Green Climate Fund

Financial Terms and Conditions of Grants and Concessional Loans

GCF/B.06/16
6 February 2014

Meeting of the Board
19-21 February 2014
Bali, Indonesia
Agenda item 16

Recommended action by the Board

It is recommended that the Board:

(a) Takes note of the financial terms and conditions of grants and concessional loans, presented in document *GCF/B.06/16 Financial Terms and Conditions of Grants and Concessional Loans*;

(b) Adopts the draft decision presented in Annex I to this document.

Financial Terms and Conditions of Grants and Concessional Loans

I. Prior Board decisions

1. At its October 2013 meeting, the Board, in its decision B.05/07, decided to adopt, for the initial operationalization of the Fund, the principles and factors for the terms and conditions of grants and concessional loans, as contained in Annex III to document GCF/B.05/23, and requested the Secretariat to develop 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.

2. At the same meeting, the Board also considered how the Fund could mobilize funds from various sources (document GCF/B.05/04) and decided, in its decision B.05/04, that the Fund will maintain flexibility to receive financial inputs and that:

> *"the Fund will receive grants from public and private sources, and paid-in capital contributions and concessional loans from public sources, and may receive additional types of inputs at a later stage to be decided by the Board".*

3. This document focuses on the financial terms and conditions of grants and concessional loans to be provided by the Fund in its initial stage.

II. Guiding principles

4. The guiding principles for determining terms of financial instruments, adopted by the Board in its decision B.05/07 (Annex III to document GCF/B.05/23), are:

(a) 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;

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

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

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

(e) Avoid crowding out commercial financing;

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

(g) Promote long-term financial sustainability; and

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

5. Broadly, the application of these guiding principles[1] would be as follows. During project or programme appraisal[2], the activity to be funded would be assessed to determine the incremental cost or the excessive risk premium[3] compared to the alternative. This would enable the determination of the minimum grant element necessary to make the investment viable. The

[1] In particular, the first guiding principle: "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".

[2] See document GCF/B.06/08.

[3] In the case of the risk premium, to determine the incremental return that would be required to bring it to the decision hurdle rate of the investor.

grant element would then be extended to the project or programme funding either in pure grant form or blended as part of a concessional loan.

6. Annex II addresses in more detail how the proposed terms and conditions will address each of the above guiding principles.

III. Proposed terms and conditions of grants and concessional loans

3.1 Initial instruments

7. As indicated above, the Fund will initially deliver its support through grants and concessional loans. It will develop and employ additional financial instruments as necessary to effectively achieve the objectives of the Fund, as may be approved by the Board. Implementing entities (IEs) and intermediaries will play an important role in the initial stage in appraising projects and programmes and, where appropriate, tailoring the right blend of financial products to make programmes viable without displacing other potential sources of finance.

8. **Financial instruments:** The following financial instruments will be deployed by the Fund in its initial stage of operations:

(a) Grants; and

(b) Concessional loans:[4]

 (i) Concessional loans 1 (deeply concessional);

 (ii) Concessional loans 2 (moderately concessional).

9. **Lending currencies**: Grants and the two sets of concessional loans would be made in international currencies and in the local currency of the project or programme, depending on the funding requirements of the project or programme and other concerns, such as country indebtedness. In the case of local currency loans, the Fund will ensure that appropriate risk hedging strategies (such as currency swaps) are in place and will closely monitor exchange risk. An operational guideline on how to deal with local currency lending risks will be developed as part of the implementation of the financial risk management framework, under the guidance of the Risk Management Committee.

10. **Service fee:** Both concessional loans 1 and 2 would charge a service fee equivalent to 0.75 per cent, consistent with the practice of concessional lending in other institutions, to cover the Fund's mobilization costs.

11. The Fund's initial financing terms (including those of the Private Sector Facility (PSF)) are summarized in Table 1 and Figure 1.

12. Annex III offers a comparison with the concessional and market-based terms of the Clean Technology Fund (CTF), the International Development Association (IDA) and the International Finance Corporation (IFC). The interest rate, service fee and maturity of concessional loans 1 is comparable to regular IDA loans after the recent adjustment of lending terms. The service charge for CTF's softer concessional loans for projects and programmes with negative rates of return, and rates of return below normal market threshold, is lower (0.25 per cent).

