrower to achieve programmatic results (such as controlling emissions or increasing climate-resilience) through a programme of policy and institutional actions.

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### 2.2.3 Option 3: Sector investment loans (SIL)

30. A SIL is a further form of concessional lending that brings sector expenditures, policies, and performance in line with the country's priorities and helps borrowers to develop the institutional capacity to plan, implement and monitor expenditures or the investment programme.

### 2.2.4 Option 4: Credit lines

31. Credit lines are another form of concessional lending, whereby a pre-established amount of credit is extended to allow the borrower to draw against it as needed for its adaptation or mitigation actions.

### 2.2.5 Option 5: Concessional financing for waterfall payment mechanisms

32. In addition to subsidizing the cost of loans, guarantees or equity investments, concessional resources can also be used as risk buffers to cover first losses in waterfall payment mechanisms that assign the payment of revenues to senior risk tranches held by development finance institutions and private investors. Under such a structure, different risk tranches of capital are created, where the first loss may be covered by concessional sources and the upper tiers by development finance and commercial investors. A waterfall repayment mechanism assigns the first payment of revenues to the senior tranches and the last to the first-loss tranche. The use of concessional resources under this structure allows additional commercial funds to be leveraged at a large scale for development purposes. The risk buffers of the higher-risk tranches also provide significant comfort to more risk-averse investors.

### 2.2.6 Option 6: Debt swaps

33. Debt conversion or debt swaps occur when an existing debt stock or stream of debt service payments is converted into another obligation or type of asset. Usually a debt swap involves the voluntary exchange of a debt instrument by a creditor with its debtor for cash, another asset, or a new obligation with different repayment terms.

34. This type of scheme has been used for environmental funding through debt-for-nature operations. Such swaps often involve a third party, such as a non-governmental organization (NGO), which buys the debt from the creditor at a discount. In turn, the NGO forgives the debt for payment in local currency in exchange for the debtor agreeing to fund certain environmental activities. Another debt swap modality involves the creditor and debtor transacting directly in relation to bilateral debt. In these cases, the creditor cancels out all or a portion of the debt and the debtor agrees to use the amount of the cancellation to fund mutually agreed environmental activities.

35. For instance, Norway provided grant funding through debt relief to assist Guyana to reduce its GHG emissions by avoiding the deforestation and forest degradation of rainforests and to shift away from forest-dependent employment and income generation.

36. The Fund could utilise debt conversions for climate adaptation as an innovative financing mechanism that supports highly indebted poor countries and the most vulnerable small countries to devote additional resources for climate change adaptation efforts.

### 2.2.7 Option 7: Performance-based payments

37. Performance-based payments refer to a grant or concessional loan that is disbursed in tranches against the verified fulfilment of predefined targets or quantified emission reductions



in a project or programme. Payment is conditional on measurable actions being undertaken. This kind of financing is aimed at rewarding innovation and successful implementation of a project with clear climate benefits. In many instances, carbon credits or units may be seen as a special type of performance-based payment.

38. Performance-based finance can be used to promote policy reforms, build capacity and undertake investment projects.

39. The Super Energy-efficient Equipment Programme (SEEP) in India, supported by the World Bank, is an example of this modality. SEEP commenced with a pilot phase in which approximately 5 million super-efficient ceiling fans will be introduced over a four-year project cycle. This programme will provide performance-based, sales-verified financing incentives to competitively selected manufacturers for producing fans that are at least 50 per cent more efficient than standard fans.

#### 2.2.8 **Option 8: Public-private partnerships (PPP)**

40. A PPP is a contractual agreement between a public agency and a private sector entity. Through this agreement, the skills and assets of each sector (public and private) are shared to deliver a service or facility. In addition to the sharing of resources, each party shares the potential risks and rewards associated with the delivery of the service and/or facility.

41. While many climate actions will continue to be undertaken by governments, the scale of the challenge means that governments cannot act alone, as they may not have adequate funds, skills or capacity. Also, some interventions may require long periods of implementation if they are delivered as public-only projects. Since public finance will be limited, multiple sources of finance, including private sector finance, can usefully be combined in different ways to deliver sustainable solutions. Such hybrid financing schemes are also more appropriate as projects become more complex and not viable purely on private financing structures, which makes a partnership between the two sectors in innovative ways desirable.

