GREEN CLIMATE FUND

Potential Approaches to Mobilizing Funding at Scale

GCF/B.08/13
2 October 2014

Meeting of the Board
14-17 October 2014
Bridgetown, Barbados
Agenda item 13(a)

Recommended action by the Board

It is recommended that the Board:

(a) Take note of the information presented in document GCF/B.08/13 *Potential approaches to mobilizing funding at scale*; and

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

Potential approaches to mobilizing funding at scale

I. Introduction

1. At its fourth meeting, as part of its deliberations on the business model framework of the Fund, the Board acknowledged the need to mobilize funds at scale from, inter alia, institutional investors such as pension funds and sovereign wealth funds, and to design modalities to that end (Decision B.04/08 paragraph (f)). It also decided that the Private Sector Facility (PSF) will operate efficiently and effectively under the guidance and authority of the Board as an integral component of the Fund, including in relation to the result areas and specific core performance indicators, where relevant (Decision B.04/08 paragraph (a)). The Board further decided that the PSF will address barriers to private sector investment in adaptation and mitigation activities, such as market failures, insufficient capacity and lack of awareness, in order to mobilize private capital and expertise at scale in accordance with national plans and priorities. This will include facilitating and enhancing the participation of national, regional and international private sector actors in developing countries (Decision B.04/08 paragraph (b)).

2. The Board also decided that the PSF will promote the participation of private sector actors in developing countries, in particular local actors, including small and medium sized enterprises and local financial intermediaries. The Facility will also support activities to enable private sector involvement in small island developing States and least developed countries. Modalities will be developed for consideration by the Board (Decision B.04/08 paragraph (c)). Finally the Board agreed that the PSF pay specific attention to Africa and to adaptation activities at the national, regional and international levels (Decision B.04/08 paragraph (e)).

3. At its seventh meeting, the Board decided that it will consider further work on the modalities of the PSF, including modalities for mobilizing private sector resources at scale by the PSF at its eighth meeting (decision B.07/08).

4. Furthermore, the Board took note of the report of the Private Sector Advisory Group (PSAG), by its Co-Chair (document GCF/B.07/10). In this document, the PSAG provided high-level recommendations to the Board, including on mobilizing private sector financing. This document will take those recommendations into account.

5. The document will propose modalities for mobilizing private sector funds at scale through the use of the instruments that have already been approved for deployment by the Fund, namely grants and concessional loans. The use of other financial instruments to mobilize funds will be considered in document *Use of other financial instruments* (GCF/B.08/12). In particular, this document will consider:

(a) Examples of other facilities using concessional funding to crowd in private climate investments;

(b) Modalities under which the Fund can mobilize funds at scale from institutional investors as contributors to the Fund’s core resources; and

(c) Modalities under which the Fund can mobilize funds at scale from institutional investors and the local and international private sectors leveraging participants in projects or programmes financed by the Fund.

6. Additional modalities under which the PSF will promote the participation of local private sector actors in developing countries will be covered in document GCF/B.08/15 entitled *Modalities to promote participation of private sector actors in developing countries*.

7. As it studies the possible modalities which the Fund could pursue to mobilize significant institutional investors funds, the PSAG will analyse the likely specific characteristics of the Fund's projects, and present to the Board its recommendations.

II. Linkages with other documents

8. This document has linkages with the following documents:

(a) *Guiding framework and procedures for accrediting national, regional and international implementing entities and intermediaries, including the Fund's fiduciary principles and standards and environmental and social safeguards* (GCF/B.08/02; GCF/B.08/03; GCF/B.08/04; GCF/B.08/05; GCF/B.08/06);

(b) *Revised programme of work on readiness and preparatory support* (GCF/B.08/10);

(c) *Terms and conditions of grants and concessional loans* (GCF/B.08/11);

(d) *Use of other financial instruments* (GCF/B.08/12);

(e) *Modalities to promote participation of private sector actors in developing countries* (GCF/B.08/14); and

(f) *Legal and formal arrangements with intermediaries and implementing entities, including policies on fees and payments* (GCF/B.08/23).

