Green Climate Fund

Business Model Framework: Terms and Criteria for Grants and Concessional Loans

GCF/B.05/07
17 September 2013

Meeting of the Board
8-10 October 2013
Paris, France
Agenda item 4 (f)

Recommended action by the Board

It is recommended that the Board:

(a) Takes note of the information presented in document GCF/B.05/07 *Terms and Criteria for Grants and Concessional Loans;* and

(b) Adopts the decision presented in Annex I.

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Business Model Framework: Terms and Criteria for Grants and Concessional Loans

I. Introduction

1. At its June 2013 meeting the Board: "*Decided to consider the terms and criteria of the grants and concessional lending to be deployed by the Fund for mitigation and adaptation through accredited national, regional and international intermediaries at its September 2013 meeting*" (decision B.04/07). This document is a response to that decision.

2. This document presents, for consideration by the Board, guiding principles for determining the terms of grants and concessional loans, and proposes three basic criteria with an indicative list of parameters to assist in determining the terms of grants and concessional loans.

3. This document builds on the discussion and considerations outlined in document GCF/B.04/06 *Business Model Framework: Financial Instruments* as well as GCF/B.04/04 *Business Model Framework: Objectives, Results and Performance Indicators*; both documents were prepared for the June 2013 Board meeting.

II. Policy considerations regarding the terms of grants and concessional loans

4. The choice of terms of grants and concessional loans (as well as of other types of financial instruments) will depend on five core factors: financial inputs, uses of funds, incentives, concessionality and expertise and capacity of financial intermediaries. Each of these factors is discussed below. In addition to these factors, the terms of financial instruments of the Fund will need to be guided by a defined set of principles (set out in Annex II) to ensure coherence and consistency.

2.1 Financial inputs

5. The average concessionality or grant element of the financial inputs to the Fund will impact on the average concessionality or grant element of financial instruments of the Fund. These matters are discussed in document GCF/B.05/04 *Business Model Framework: Financial Inputs.*

2.2 Uses of funds

6. An important factor in determining whether a specific instrument should be used to fund an activity relates to the use of funds:

(a) If the support is addressing the identifiable additional costs of the investment necessary to make the project viable;

(b) If it addresses a key risk at some point of the financing cycle;

(c) If it decreases the cost of capital by enhancing the capital structure of projects; or

(d) If it provides access to capital.

7. Financial instruments of the Fund in the form of grants and concessional loans will include a grant element tailored to the identifiable additional costs or the risk premium required, in order to make activities viable.

8. In addition, when determining terms for public sector operations, it will be important to take into account the overall levels of public debt in the recipient country, so as to not encourage excessive indebtedness.

2.3 Incentives

9. The terms of financial instruments can provide incentives to encourage the delivery of results, improve viability of implementation, increase the efficient use of resources, mitigate risks and/or reduce moral hazards.

10. An example of this is results-based financing approaches, including payment for verified results, which can be used to incentivize mitigation actions. In this case, the term would be payment *on delivery* of desired results (e.g. verified emissions reductions or verified gigawatts of power produced using renewable sources). This structure has the advantage of minimizing the risk to the Fund that the activity will fail, as the Fund's resources would only be spent on delivery of desired results. In some cases, commercial financing institutions might be willing to lend against the Fund's contingent promise to pay. However, only entities with solid experience in the relevant field and access to other sources of finance are typically in a position to enter into this type of arrangement.

11. These types of incentives will have to be captured in the terms of financial instruments.

2.4 Concessionality

12. It is important to ensure that concessional terms do not displace investments that might have taken place anyway using commercial terms. Concessional forms of finance need to be designed to minimize market distortions and potential disincentives to private investment. Therefore, clear information and understanding of the specific circumstances in which instruments are to be used will be important in assessing the level of support for activities and the market conditions in which they are implemented. In some instances, this will translate into minimizing the level of concessionality or maximizing the level of non-grant elements of instruments.

13. An additional important feature of the Fund will be its ability to provide instruments to blend the Fund's resources with other sources of financing and tailor terms to a target level of concessionality, which will vary depending on project-specific factors.

2.5 Expertise and capacity of financial intermediaries and implementing entities

14. In the initial phase of Fund operations, the terms of financial instruments will be negotiated by accredited financial intermediaries and implementing entities. Multilateral development banks and international financial institutions have a full range of capabilities to handle any type of non-grant instruments. United Nations agencies can also handle non-grant instruments, but will usually work through a regional or national institutional partner to handle financial arrangements. If financial intermediaries or implementing entities are not experienced in appraising, negotiating and supervising non-grant instruments, they will lack expertise and skills to manage non-grant instruments. This will also apply in the case of private sector entities where a diverse set of expertise, skills and implementing capacity will be required.

III. Policy considerations regarding the criteria for grants and concessional loans

15. The criteria for determining appropriate terms for financial instruments can be grouped under the following broad categories:

(a) Contribution to the result areas of the Fund;

(b) Viability of implementation; and

(c) Efficient and catalytic use of resources.

16. The criteria and parameters contained in Annex III were selected to provide the information needed to determine the terms of financial instruments.

17. Parameters such as contribution to a paradigm shift and market impact are evidently very important. In addition, parameters such as geographical scope of activities and duration of the proposed activity are central to determining the terms of financial instruments. Annex III attempts to provide an indicative list of relevant parameters for the above criteria. They reflect lessons learned from the experience of existing climate change funds and other relevant international funds, as well as the latest thinking from those who have worked with these funds.