42. PPP models can potentially address challenges in adaptation and mitigation efforts in sectors such as housing, communication, infrastructure, health, agriculture and water and sanitation.

43. An example of a PPP is the Bulgaria Energy Efficiency Fund, in which the World Bank, the GEF and the Austrian Government, together with a private sector fund management consortium and local financial institutions in Bulgaria, joined efforts to create the combined capacity of a lending institution, a credit guarantee facility and a consulting company. They provided technical assistance to Bulgarian enterprises, municipalities and private individuals in developing energy efficiency investment projects and assisted their financing and co-financing and played the role of guarantor for other financing institutions.

#### 2.2.9 **Option 9: Blending with finance from multilateral development banks, bilateral agencies and market sources**

44. Blending the Fund's financial instruments with those of multilateral development banks (MDBs), bilateral agencies and market sources could be used in middle-income countries to enhance the terms of financing in order to make investments viable. Fund resources could be used to cover the incremental costs of the investments.

45. The Clean Technology Fund (CTF) has many blending options to co-finance projects and programmes with MDBs. For example, it provided a concessional loan to the Government of the Philippines to help the country implement projects that will mitigate climate change by deploying low carbon energy technologies and encouraging energy efficiency measures for industry, commercial buildings and municipalities. These projects receive co-financing from the

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World Bank and the ADB's regular operations and also aim to mobilize additional financing from both the government and the private sector.

#### 2.2.10 **Option 10: Advance market commitments**

46. An advance market commitment is a mechanism that generates incentives for private sector engagement by ensuring viable market demand. Thus, an advance market commitment could be aimed at creating a market for future technologies relevant to developing countries that are sufficiently large and credible to stimulate private investment into research and development and manufacturing capacity. In the context of climate change, the end goal would be to accelerate the availability and introduction of climate-friendly technologies to developing countries.

47. An advance market commitment requires sponsors to make legally binding financial commitments to support a market of a pre-agreed value. The technology's specifications are defined in advance with the participation of the developing country decision-makers. Participating firms commit to supply a successful technology at a pre-guaranteed price. The market price is thus guaranteed and the aggregate value or advanced market commitment sum is defined in advance. If the developing country does not order the product, the technology developer cannot start to draw down on the advance market commitment value. This creates incentives for technology developers to bring to market products with the specifications that developing countries are demanding.

48. To date, this type of mechanism has been mostly used in the public health sector to encourage the research, development and production of vaccines against diseases that affect people in developing countries. The principles can be applied to other types of technology, such as low carbon energy, and could represent an important tool for funding low carbon technology development and transfer.

#### 2.2.11 **Option 11: Discounted grants**

49. Generally, grants are provided at their full nominal value at the beginning of an investment. The full amount of the grant is drawn from the accounts of the funder. An alternative modality of grant provision is when an investor receives a loan on market conditions. Assuming that the amortization of the loan is going to be on a bullet repayment at the end of the maturity, the Fund could provide a grant at the present value of the bullet payment and invest the amount on a zero coupon bond so that at the date of the bullet payment the value of such coupon would equal the amount of the amortization. In such a case, the value of the grant is equivalent to the principal amount of the loan.

50. If the Fund were to use discounted grants, it could support a greater number of projects using the same level of resources as if it used only undiscounted grants.

### **III. Additional considerations and areas for further work**

51. A common typology of instruments might help to identify the specific instruments and modalities that may be best suited for the specific objectives and results of the Fund. Additionally, it might assist in determining the focus of instruments in the initial phase of the Fund, without excluding the possibility of considering different instruments and modalities in the future.

52. In relation to their focus, financial instruments can be classified into the following types:

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- (a) Instruments that address the viability of projects, that is, that provide an economic signal that impacts on the revenue stream of a project or the value of an asset, hence increasing the return on debt or equity;
  - (b) Instruments that address key risk at some point of the financing cycle; and
  - (c) Instruments that decrease the cost of capital by enhancing the capital structure of projects.