III. Enhancing the Fund's core resources: mobilizing funds at scale from institutional investors and the financial markets as contributors

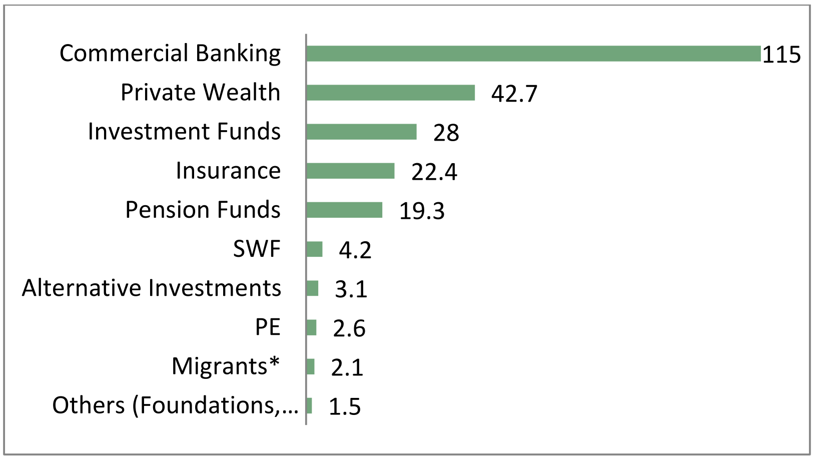
9. The Governing Instrument of the Fund states that the Fund will receive financial inputs from developed country Parties to the Convention, and may also receive financial inputs from other sources, public and private, including alternative sources. Other potential sources of financing could be institutional investors (e.g. pension funds) and financial markets.

10. The PSF will ensure that it mobilizes private sector funds in a way that is consistent with the operating modalities of the Fund as defined in the Governing Instrument. It will operate in a country-driven approach, promoting the participation of private sector actors in developing countries in particular local actors, including small- and medium-sized enterprises and local financial intermediaries, in SIDS and LDCs.[1] In particular, the PSF will ensure that mobilized private sector funds are complementary to and coherent with those of other funds, entities, and channels of climate change financing outside the Fund.[2] It will furthermore take into account the Fund's policies and procedures for the initial allocation of the Fund's resources (decision B.06/06), and the Fund's eight strategic goals towards which it will channel its resources (decision B.07/04). This will ensure that the PSF is maximizing its climate change impact and contributing to the Fund's objectives.

[1] Governing Instrument, paragraphs 42 and 43.
[2] Governing Instrument, paragraph 31.

3.1 Sources of Private Sector Funding

Table 1: Global asset pools (US$ T)



Sources: KPMG, E&Y, OECD Environmental Papers No. 46, Bloomberg

11. The largest pools of private sector assets are mobilized by Commercial Banks, Investment Funds, Insurance Companies, Pension Funds and Sovereign Wealth Funds. We can add to these, Private Wealth controlled by High Net Worth Individuals. Success in mobilizing funds at scale from the private sector is predicated on understanding how these players behave, so as to better understand in how the Fund can capture their resources. An overview of these institutions' ability to invest in climate change projects and programmes can be found in Table 2.

Table 2: Institutions' ability to invest in climate change projects and programmes

	Propensity to invest in climate change in developing countries – including SIDS, LDCs and Africa	**Special considerations**
Commercial Banks	High tolerance for taking on unrated credit risk. Will take on illiquidity risk. Existing depth of funding in LDCs, SIDS and Africa. Do not require inordinate return on their investments Can invest in multiple types of financial products. Can accommodate multiple types of inter-investor and inter-creditor agreements Particularly well-suited to a country-driven approach given their current role in local economies Ability to mobilize funds in small and large projects	Will require ratings when investing outside their home country Tenor/appetite is restricted to under 7 years (can be stretched to 10 years) Requirement is high for local track records in excess of five years. Low appetite for new technologies and projects
	Propensity to invest in climate change in developing countries – including SIDS, LDCs and Africa	**Special considerations**