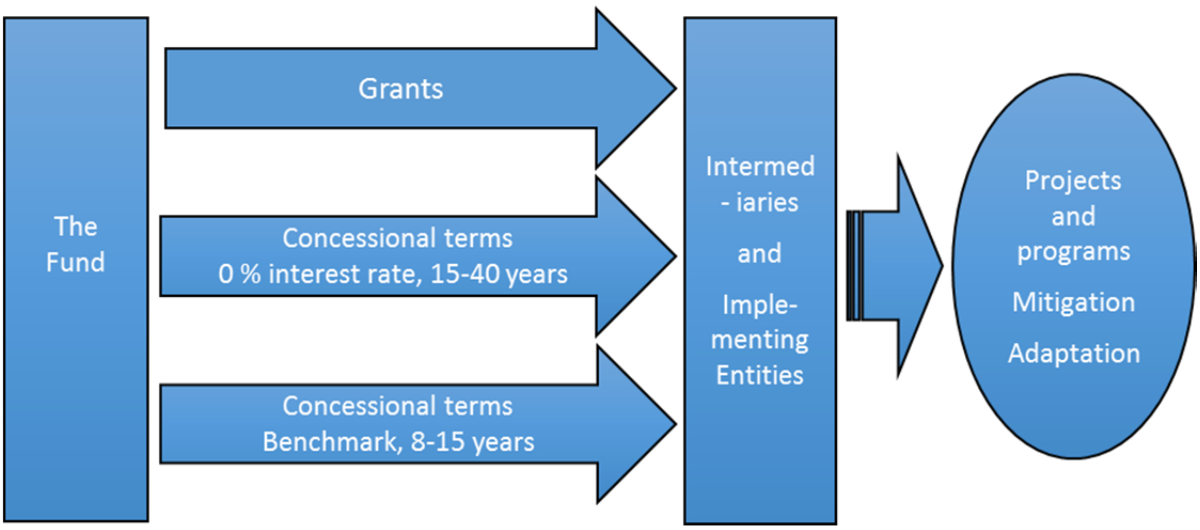
[4] In its broadest meaning, concessional finance comprises financial products, including loans, guarantees, and equity investments, provided on terms that are below market rates. According to the Organisation for Economic Co-operation and Development (OECD)/International Monetary Fund (IMF) definition, concessional loans are loans extended on terms more generous than market loans. Concessionality is achieved either through interest rates below those available on the market, the impact of which can be further enhanced through a favourable, tenor or repayment profile. A methodology to calculate the appropriate concessionality of funding from the Fund will be determined at a later stage.

Table 1: Financial terms and conditions of grants and concessional loans for the initial phase of the Fund's operations

	Currency	Interest rate	Service fee	Maturity	Grace period
Grants	• International • Local		No repayment required		
Concessional loans 1	• International • Local	0 per cent	0.75 per cent	15 to 40 years	5 to 10 years
Concessional loans 2	• International • Local	Benchmark rate of lending currency, e.g.: - Euros: European Central Bank rate - US dollars: United States Treasury bond rate	0.75 per cent	8 to 15 years	2 to 4 years

13. Each instrument can be used separately and the three instruments could be blended to give the right level of incentives to make projects and programmes viable without displacing or "crowding out" other potential sources of financing that would otherwise have been provided. This will enable the Fund to provide a broad range of concessional support, ranging from pure grants to benchmark lending (near commercial) rates, so that the Fund can tailor its support to provide the absolute minimum subsidy necessary to achieve its transformational objectives. For each project or programme, the amount the concessional element necessary to make an investment viable or cover specific activities will be assessed during appraisal.

