Financial Terms and Conditions of Grants and Concessional Loans

GCF/B.08/11
7 October 2014

Meeting of the Board
14-17 October 2014
Bridgetown, Barbados
Agenda item 11

Recommended action by the Board

It is recommended that the Board:

(a) Take note of the information presented in document GCF/B.08/11 *Financial Terms and Conditions of Grants and Concessional Loans*; and

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

Financial Terms and Conditions of Grants and Concessional Loans

I. Introduction

1. The Governing Instrument provides that the Fund will initially extend grants and concessional loans to approved climate change programmes and projects through implementing entities. Other modalities, instruments or facilities may be used subsequently, as approved by the Board.

2. At its fifth meeting, in its decision B.05/07, the Board adopted the principles and factors for the terms and conditions of grants and concessional loans for the initial operationalization of the Fund, as contained in Annex III to document GCF/B.05/23. The Board also requested the Secretariat to develop terms and conditions of grants and concessional loans for its consideration, guided by these principles and criteria, and taking into consideration progress on the business model framework.

3. At the same meeting, the Board decided that the Fund will retain the flexibility to receive financial inputs, will receive grants from public and private sources, 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. It also noted convergence on the importance of the relationship between the terms and conditions of financial instruments and the types of financial inputs received by the Fund (decision B.05/04).

4. At its sixth meeting, the Board, having considered document GCF/B.06/16 on *Financial Terms and Conditions of Grants and Concessional Loans*, requested the Secretariat to revise the document for the seventh Board meeting, taking into account the ongoing work on the financial risk management and investment frameworks.

5. At its seventh meeting, the Board agreed to consider the financial terms and conditions of grants and concessional loans at its eighth meeting in order to allow Board members to focus on the remaining essential requirements for the commencement of resource mobilization at the seventh meeting, and to improve understanding of the terms and conditions of incoming contributions, notably the contribution policies.

6. At the second Initial Resource Mobilization meeting on 8 and 9 September 2014 in Bonn, Germany, interested contributors and observer members of the Board finalized recommendations on the Fund's contribution policies, for consideration by the Board at its eighth meeting.

7. The purpose of this document is to outline options for the financial terms and conditions to be adopted by the Board for grants and concessional loans to be initially provided by the Fund.

II. Linkages with other documents

8. This document has linkages with the following documents:

(a) *Use of other Financial Instruments* (GCF/B.08/12);

(b) *Potential Approaches to Mobilizing Funding at Scale* (GCF/B.08/13); and

(c) *Policies for Contributions to the Green Climate Fund: Recommendations by Interested Contributors* (GCF/B.08/17).

III. Constraints on the range of possible terms and conditions for the Fund's provision of grants and concessional loans

9. A certain number of prior decisions and other constraints will set bounds on the terms and conditions that the Fund can apply to its grants and concessional lending. These include the Fund's financial policies (comprising financial risk policies and investment policies) and contribution policies:

3.1 Financial policies

(a) **Board-approved financial risk policies** (decision B.07/05): These form part of the Fund's financial risk management framework and will ensure that the Fund takes on the appropriate level of risk in its activities in order to achieve its objectives; and

(b) **Board-approved investment policies** (decision B.07/06): These form part of the Fund's investment framework and ensure that projects and programmes approved for funding are in line with the overall objectives of the Fund as set out in the Governing Instrument.

3.2 Contribution policies

(a) The proposal for policies regarding contributions to the Fund has been developed based on recommendations by potential contributors to the Fund as part of a collective engagement in the initial resource mobilization process (document GCF/B.08/16). These will be presented to the Board for consideration at its eighth meeting. These policies outline the parameters for financial inputs to the Fund and propose the following initial constraints:

   (i) ***Initial prudential debt limit*** (i.e. ratio of loans to total funding received at portfolio level): A maximum 20per cent of loans to total funding is proposed;

   (ii) ***Initial capital cushion*** (i.e. capital cushion contribution required alongside loans received): A level of 20 per cent is proposed;

   (iii) The contribution policies specify that contributions may be received in major convertible currencies.[1] The Fund will also have multiple holding currencies. In order to manage exchange risk related to multiple currencies, the Fund will, wherever possible, extend loans in the same currencies by ensuring that the amount of a loan granted in any currency matches the contributions received as concessional loans in the same currency. Outgoing loans will carry a lower level of concessionality than contributions. This will ensure that that reflows in any major convertible currency exceed debt service obligations in the same currency; and

   (iv) The Fund's contributions policies also set out the terms and conditions for the authorized instruments received. Two options for loan terms are proposed: a more concessional option (Option 1) and a less concessional option (Option 2). The loan contribution terms are outlined in the table below:

[1] US dollar, Euro, Yen, GB pound.