53. The different types of instruments that could be utilized during the first phase of the Fund or, alternatively, phased in as the operations of the Fund develop, can be categorized as follows:

- (a) Instruments that address the viability of mitigation and adaptation projects. From an economic perspective, climate change is mostly an externality problem, and without public support to internalize the cost of such externality, most mitigation and adaptation activities will remain unviable;
- (b) Instruments that address key risks in the financing cycle. For example, changes in policy and regulatory frameworks are a constant and central risk for investment in specific sectors. Therefore, the Fund could provide guarantees that safeguard investments against potential changes in policy and regulation that could have a material impact on the viability of the project;
- (c) Instruments that decrease the cost of capital or provide access to capital. Access to capital is difficult for entities without a track record or projects that employ technologies that are new and are only just being commercialized. Providing loans to projects at a concessional rate may improve the overall capital structure of projects, making them more attractive and helping them secure commitments from parties involved in financing a project (financial close);
- (d) Allowing for flexibility. The Board could consider allowing for flexibility in the types of instruments that may be employed or phased-in by the Fund, based on an ongoing identification of needs and priorities. Having such flexibility would allow the Fund to determine which type of instrument is better suited for the specific barrier or risk that the Fund is trying to target. Additionally, it would allow for blending either by the Fund itself or combined with instruments from other sources of financing.

54. The use and modalities (structures) of financial instruments will depend on several factors, including:

- (a) The Fund's level of financial resources, and the type of financial inputs provided to the Fund;
- (b) The terms and conditions of such financial inputs; and
- (c) Whether and how various financial inputs of capital are managed and allocated for activities.

55. The Fund is open to receiving financial inputs from variety of sources. Therefore, it will be critical to ensure adequate fund management and risk management frameworks. The experience from the World Bank Group and the Climate Investment Funds (CIFs) has shown that mixing contributions (for example, grant and loans) increases the complexity of fund management. Ensuring adequate allocations of different financial inputs and the ability to monitor risk (both financial and non-financial) will require an overall risk management framework. The development of a robust risk management framework could allow the Fund to cope with the complexity of mixing different financial inputs.

56. It is also of particular relevance to note that the use and applicability of instruments will depend on the type of intermediaries and access modalities the Fund uses to deploy resources. However, this should not detract from addressing the urgent and immediate adaptation needs

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of developing countries that are particularly vulnerable to the adverse effects of climate change, including the least developed countries (LDCs) and vulnerable small island developing States (SIDS) and African States.

57. When the Fund operates through intermediaries such as multilateral, regional or national development banks, it will rely on the information, assessment and risk management of such intermediaries. Furthermore, it will have to rely heavily on the processes and control capacities of the intermediaries.

58. An additional consideration when relying on different financing intermediaries or agencies is that the Fund's implementing structure will be rather fragmented. Thus, it may be necessary to define some minimum fiduciary standards for such intermediaries.

59. For example, CIFs-funded projects are only implemented by five MDBs. The MDBs identify and appraise the projects that they jointly finance with the CIFs through their own internal process. CIFs funding is automatically bundled with MDB financing, thus the final financial package offered to recipient countries is dependent on the range of tools they each have at their disposal.

60. The Board may wish to determine the level of subsidiarity that may be desirable for intermediaries in the early years of the Fund's operations and how such responsibilities may be undertaken by the Fund as it evolves. Therefore, the Board could consider which capacities should be developed by the Fund in order to build adequate internal assessment and risk management practices.

61. In the future, the Board may opt to work with countries, public entities or private entities and provide grants, loans, guarantees and equity structures directly, this would require the Fund to develop adequate financial, credit and risk management structures of its own to sustainably endorse and manage risk.

62. Furthermore, when the Fund employs concessional lending, it will have to manage and decide what to do with the financial reflows arising from its lending activities. It will also have to determine the level of concessionality of each loan. The specific level of concession could be determined by financial intermediaries. However, if the Board approves such concessionality, it would initially have to rely on the information and assessment provided by the intermediaries. The level of concession offered will be important, because, if not appropriate, it could create a distortive effect and create further financing barriers for private investments.

63. The types and modalities for the use of non-grant instruments will vary between financial intermediaries, consistent with their capacities and comparative advantages. The MDBs have a full range of capabilities to handle any type of non-grant instruments. The United Nations (UN) agencies can also handle non-grant instruments, but will usually work through a regional or national institutional partner to handle financial arrangements. For example, depending on the agency and the specific goals of the project, returns on GEF investments, if any, can be held in the country for follow-on investments, or be reflowed to the GEF Trust Fund. Beneficiaries, terms, tenors, expected rates of return and other details of the investment strategy are established with the implementing entity at the time of inclusion in the GEF work programme, and approved by the GEF Council. The details are then finalized between the GEF Chief Executive Officer (CEO) and the implementing entity at the time of CEO endorsement, which delegates authority to the GEF implementing entity for due diligence and other investment decisions.