Figure 1: Funding flows

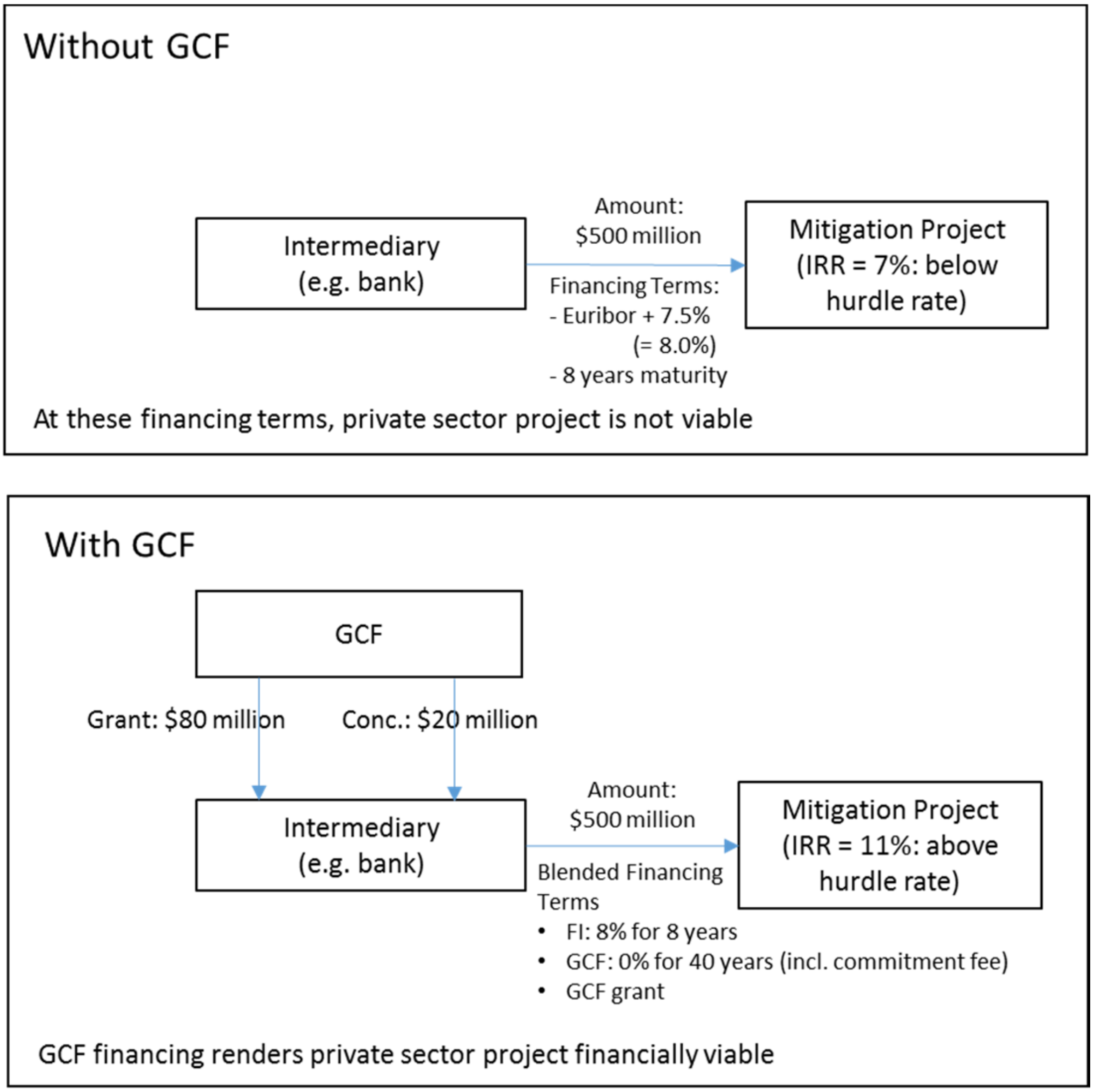


14. Grants and concessional loans from the Fund will also be blended with IEs' and intermediaries' own financing, to provide a final financing cost to projects and programmes that is lower than it would have been without the Fund's participation in that project's or programme's risk profile. Such final blended financing might not necessarily be below market rates for the entire financing envelope of the project or programme, but it would be below the

rate that the project or programme would have received on that market, given its risk profile. In this way, risky activities with a high potential of climate impact will be able to obtain financing.

15. An example of such blending is provided in Figure 2.

Figure 2: Blending of the Fund's grants and concessional loans with implementing agencies' and intermediaries' own financing



16. The Fund may consider establishing general criteria for concessional terms based on classification of countries (e.g. small island developing States and least developed countries), type of project (adaptation, mitigation, private sector), and specific sectors. These criteria would be part of the Fund's investment framework (see document GCF/B.06/11).

17. Grants provided in the initial phase of the Fund's operations are traditional grants without repayment obligation, except in the event that disbursements were obtained due to corruption or fraudulent action. At a later stage, various special types of other grants could be considered, such as grants linked to performance (e.g. for the development of new technologies) or grants with repayment obligations (e.g. revolving grant facility). Such grants might be useful in the context of certain types of mitigation programmes.

18. **Fund policy concerning country indebtedness:** The terms and conditions for lending activities will take into account the expected risk and the return of the respective project or programme, including a country's indebtedness and ability to repay. The Fund will pay particular attention to avoid contributing excessively to sovereign indebtedness. As the project and programme beneficiaries will be either public, private, or public-private partnerships, in the cases of public activities and public-private partnerships, the degree of increased sovereign indebtedness (loans) or contingent liabilities (guarantees) would be assessed. Close coordination with country authorities and the IMF would be undertaken to avoid breaching loan and liability limits, for example, by relying on grants only for public projects or programmes in highly indebted countries and countries having benefitted from the Highly Indebted Poor Country (HIPC) debt reduction initiative. Country indebtedness will also be actively tracked as part of the Fund's financial risk management framework.