Table 1: Terms of Loan Contributions to the Fund

	Currency	Service fee	Interest	Maturity	Grace period (applied to interest and principal repayments)
Option 1: (more concessional)	Major convertible currency	n/a	Up to 1 per cent per annum; payment every six months after the grace period	40 years	10 years
Option 2: (less concessional)	Major convertible currency	n/a	Up to 1 per cent per annum; payment every six months after the grace period	25 years	5 years

10. The terms and conditions proposed in this document for adoption by the Board align with these prior constraints.

IV. Terms and conditions of outgoing grants

11. Grants will be tailored to cover the agreed full or incremental costs of the investment necessary to make the project viable.[2] Grants provided by the Fund may be grants with or without repayment contingency. Grants provided by the Fund with repayment contingency principally apply to private sector operations in order to maximize the effectiveness and efficiency of the Fund's resources, and to avoid the risk of distortive subsidies to the private sector. In such cases, grants could be channelled through intermediaries to provide guarantee- or equity-like instruments to climate change projects and programmes where the Fund's exposure is limited to the amount of the grant provided. The terms and conditions of such repayable grants would be determined on a case-by-case basis.

12. In line with the Fund's financial risk policies (decision B.07/05), every effort will be made to avoid cross-subsidization of grants and concessional loans, meaning that grants will not be used to subsidize loan repayments to the Fund. All grants will be repaid by the responsible party in the event that disbursements were obtained due to corruption or fraudulent action, or other unforeseen circumstances.

13. A one-time, up front service fee for grants of 0.50 per cent will be charged. In order to encourage disbursement of grants, an additional commitment fee of up to 0.75 per cent will be charged on the undisbursed balance of the grant. Such fees are consistent with the practice of concessional financing in other institutions such as the International Development Association (IDA) and the Clean Technology Fund (CTF) and are intended to cover the Fund's administration and mobilization costs.[3]

[2] Governing Instrument, paragraph 54.
[3] Footnote 14 http://www.worldbank.org/ida/papers/IDA17_Replenishment/IDA17-Updated-Financing-Framework-September-2013.pdf. Annex III provides terms and conditions for funds similar to the Fund.

14. The terms and conditions of grants are outlined in the following table:

Table 2: Terms and conditions of outgoing grants

	Currency	Once time service fee	Commitment fee	Repayment terms
Grants	Major convertible currency	0.50 per cent of the grant amount up front	Up to 0.75 per cent on undisbursed balances	Grants without repayment contingency: no repayment required[1] Grants with repayment contingency: terms adapted to the required concessionality of the project or programme

[1] Except in cases of corruption or other non-compliance with fiduciary standards.

V. Options for terms and conditions of outgoing concessional loans

15. Concessional loans will also be tailored to cover the agreed full or incremental costs of the investment necessary to make the project viable.[4] The Fund will provide concessional loans in the form of senior and subordinated debt.

16. In addition to charging an interest rate on extended concessional loans, the Fund will charge an annual service fee of 0.50 per cent on disbursed balances and a commitment fee set at up to 0.75 per cent of the undisbursed balance to encourage disbursement. The service fee and commitment fee will cover the Fund's administration and mobilization costs. In the event of private sector operations where the project sponsor is the loan obligor and the intermediary takes an agent role, the Fund may be required to pay a fee to the intermediary administering the loan. While such additional costs would be borne by the loan obligor, the terms of the loan would take these into account.

17. In addition to the service and commitment fees needed to cover the Fund's administrative costs, the Board will need to decide on two key variables for the terms and conditions of its financing:

(a) *The number of concessional loan types* the Fund will extend; and

(b) *How the interest rate(s) will be set.*

18. There are several options for these two sets of variables:

(a) **<u>Variable A</u>: Number of concessional loan types provided by the Fund**:
The Board could decide to adopt one, two or three (or more) sets of terms and conditions for concessional loans:

(i) <u>Option A.1</u>: One type of loan;

(ii) <u>Option A.2</u>: Two types of loan, the first with high concessionality and the second with moderate concessionality; and

(iii) <u>Option A</u>.3: Three types of loan, the first with high concessionality, the second with moderate concessionality, and the third with low concessionality.