Private Wealth and "Sophisticated" High Net Worth Individuals	High tolerance for taking on un-Rated risk, both credit and equity Will take on liquidity risk Depth and knowledge of LDCs, SIDS and Africa. Can invest in multiple types of financial products. Over US$ 5 trillion of new private wealth expected to be created over the next two years in developing countries.	Require an elevated return on investments.
Conventional Investment Funds	No propensity to invest in climate change projects and programmes	Require high levels of liquidity. Subjected to elevated levels of return-on-investment (beat the benchmark) Tenor/appetite restricted to less than five years
Pension Funds and Insurance	Appetite for extra-long tenors (greater than ten years) in line with climate-sensitive project finance requirements Increasingly well-suited to a country-driven approach as governments ask that funds be invested domestically and place restrictions on cross-border placements	Require investment grade-Rated investments that are highly liquid. A minimal portion of their investment portfolio may be placed in illiquid and un-Rated instruments
Sovereign Wealth Funds	Some tolerance for taking on un-rated credit risk. Some tolerance for taking on illiquidity. Existing depth of funding in LDCs, SIDS and Africa. Can invest in multiple types of financial products.	Subject to tight confidential internal investment guidelines. Some behave as private wealth would; others behave as would a pension fund.
Alternative investment funds, including private equity	High tolerance for risk. Will take on illiquidity. Appetite for exposure to LDCs, SIDS and Africa. Can invest in multiple types of financial products	Tenor/appetite is restricted to under 7 years (can be stretched to 10 years) subject to elevated levels of return.

12. The Fund shall in the immediate term focus on mobilizing fund at scale from local commercial banks, local pension funds, local insurance companies, sovereign wealth funds and high net worth individuals.

13. The Fund will ultimately seek to invite investors to place their funds at the Fund level. However, this is unlikely to happen in the short term, until such times as the Fund can establish a credit rating and/or a track record. The Fund would need to build up a portfolio of investments and a balance sheet before inviting, at a scale of more than US$ 5 million, commercial banks and institutional investors.

14. The Fund would therefore look to the intermediaries through which it acts to structure investments into climate change in such a manner that will attract and accommodate the

aforementioned targeted third party investors, i.e. commercial banks and institutional investors. These are described in the following section.

3.2 Products and structures to mobilize funds at scale

15. The intermediaries can attract third party investors through bonds; commercial paper; syndications and club deals; and private placements programmes.

3.2.2 Bonds

16. Bond programmes present the single largest avenue through which the GCF can mobilize private sector funds at large scale. In fact, the costs associated to issuing a bond usually require an issue size of US$ 300 – 500 million to be justified.

17. Bonds, which tend to be long term in nature, require long term capital commitment by private sector investors. They expose investors to a relatively material level of credit and interest rate risk; in part due to their medium / long term nature. They are nonetheless attractive to investors when they are risk rated "BBB+" (or better) and liquid. An investment grade risk rating provides investors with some assurance that the underlying exposure is credit worthy, transparent and subscribes to a minimum degree of international best practices with respect to accounting policies and risk management practices. Liquidity affords a Private Sector investor the ability to easily sell a bond if the investor:

(i) Anticipates a general downturn in the market and/or concerned industry;

(ii) Anticipates a deterioration in the credit; and/or

(iii) Desires to monetize the asset for internal reasons that may be related to liquidity needs or portfolio considerations. Investment grade bonds that are liquid are particularly attractive to pension funds and insurance companies who require long term investments to match the maturity profile of their financial obligations.

18. The use of bonds is particularly well-suited for attracting funds at scale from commercial banks, pension funds, insurance companies, sovereign wealth funds and private wealth.

19. In the short term, the GCF can work through national and regional intermediaries to issue, underwrite and/or market make project specific bonds. These intermediaries would ring fence one or more assets / projects in a special purpose vehicle, against which bonds can be issued. These could be projects in which the GCF already participated. The GCF could also add value by injecting credit and/or liquidity enhancing elements. For example, the GCF could propose a first or second loss mechanism; a pool of funds to one or more intermediaries so that they could inject liquidity into the bond by acting as market maker(s).