3.2 Key grant and loan documents

19. The key documents that will be required for the initial modalities of the Fund's operations are:

<u>Grants</u>

(a) Term sheet;

(b) Grant agreement; and

(c) Project/programme agreement.

<u>Loans</u>

(a) Term sheet;

(b) Loan agreement; and

(c) Project/programme agreement.

20. The legal documents will determine the agreement's terms and conditions, maturity, and other conditions, including default and describe the project/programme and its milestones in details. This process is laid out in document GCF/B.06/08.

21. These grant and loan documents would be negotiated with IEs and intermediaries and would be based on standard Fund templates, prepared by the Fund's General Counsel.

22. Annex IV provides a draft sample term sheet template.

Annex I: Draft decision of the Board

The Board:

Approves the financial terms and conditions of grants and concessional loans presented in Table 1 for the initial phase of the Fund's operations.

Table 1: Financial terms and conditions of grants and concessional loans for the initial phase of the Fund's operations

	Currency	Interest rate	Service fee	Maturity	Grace period
Grants	• International • Local		No repayment required		
Concessional loans 1	• International • Local	0 per cent	0.75 per cent	15 to 40 years	5 to 10 years
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Annex II: Guiding principles and financial terms and conditions of grants and concessional loans

Guiding principles	Instruments
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	The incremental costs or the required risk premium will be assessed during the appraisal of the project. IEs and intermediaries will appraise the projects.
Seeking the right level of concessionality, so as not to displace investments that would otherwise have occurred, including for private sector investment	The level of required concessionality will be assessed during appraisal to minimize the use of the Fund's resources. Blending of financial products will determine the average overall concessionality. Country risk should be included in the evaluation.
Levels of indebtedness capacity of the recipient should be taken into account so as not to encourage excessive indebtedness	Targets to be established, based on Official Development Assistance (ODA) practice. Close coordination with country authorities and IMF. In highly indebted countries or countries having benefitted from the HIPC initiative, grants only would be provided for public activities and the public share of public-private partnerships.
Structure terms on a case-by-case basis to address specific barriers	Specific terms for each funded activity will be determined based on barriers assessed during the appraisal of the project.
Avoid crowding out commercial financing	The level of required concessionality will be assessed during appraisal to avoid underpricing.
Leveraging of other financing, including public and private financing, seeking to maximize leverage in the case of private financing	Maximizing external financing is consistent with the guiding principle of minimizing the Fund grant element needed for project/programme viability.
Promote long-term financial sustainability	Only projects that demonstrate financial viability, in the form of an acceptable financial rate of return and other ratios (e.g. debt service coverage ratio) will be financed to be set in the investment and financial risk management frameworks.
Apply due diligence to assess the risk to the investment	The Fund will carry out diligence of the appraisal of the project prepared by the intermediary or IE to assess project's or progamme's risk profile.

Terms of financial instruments					
The average concessionality or grant element of the financial inputs to the Fund The grant element of concessional finance will be tailored to provide the appropriate incentive to facilitate the implementation of mitigation and adaptation activities		Interest rate	Service fee	Maturity	Grace period
	Grants		No repayment required		
	Concessional loans 1	0 per cent	0.75 per cent	15 to 40 years	5 to 10 years
	Concessional loans 2	Benchmark rate based on currency of lending	0.75 per cent	8 to 15 years	2 to 4 years
Concessional forms of finance will be designed to minimize market distortions and potential disincentives to private investment	IEs’ and intermediaries’ terms will apply. During appraisal, an assessment will be determined how to avoid market distortions and potential disincentives to private investment.				
The expertise and capacity of intermediaries and implementing entities	IEs and intermediaries will appraise projects and programmes. The Fund will assess their expertise and capacity as a part of accreditation.				

Annex III: Financial terms and conditions of other institutions providing concessional market-based loans

I. Clean Technology Fund (CTF)

1. The Clean Technology Fund (CTF) offers grants and two loan products:

(a) Softer concessional loans (0 per cent interest rate, 40 years maturity, 10 years grace period, 0.25 per cent service charge) for projects with:

(i) Negative rates of return; and

(ii) Rates of return below normal market threshold;

(b) Harder concessional loans (0 per cent interest rate, 20 years maturity, 10 years grace period, 0.75 per cent service charge) for projects with i) rates of return near or above normal market threshold, but below risk premium for project type, technology or country, and ii) rates of return near or above normal market threshold, but acceleration in deploying the low carbon technology will have higher opportunity costs.