64. Pending the Board discussions on the types of financial instruments that should be employed by the Fund, the Board could develop criteria for the selection of the modalities of such instruments. Some of the criteria that the Board could consider are:

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- (a) Transformational impact, which will require a broad scope of activities by the Fund. Bringing about transformation will likely require action at many levels and in various forms;
  - (b) Effective impact on the feasibility of the investment to determine how successful instruments are in facilitating investments;
  - (c) Efficient use of the Fund's resources to determine that instruments are delivering maximum impact with the smallest amount of resources;
  - (d) Potential to leverage resources from other sources to determine how the Fund's resources attract a broad range of resources from other sources to co-finance or contribute to Fund's activities;
  - (e) Replicability of financial schemes. Some activities may be of particular strategic importance given that they could be replicated and/or scaled up;
  - (f) Impact of the Fund's intervention and co-benefits from the Fund's support; and
  - (g) Scalability of capital flows. Achieving transformational change will require the mobilization of resources at scale. Hence the potential to reach sufficient scale of financial flows is central to addressing the challenge of climate finance.

65. Additionally, the Governing Instrument established that the Fund's resources can be deployed not just for individual projects but also through programmatic approaches. The use of a programmatic approach aims to facilitate the scale of action to achieve transformational impact. This is coupled with efforts to reduce transaction costs. Support for programmes and projects could be coupled with technical assistance and strengthening of capacities for country coordination to build enabling environments that can catalyse both public and private climate finance at scale and achieve transformational impacts. Achieving a paradigm shift will involve investing in capability to design and implement broad systemic change, as well as investing in readiness for transformational change leading to greater resilience and lower emission economies.

66. A lesson learnt by international financial institutions and other funds is that investments within sectors that are subject to inadequate policies have a high probability of failure. Intervening with programmatic approaches, which could include policy-based loans, could have a more reliable effect.

67. Finally, it is important to note that the structure and organization of the Fund, the types of financial inputs it will receive (sources) and the Fund's access modalities and fiduciary responsibilities will impact upon the types of instruments that the Fund might employ now or in the future. The Board may wish to take these matters into consideration when deciding on the business model framework of the Fund.

68. For the Fund to have a well-structured financial instrument policy framework, there are some areas for further work in the short and medium term, such as:

- (a) Risk management framework of the Fund;
- (b) Ways to determine the level of concessionality of the Fund's loans;
- (c) Modalities of the Fund's financing instruments;
- (d) Terms and conditions of the Fund's financing;
- (e) Complementarities between the Fund's and multilateral and bilateral financial institutions' instruments;
- (f) Mechanisms to promote competition to access the Fund's resources;
- (g) Mechanisms that help address the problem of scale of financial flows; and
- (h) Mechanisms or instruments that allow the Fund to access capital markets.

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## Annex I: Draft decision of the Board

The Board, having reviewed document GCF/B.04/06 *Business Model Framework: Financial Instruments*:

1. Decides that the Fund will commence its operations with the provision of grants and concessional lending to accredited national, regional and international intermediaries and implementing entities to achieve the Fund's objectives;
2. Further decides that, over time, the Fund will also deploy other financial instruments, including guarantees and equity investments, in pursuit of its objectives;
3. Notes that the Fund should utilize a broad range of modalities for the application of the Fund's instruments;
4. Requests the Interim Secretariat to prepare a document recommending the terms and conditions of the grants and concessional lending to be deployed by the Fund to accredited intermediaries and implementing entities during the initial phase of the Fund, to be considered by the Board at its September 2013 meeting.