(b) **<u>Variable B</u>: Manner by which interest rates are determined**:
Secondly, the Board will need to agree on the manner by which the terms and conditions of concessional loans are set. As stipulated in the Fund's financial risk management framework, the average concessionality level of outgoing loans will be less than the average concessionality level of incoming contributions with a sufficient margin to cover

[4] Governing Instrument, paragraph 54.

credit risk (decision B.07/05). The Board may wish to take this into account when choosing from the following options:

(i) Option B.1: Based on the Fund's cost-of-borrowing. The Fund's interest rate would be set at the interest rate of loan-type contributions it receives, plus a set margin to cover credit risk, as per the Fund's financial risk policies (decision B.07/05). This option depends on the outcome of the collective engagement in the initial resource mobilization; and

(ii) Option B.2: Based on market rates. The Fund's terms would be based on market terms (e.g. lending at a risk-free market reference such as the Fed market rate if lending in US dollars, applying market maturities and a grace period).

19. The modality options for determining terms of concessional loans are outlined, in example form, in the following table:

Table 3: Manner by which interest rates are determined—example terms and conditions of outgoing loans

	Currency	Service fee	Commitment fee	Interest rate
Option B.1	Major convertible currency	0.50 per cent annually on disbursed amounts	Up to 0.75 per cent annually on undisbursed amounts	Based on cost-of-borrowing of loan-type contributions received plus a margin to cover credit risk
Option B.2	Major convertible currency	0.50 per cent annually on disbursed amounts	Up to 0.75 per cent annually on undisbursed amounts	Based on benchmark rate of lending currency e.g.: - Euros: European Central Bank rate - US dollars: United States Treasury bond rate - Yen: Bank of Japan benchmark rate Plus a margin to cover credit risk, ensuring that such loans are concessional

VI. Recommendations and next steps

20. **In terms of number of loan types, the Board may wish to choose option A.2**, which consists of two concessional loans (high concessionality and moderate concessionality). This option would provide flexibility and allow the Fund to tailor its terms to suit the particular needs of a programme or project. It would also allow the Fund to link the terms of its loans to the investment framework to ensure that high-impact projects and programmes are funded. For instance, highly concessional loans could be provided to projects and programmes in vulnerable countries with high impact and initially unattractive returns on investment (ROIs); moderately concessional loans could be provided to mitigation projects and programmes with marginal ROIs and to other recipients. For private sector projects, the actual financial terms and conditions are expected to be generally less concessional and tailored to the needs (e.g. maturity, grace and interests) of the climate project and programme which the Fund is funding. The intermediary will be acting as an arranger/agent who supports the Fund in the structuring of the senior or subordinated concessional loan.

21. **In terms of interest rates, the Board may wish to choose option B.1** and establish the Fund's terms based on the terms of contributions it receives. This option would allow the

Fund to establish and monitor the terms of outgoing loans against the terms of incoming contributions. It would also help the Fund to manage financial risks, ensuring its financial viability along with its sustainability and scalability. Option B.2 is not deemed sufficiently concessional, although it may be reconsidered in the future based on the Fund's operations.

22. Based on the options outlined above, the terms of the Fund's outgoing loans would be as outlined in the following table:

Table 4: Terms and conditions of outgoing loans

	Currency	Service fee	Commitment fee	Interest rate	Maturity	Grace period
High concessionality	Major convertible currency	0.50 per cent annually on disbursed amounts	Up to 0.75 per cent annually on undisbursed amounts	Based on cost-of-borrowing terms of loan-type contributions received plus a margin that covers credit risk	Up to 40 years	Up to 10 years
Moderate concessionality	Major convertible currency	0.50 per cent annually on disbursed amounts	Up to 0.75 per cent annually on undisbursed amounts	Based on cost-of-borrowing terms of loan-type contributions received plus a margin that covers credit risk	Up to 25 years	Up to 5 years

23. The Board may wish to adopt the decision as contained in Annex I.

Annex I: Draft decision of the Board

The Board, having reviewed document GCF/B.08/11 *Financial Terms and Conditions of Grants and Concessional Loans*:

(a) Decides that the Fund will provide grants both with and without repayment contingency in order to tailor the Fund's resources to cover the agreed full or incremental costs of the investment necessary to make the project viable, as stipulated in the Governing Instrument;

(b) Further decides that the terms and conditions of grants with repayment contingency would be determined on a case-by-case basis;

(c) Adopts two sets of concessional loan terms: the first with high concessionality, the second with moderate concessionality;

(d) Decides that the terms of concessional loans will be based on the terms of the Fund's incoming loan-type contributions plus a margin such that the average concessionality level of outgoing loans will be less than the average concessionality level of incoming contributions with a sufficient margin to cover credit risk, as per the Fund's financial risk policies;

(e) Adopts the terms and conditions of grants and concessional loans as contained in Annex II to this document; and

(f) Decides that the financial terms and conditions of repayable grants and concessional loans for private sector projects will be generally less concessional and ensure that maturity, grace and interests are tailored to the needs of the climate project and programme funded by the Fund.

Annex II: Terms and conditions of grants and concessional loans

The Fund's financial terms and conditions of grants and concessional loans are outlined in the following table:

Table 1: Terms and conditions of outgoing grants and concessional loans

<table>
<tr><th></th><th>Currency</th><th>Service fee</th><th>Commitment fee</th><th>Interest rate</th><th>Maturity</th><th>Grace period</th></tr>
<tr><td>Grants</td><td>Major convertible currency</td><td>0.50 per cent of grant amount up front</td><td>Up to 0.75 per cent on undisbursed balances</td><td colspan="3">Grants without repayment contingency: no reimbursement required[1]
Grants with repayment contingency: terms adapted to the required concessionality of the project or programme</td></tr>
<tr><td>Highly concessional loans</td><td>Major convertible currency</td><td>0.50 per cent annually on disbursed amounts</td><td>Up to 0.75 per cent annually on undisbursed amounts</td><td>Based on cost-of-borrowing terms of loan-type contributions received plus a margin that covers credit risk</td><td>Up to 40 years</td><td>Up to 10 years</td></tr>
<tr><td>Moderately concessional loans</td><td>Major convertible currency</td><td>0.50 per cent annually on disbursed amounts</td><td>Up to 0.75 per cent annually on undisbursed amounts</td><td>Based on cost-of-borrowing terms of loan-type contributions received plus a margin that covers credit risk</td><td>Up to 25 years</td><td>Up to 5 years</td></tr>
</table>

[1] Except in cases of corruption or other non-compliance with fiduciary standards.

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

I. Clean Technology Fund (CTF)

1. The CTF offers grants and two loan products:

- The maximum preparation grant for investment plans or projects is USD$1 million. A fee of 5 per cent from the CTF trust fund for the multilateral development banks' (MDBs) free for administering and supervising individual preparation grants has been agreed.
- Softer concessional loans (0 per cent interest rate, 40 years maturity, ten-year grace period 0.25 per cent service charge) for projects with:
  - ❖ Negative rates of return; and
  - ❖ Rates of return below normal market threshold;
- Harder concessional loans (0 per cent interest rate, 20 years maturity, ten-year 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.
- A fee of 0.18 per cent on the concessional loans has been agreed to cover the MBD's cost of managing the projects and programmes ("MBD fee").

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 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 IDA's lending terms were adjusted in July 2011 to reflect the economic capabilities of the IDA's clients:

(a) The lending terms offered to the 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 in a new blend credit with a 25-year maturity, five-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); and

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

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

Product type	Maturity (years)	Grace period (years)	Service charge[2] (%)	Interest (%)
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

[2] 0.75 per cent of the disbursed and outstanding credit balance.
Source: IDA16 Mid-Term Review, Implementation and Results Progress Report.

III. IDA-17

4. The IDA 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 the IDA's credits;

(b) **Grace period**: The Grace period would be five years for a 25-year loan or ten 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; and

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

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

IV. International Finance Corporation (IFC)

5. The International Finance Corporation (IFC) prices its lending based on a matrix of country and project risks. These are based on Libor and a country spread, which is not publicly disclosed, and is continuously updated on the basis of market developments. The cost of the transaction is also estimated using an in-house model. Finally, the result is compared with other available indicators, such as recent bond issues or a loan in the same sector in another country with the same credit rating, before the final terms are decided upon.