2. Interest rate and other terms of CTF private sector loans are individually tailored to the project on the principle of "minimum concessionality", and are not disclosed by multilateral development banks (MDBs).

Source: Clean Technology Fund, Financing Products, Terms and Review Procedures, for Public Sector Operations, November 2013.

II. International Development Association (IDA)

2.1 IDA-16

3. The International Development Association (IDA)'s lending terms were adjusted in July 2011 to reflect the economic capabilities of IDA's clients:

(a) The lending terms offered to IDA's more economically advanced recipients (blend and gap countries) were hardened to reflect their stronger financial capacity. The new terms combine the old blend terms (35 year maturities) for blend countries and hardened term credits (20 year maturities) for gap countries into a new blend credit with 25-year maturity, 5-year grace period and 1.25 per cent interest rate (in addition to the standard service charge of 0.75 per cent and commitment charges);

(b) The maturity of IDA's hard term credits was shortened from 35 years to 25 years, with a 5-year grace period, and expanded eligibility to include all blend countries. Finally, all small island developing States are now eligible to receive assistance on regular credit terms.

Table 2: Summary of IDA's current lending terms by product type in financial year 2013

Product type	Maturity (years)	Grace period (years)	Service charge[1] (per cent)	Interest (per cent)
Grants	n/a	n/a	n/a	n/a
Regular	40	10	0.75	n/a
Blend	25	5	0.75	1.25
Hard term	25	5	0.75	1.5
Partial risk guarantee	n/a	n/a	0.75	n/a

1) 0.75 per cent of the disbursed and outstanding credit balance.

Source: IDA16 Mid-Term Review, Implementation and Results Progress Report.

2.2 IDA-17

4. The International Development Association proposed that concessional loans (from partners) have terms as follows:

(a) **Maturity**: Maturities would be either 25 or 40 years to match the terms of IDA's credits;

(b) **Grace period**: Grace period would be 5 years for a 25-year loan or 10 years for a 40-year loan;

(c) **Principal repayment**: Principal repayments of concessional loans would begin after the grace period;

(d) **Coupon/Interest**: IDA concessional loans would have an all-in special drawing rights (SDR)-equivalent coupon of up to 1 per cent;

(e) **Currencies**: IDA would accept concessional loans in SDR or any one of the SDR basket currencies, namely the US dollar, Euro, Japanese yen and British pound.

Source: IDA17 Concessional Partner Loans, November 21, 2013.

III. International Finance Corporation (IFC)

5. The International Finance Corporation (IFC) prices its lending based on a matrix of country and project risks, which is not publicly disclosed, and is continuously updated based on market developments. This is compared with other available indicators, say, recent bond issues; a loan in same sector in another country with the same credit rating, and the final terms are decided upon.

Annex IV: Draft term sheet template (sample)

GREEN CLIMATE FUND **TERM SHEET** **Summary of financial terms and conditions** **(date)**	
Project/programme title	
Project/programme objective	
Borrower	
Guarantor	
Implementing entity or intermediary	
Project sponsor	

Activity to be funded	
Country or region	
How does the activity seeking Green Climate Fund funding support the country's/region's objectives to limit or reduce greenhouse gas emissions and/or climate change adaptation?	Explanation:
Theme (adaptation or mitigation)	
Does the activity support climate change adaptation in a vulnerable country? (yes/no)	
Is this activity funded through the Private Sector Facility? (yes/no)	
Total activity financing	
Requested Green Climate Fund funding	

Financial instruments and terms			
Grant	Amount (US$ million)	Currency	Disbursement period
	Fee/charges	Reimbursable?	If reimbursable, term, schedule
		(Yes/no)	
Concessional loan I	Amount (US$ million)	Currency	Maturity
	Interest rate and accrual period	Grace period	Disbursement period
	Fees/charges		
Concessional loan II	Amount (US$ million)	Currency	Maturity
	Interest rate and accrual period	Grace period	Disbursement period
	Fees/charges		
Total Green Climate Fund funding provided (Grant + loan)	Amount (US $ million)		

Special conditions	
Conditions precedent to effectiveness (CP)	1. CP 1 2. CP 2 3. CP 3 4. …
Loan covenants	1. Covenant 1 (e.g. minimum debt service coverage ratio – DSCR) 2. Covenant 2 3. Covenant 3 4. …