20. In the medium / long term, the GCF will be able to attract private sector investors directly onto its "balance sheet" through bonds, at a reasonable rate, once it obtains a risk rating of "A" or better from a qualified rating agency. This will occur once the GCF can either:

(i) Evidence a sound risk portfolio supported by a sound risk architecture that includes strong liquidity and solvency attributes; or

(ii) Evidence sufficiently strong "parent" support from investment graded states via their commitments to fund. Both scenarios will require time.

3.2.3 Commercial paper

21. Commercial Paper (CP) programmes can also be used to attract private sector investments at scale. They may be the least suitable method of attracting private sector funds directly onto the GCF's Balance Sheet. However, they present a strong short term alternative to attracting local private sector funds into projects (or project clusters).

22. CPs provide investors with the option of placing funds with an entity for less than one year. Upon termination of the maturity period, investors will either:

(i) Renew their investment; or

(ii) Be repaid by funds raised through the issue of new CP; or

(iii) Be repaid by the entity through the use of funds unrelated to the CP.

23. CP exposes investors to relatively high credit and liquidity risk. Investors will invest into a CP only if they are confident that the issuing entity is capable of:

(i) Generating sufficient cash through operations to buy out the CP at maturity; or

(ii) Maintaining sufficiently good credit quality to attract investors into the next CP issue / tranche.

Investors will be attracted to CP if they are:

(i) Very familiar with the risk of the underlying obligor; and

(ii) Confident as to the CP's liquidity. The former requisite makes CP a particularly attractive option for "crowding-in" investments at scale by local investors.

24. CPs are particularly well suited to mobilize funds at scale from local banks and from High Net Worth Individuals who are familiar with a local project and/or programme. CPs may, for example, present a great opportunity to crowd-in private funds into MSME programmes / portfolios. This would best be achieved by local institutions if they ring fence the MSME portfolio into a special purpose vehicle against which the CP would be issued. The GCF could add value in the same manner as described above in the Bond section.

25. CPs are relatively ill suited for the GCF to mobilize funds at scale directly onto its balance sheet, in large part due to the fact that their short term nature does not suit the long term nature of the GCF's requirements.

3.2.4 Syndications and Club Deals

26. Syndications are illiquid in nature. They present no easy way out for investors. As such, investors will tend to expect higher returns than on bonds and will limit their tenor exposure to 5 - 7 years (10 years on rare occasions). They present two primary benefits, both emanating from the fact that syndicated loans are subject to a much lower regulatory / licensing hurdle than commercial paper and bonds – syndicated loans are not considered securities and as such fall under the same regulatory framework as loans. Therefore, they can be carried out with minimal transaction costs and thus be used to crowd-in private sector funding on smaller scale projects. Also, they are already ubiquitously used by banks to disseminate risk and do not require a mature financial market.

27. Syndications and Club Deals could be used to crowd-in funds from local private sector banks into projects and programmes. The GCF can add material value by providing support to enhance credit (e.g. first or second loss guarantees); and/or tenor profile (e.g. bear the risk on

the residual portion of a loan that extends beyond 10 years). The GCF can also add value by acting as the first mover / anchor investor on a deal; such an anchor is often required to catalyze the participation of banks.

3.2.5 Private placement programmes

28. Private Placements are an intermediary step between Syndications (Loans) and Bonds/Commercial Paper (Securities). Their regulatory / licensing hurdle and transactional costs are reflective of this fact. Private Placements are often used in the Private Sector when seeking 3 – 7 year funds for a non – rated entity or project that does not meet the quantum volume requirement to justify seeking a rating and issuing a bond.