18. These criteria are meant to be broadly applicable across mitigation and adaptation activities, whether in the public or private sectors. Some of the criteria will be used only for certain types of activities, but many are relevant to all activities.

19. In line with decision B.04/07, such criteria are intended to apply in the context of the initial focus on grants and concessional loans, but may also be applicable with little or no modification when employing additional financial instruments. This approach is aimed at minimizing any possible disruption, hence making it easier to be implemented more broadly.

IV. Final considerations

20. Based on the matters discussed in Section II, guiding principles and factors for determining terms of financing instruments are presented for consideration by the Board. They are contained in Annex II.

21. Further to the guiding principles and factors, the three broad criteria and the parameters outlined in Annex III will combine to help determine the key terms of a grant or concessional loan.

22. Some of the key terms of instruments are: amount, maturity, repayment, interest rate, security and subordination. For each of these terms, one or two of the criteria or core factors may play a more significant role. For example, the amount of a grant or concessional loan will be heavily influenced by an assessment of efficient and catalytic use of resources, whereas the maturity will be strongly influenced by the uses of funds factor. There is no formula for determining these terms; however, the consistent and thoughtful application of guiding principles, core factors and criteria will help.

23. Pending decision by the Board, the Secretariat will develop standard terms and conditions for grants and concessional loans guided by the principles contained in Annex II. Nevertheless, each activity proposed to the Fund will need to be evaluated on its own merits. If a proposed activity requires support under terms other than the standard terms, these will be negotiated for the specific situation.

Annex I: Draft decision of the Board

The Board, having reviewed document GCF/B.05/07 *Terms and Criteria for Grants and Concessional Loans*:

(a) Decides to adopt the principles and factors for the terms and conditions of grants and concessional loans, as contained in Annex II to document GCF/B.05/07**;**

(b) Decides to adopt the criteria for the terms and conditions of grants and concessional loans, as contained in Annex III to document GCF/B.05/07**;**

(c) Requests the Secretariat to finalize standard terms and conditions of grants and concessional loans for consideration by the Board at its first meeting in 2014, guided by these principles and criteria, and taking into consideration progress on the business model framework; and

(d) Further requests the Secretariat to prepare a document for consideration by the Board at its third meeting in 2014 on the use of other financial instruments, including guarantees and equity investments.

Annex II: Guiding principles and factors for determining terms of financial instruments

(a) Guiding principles applicable to public sector operations:

(i) Grant elements should be tailored to incremental cost or the risk premium required to make the investment viable;

(ii) Concessional terms should not displace investments that would otherwise have occurred, including for private sector investment;

(iii) Overall levels of public debt in the recipient country should be taken into account so as not to encourage excessive indebtedness.

(b) Guiding principles applicable to private sector operations:

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

(ii) Minimize concessional terms by assessing needs, market conditions and other factors;

(iii) Avoid distortion and crowding out commercial financing;

(iv) Maximize leveraging of other financing, including public and private financing;

(v) Promote long-term financial sustainability; and

(vi) Apply due diligence to assess the risk to the investment.

(c) 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 the Fund and the average concessionality or grant element of financial instruments of the Fund;

(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; and

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

Annex III: Basic criteria and indicative parameters

1. The three basic criteria and the related indicative parameters detailed below are intended to be used in considering the terms and conditions of instruments deployed by the Fund for mitigation and adaptation, including the private sector.

I. Contribution to the results areas of the Fund

2. Expected *results*, *type*, *level* and *timing* of impact towards the shift to low-emission and/or climate-resilient development pathways from the proposed activity.

1.2 Results: Areas and impact

3. Result areas

4. Impact (description and/or quantification of expected results), in terms of:

(a) Scope (programmatic or project-based);

(b) Paradigm shift (contribution to a paradigm shift);

(c) Market impact (minimize market distortion for private sources of finance, minimize market distortion from use of public resources, maximize positive market externalities and maximize predictability);

(d) Integration (coherence and complementarity with relevant standards and safeguards); and

(e) Co-benefits and costs associated with the proposal.

1.3 Types of activities

(a) Programmatic-based (description of how the proposal will support expected results);

(b) Project-based (description of how the proposal will support the expected results); and

(c) Capacity building and readiness (description of how the proposal will support the expected results).

1.4 Level(s): Geographical scope of activities

(a) International;

(b) Regional;

(c) National; and

(d) Sub-national.

1.5 Timing: Timeframe of the impact of activities

(a) Near term;

(b) Medium term; and

(c) Long term.

II. Viability of implementation

5. Likeliness of success, in particular:

(a) Track record (relevant experience of intermediary);

(b) Context (description of key policies, regulatory and/or market environment factors that will affect the delivery of results);

(c) Stakeholders (map of key actors and interests, demand for proposal and alignment of interests);

(d) Risk management (identification of key risks and mitigation/management approach for each); and

(e) Funding structure (description of funding structure).

III. Efficient and catalytic use of resources

(a) Budget (proposed budget using a specified template);

(b) Efficient use of resources (explanation for the needed level of resources from the Fund, including an analysis of why lower funding would not be sufficient to achieve the desired results and an explanation of what would otherwise happen without access to the Fund's resources); and

(c) Catalytic use of resources (description of confirmed and potential sources of co-funding, including an estimate of the amount of co-funding and the probability of realization for each source).