**Annex II: Matrix of instruments, modalities, advantages and disadvantages**

Instrument/ Modality	Definition	Advantages/Disadvantages	Examples
Grant	Resources aimed at funding investments without the expectation that the money be repaid.	<p>Advantage: Provides technical assistance and capacity building. Gives viability to a project. Covers full cost of adaptation, complement other instruments.</p> <p>Disadvantage: there are no reflows.</p>	In 2012, ADB provided a technical assistance grant financed by the Japan Fund for Poverty Reduction to help the Government of Indonesia build strong capacity so that it can continue developing good climate change policies that can be turned into planning and programme implementation at the national and local levels.
Concessional loan	Upfront transfer of resources with the agreement that the money will be repaid on conditions more favourable than market terms by offering low or no interest rates, longer repayment and/or grace periods, or a combination of them.	Advantage: Used when market financing would make the investment unviable. Reduces risk to all lenders, it can encourage local banks to enter the lending market for energy efficiency and renewables.	IADB loan to Trinidad and Tobago to strengthen and modernize the regulatory, institutional and policy framework to develop and promote instruments to assess and reduce vulnerability and risks associated with climate change and to promote carbon markets and policies to reduce GHG emissions.
Guarantee	Commitments in which a guarantor undertakes to fulfill the obligations of a borrower to a lender in the event of non-performance or default by the borrower of its obligations, in exchange for a fee.	<p>Advantage: Attracts capital through debt on terms that could ensure the feasibility of a project. Mitigates or manages risks.</p> <p>Disadvantage: it is hard to quantify risks and in international financial institutions, it accounts for the same amount of financing quota as a loan.</p>	IFC partial credit guarantees to provide financing to various segments, including residential, commercial, municipal and energy supply.
Equity	Injection of capital to grow operation of a project or a firm to leverage resources as it mitigates risk for other investors, used when the probability of failure is high, but still with positive probability of success, therefore, of return to the equity holder.	<p>Advantage: Support for innovation of start-ups. Leverages resources.</p> <p>Disadvantage: difficult to quantify risks and define with certainty the level of participation in the total equity.</p>	IFC/GEF Photovoltaic Market Transformation Initiative designed to accelerate the sustainable commercialization and financial viability of energy services, based on solar electricity technology in India, Kenya and Morocco.
Debt swap	Voluntary exchange of a debt instrument by a creditor with its debtor for cash, another asset, or a new obligation with different repayment terms.	<p>Advantage: Ensures additional resources for adaptation investments while reducing the level of debt of the country.</p> <p>Disadvantage: It may generate negative incentives for the borrower to honour its debt.</p>	Norway grant to Guyana to reduce its GHG emissions avoiding the deforestation and forest degradation.

Instrument/ Modality	Definition	Advantages/Disadvantages	Examples
Advanced market commitment	Mechanism that generates incentives for private sector engagement by creating a viable market demand.	Advantages: Encourages innovation by ensuring demand of a product and helps to develop a self-sustaining market by creating demand. Uses public money only when there is a concrete outcome. Disadvantage: It is a relatively innovative mechanism not fully explored in sectors outside the health sector.	This type of mechanism has been used to produce vaccines against neglected diseases in developing countries, but can be replicated to develop other types of technology such as low carbon energies.
Performance-based payment	A grant or concessional loan disbursed in tranches against verified fulfilment of predefined targets or quantified emission reductions in a project or programme.	Advantage: Rewards successful implementation of projects/programmes. Promotes policy reforms, build capacity, and undertake investment projects. Disadvantage: It may be complex to define the baseline to measure the performance required for making the payments.	The Super Energy-efficient Equipment Programme (SEEP) in India to introduce approximately 5 million super-efficient ceiling fans over four year project cycle. It will provide performance-based, sales-verified financing incentives to competitively selected manufacturers for producing more efficient than average fans.
Public-private partnership	Agreement between a public agency and a private sector entity through which mutual skills and assets are shared in delivering a service or investment.	Advantage: Delivers sustainable solutions by partnering between sectors. Used in complex structures and those not viable purely on private financing.	Bulgaria Energy Efficiency Fund, in which the World Bank, GEF and Austrian Government, together with a private sector fund management consortium and local financial institutions provided technical assistance to Bulgarian enterprises, municipalities and private individuals in developing energy efficiency investment projects and then assists their financing, co-financing or plays the role of guarantor in front of other financing institutions.
Co-financing	Blending resources with MDBs, bilateral agencies, market sources instruments to enhance terms of financing to make an investment viable.	Advantage: Enhances terms of financing, leverages resources	CTF/World Bank/ADB loan to the Government of the Philippines to help the country implement projects that will mitigate climate change.
Policy based loan	Non-earmarked financing aimed at helping a borrower achieve sustainable climate friendly results through a programme of policy and institutional actions.	Advantage: Encourages policy development and capacity building.	
Adaptable programme loan	Phased support for long-term development programmes with a long-term perspective on specific sectors.	Advantage: Supports long term strategies	