29. Private Placements can be used to crowd in funding from High Net Worth Individuals and sovereign wealth funds.

30. The aforementioned products and structures to mobilize funds at scale can be found in Table 3.

Table 3: Products and structures to mobilize funds at scale

	Potential to mobilize at scale and other advantages	Challenges	Fund's value addition through the use of instruments	Targeted sources of funds	Examples of use
Bonds	Highest Potential for Scale: Lots of US$ 500M; range of US$ 100M – 1B. Can be Used directly by GCF or at Project Specific Level. Replicable at scale and fosters an integrated approach that is Complementary to and Coherent with actions being taken by other channels of climate finance change.	High Regulatory Hurdles (Time to market & Transactional Costs) Investors prefer Liquid & Investment Grade Instruments (Favors large issues and issuers). Not Conducive to MSMEs or for use in SIDS and small LDCs, unless carried out on a regional based portfolio approach – requiring an additional layer of complexity.	Credit Enhancement Market Signaling Liquidity Enhancement Information Sharing Capacity Building	Commercial banks, pension funds, insurance companies, sovereign wealth funds and private wealth.	Short Term: Crowd In Private Sector Funding into an IPP by providing partial guarantee on the offtake agreement. Short Term: Provide intermediaries with the necessary funding and credit risk mitigation guarantee so that they can take on the role of market – maker and provide liquidity for an otherwise illiquid issue. Long Term: Raise Funds directly for the GCF.
Commercial Paper	High Potential for Scale: Lots of US$ 50M – 500M. Replicable at scale and fosters an integrated approach that is Complementary and Coherent with other providers of funds. Very well suited to use by local Financial Institutions seeking exposure on obligors they already know; and as such well positioned to create climate awareness and the related "multiplier" / replicator effect amongst said institutions.	Mid/High Regulatory Hurdles (Time to market & Transactional Costs). Investors demand liquidity and/or credit quality. Not well suited for use in large scale and capital expenditure projects.	Credit and Liquidity Enhancement Support	Local banks and from High Net Worth Individuals	Short Term: Provide Intermediaries with the necessary funding to take on the role of market – maker for new CP issues and issuers that targets supply chain financing.

	Well Suited for Supply Chain Financing – Can Address Structural Disadvantage faced by new players that offer climate sensitive alternative products but that do not have the means to offer supplier financing or to carry a sufficient stock of inventory to ensure after-sales servicing.				
Syndications & Club Deals	Medium - High Potential for Scale. Lots of US$ 300M; with range of US$ 25M to US$ 500M. Very Low Regulatory Hurdles – Quickest time to market and lowest transactional costs. Well suited to use by a limited number of financial institutions ready to take on medium term exposure on names they already know.	Slow to create replicability and the associated multiplier effect amongst financial institutions and beneficiaries. Favors names that have an established credit track-record with financial institutions.	Credit Enhancement and Market Signaling Information Sharing Capacity Building.	Local banks	Syndication: Crowd-In Private Sector Funding into an IPP. Club Deal: Crowd-In Private Sector Funding into the climate sensitizing of a real estate development projects.
Private Placements	Medium Potential for Scale; lots of US$ 50M – 300M. Ability to crowd-in funds of High Net Worth Individuals (HNWI) into syndications and Club Deals that would otherwise be targeted at only banks. Ability to crowd-in private sector equity (including from HNWI), pre-IPO.	No appetite by banks. Limited and very selective appetite from institutional investors. High returns sought by investors.	Credit Enhancement. Information sharing Capacity Building.	High Net Worth Individuals and sovereign wealth funds	Crowd-In Private Sector Funding into a pilot project that offers enhanced returns.

IV. Leveraging: mobilizing funds at scale from institutional investors and private investors at the project or programme level

4.1 Using existing instruments to attract third party funds at scale

31. The Governing Instrument of the Fund provides that the Fund will provide financing in the form of grants and concessional lending. This section will outline how the PSF can deploy these instruments through accredited intermediaries to provide the aforementioned enhancements required to attract third party funds at scale.

32. Through the provision of risk bearing capacity and concessional resources, the Fund can enhance risk or liquidity profiles to make it feasible for intermediaries to mobilize their own resources, and/or those of third parties, into climate projects and programmes that would not have otherwise achieved financing.