Instrument/ Modality	Definition	Advantages/Disadvantages	Examples
Sector investment loan	Financing to bring sector expenditures, policies, and performance in line with a country's priorities and develop institutional capacity to plan, implement, and monitor expenditures or investment programme in a specific sector.	Advantage: Supports sector transformations.	
Discounted grants	An investor of a project gets a loan on market conditions. Assuming that the amortization of the loan is going to be on a bullet repayment at the end of the maturity, the Fund could provide a grant at the present value of the bullet payment, invest the amount on a zero coupon bond so that at the date of the bullet payment the value of such coupon would equal the amount of the amortization. Therefore, in this way, the grant actually is equivalent to the principal amount of the loan.	Advantage: Maximizes Fund resources.	The Yucatan Accord provided US\$ 18 million as grant resources to buy a zero coupon bond of the same maturity of the US\$ 40 million loan provided by the Central American Bank for Economic Integration (CABEI) to the Government of Honduras, so that at the end of the maturity period the zero coupon bond equals the nominal amount of the loan and it is used to repay the principal.

**Annex III: Existing climate change funds and special programmes<sup>1</sup>**

<b>Fund/Institution</b>	<b>Amount</b>	<b>Instrument</b>	<b>Type of activity</b>
GEF (1992)	US\$ 3 billion for mitigation and enabling activities and US\$ 400 million for adaptation	Mostly grant, co-financing	Adaptation, capacity building, mitigation, agriculture, climate-resilient, energy, energy efficiency, forestry, low-carbon, renewable energy, sustainable land management, transport, water
Climate Technology Fund (CTF) (2008)	US\$ 5.2 billion pledged	Co-financing, grant, loan, official development assistance (ODA)	Mitigation, agriculture, energy, energy efficiency, fuel switching, industry, infrastructure, transport
Scaling-up Renewable Energy Program for low income countries (SREP) (2009)	US\$ 505 million pledged	Co-financing, equity, grant blended with International Development Association (IDA), loan	Mitigation, energy, forestry, natural resources management, renewable energy, sustainable land management
Forest Investment Programme (FIP) (2009)	US\$ 639 million pledged	Grant, ODA	Mitigation, climate-resilient, forestry, low carbon, sustainable land management
Forest Carbon Partnership Facility (2008)	US\$ 648 million (US\$ 258 million under Readiness Mechanism and US\$ 390 million under Carbon Finance Mechanism)	Carbon finance, grants	Mitigation, forestry
UN-REDD Programme (2008)	US\$ 117 million	Grant, technical assistance	Capacity building, mitigation, forestry, natural resources management, sustainable land management
Least Developed Countries Fund (LDCF) (2003)	US\$ 537 million	Grant, ODA, technical assistance	Preparation of National Adaptation Programmes of Action (NAPAs)
Special Climate Change Fund (2006)	US\$ 240 million pledged	Grant, ODA	Adaptation, technology transfer, capacity building, agriculture, climate resilient, coastal zone management, disaster risk reduction, infrastructure, natural resource management, population and human settlement, sustainable land management, water
Pilot Programme for Climate Resilience (PPCR) (2008)	US\$ 1.3 billion pledged	Grant, loan, ODA, technical assistance	Adaptation, agriculture, climate-resilient, coastal zone management, energy, forestry, infrastructure, low-carbon, population and human settlements, sustainable land management, water
Adaptation Fund (2001)	US\$ 325 million	Grant	Adaptation, agriculture, climate-resilient, coastal zone management, disaster risk reduction, energy efficiency, forestry, industry, infrastructure, low-carbon, natural resource management, population and human settlements, sustainable land management, water, water efficiency

<sup>1</sup> This Annex was developed using the websites of all the listed funds and special programmes, as well as the Climate Finance Options website <http://www.climatefinanceoptions.org>.

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## **Annex IV: List of referenced and reviewed literature and information sources**

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