33. At its seventh meeting, the Board adopted accreditation criteria for intermediation functions that allow accredited intermediaries to blend and on-lend the Fund's resources with their own or with third party resources and/or to act as an agent of the Fund's resources (decision B.07/02) thereby structuring effective financial solutions. Examples of such support for accredited financial intermediaries are as follows:

(a) The Fund could use its concessional resources to support issuance by financial intermediaries of debt securities in local capital markets for climate-related investments. Examples of such support could be by offering concessional funding to provide credit and/or liquidity enhancement of the underlying bond (e.g. a first loss structure, liquidity / market-making for green securities provided by a local intermediary), and therefore make the investment more feasible for a wider group of financiers;

(b) To extend grace and repayment periods beyond what would otherwise be available in the market. This would improve the creditworthiness and liquidity profiles of programmes and projects, making them feasible investments for a wider range of actors;

(c) To enable intermediaries to provide subordinate debt tranches that partially mitigate risks inherent in climate projects that may not be present in the fossil fuel alternative (e.g. technology risk); this would make projects feasible for a wider range of financiers than would otherwise be the case.

34. The Fund could take intermediary risk by extending lines of credit to accredited financial institutions in the form of a programme. Once a programme is duly approved, the sub-projects would be subject to the approval processes and administrative management of the intermediaries, as guided by the Fund. This is particularly useful for Micro, Small and Medium Enterprise (MSME) projects and activities.

35. The Fund could also work with and through intermediaries to take on beneficiary risk. Working through intermediaries will help ensure that:

(i) The Fund better safeguard donor funds by using local expertise (legal / regulatory; economic; commercial) and resources (due diligence, structuring) of intermediaries that act in the local market;

(ii) The Fund creates a greater impact across meaningful sectors of the local economy; and

(iii) The Fund maximizes reach and scalability through a “local demand” driven approach.

Taking on beneficiary risk, through intermediaries, will help ensure:

(i) Letter tailoring of solutions so as to meet the Fund’s goals and objectives;

(ii) Better safeguarding of donor funds by ensuring a second level of due diligence, tighter monitoring and accountability of projects and intermediaries;

(iii) A thematic / project based approach that is intermediary neutral and therefore less likely to create market distortions; and

(iv) That the concessionality of the Fund’s financing will reach its intended beneficiaries and not be captured by the intermediaries.

4.2 Using a competitive platform to select intermediaries most capable of attracting third party funding

36. The Fund could issue Request for Proposals (“RFPs”) to “auction out” concessional funding to actors that present the most attractive alternative for using concessional resources to realize projects while attracting third party funding at scale. In so doing, the Fund expects private sector actors and intermediaries to create project- or programme-specific structures so that:

(i) Third party investors can crowd-into a specific project or programme; and

(ii) The Fund can have enhanced input into the design of a financial solution and have enhanced monitoring capabilities with respect to the use of the deployed resources.

4.3 Ensuring the best use of the Fund’s Concessionality

37. The mobilization at scale of diverse third party private sector funds into a project or programme is the acid test that concessionalities are passed on to the intended beneficiaries rather than to intermediaries. Concessional resources will have been deemed to have reached their intended beneficiary if third party investors oversubscribe into a project or programme that would not have been financially feasible without the concessionality.

38. In order safeguard its resources, the Fund will ensure that the concessionality of its financing will reach its intended beneficiaries and not be captured by the intermediary and/or executing entity.

39. Exposure to project and programme risk by the Fund through intermediaries would serve a dual purpose: firstly, it would act as a strong attractive signal to third party investors and hence help to mobilize funds at scale; secondly, it will allow precise tailoring of concessionality to avoid capture by the intermediary and would allow the Fund to better influence and monitor results.

V. Recommended action and next steps

40. The Board may wish to adopt the decision as contained in Annex I to this document.

Annex: Draft decision

The Board, having reviewed document GCF/B.08/13 *Potential approaches to mobilizing funding at scale*:

(a) Agrees that accredited intermediaries through which the Fund works will create structures and use the Fund's concessional resources to attract third party funding into specific projects and programmes through bonds, commercial paper, syndications and club deals, and private placements;

(b) Agrees that accredited intermediaries will target raising third party funds from local and international commercial banks; pension funds; insurance companies; sovereign wealth funds, investment funds and High Net Worth Individuals;

(c) Decides that when using a competitive process to select an intermediary, the Fund will take into consideration the bidding parties' abilities to attract third party funds into projects and programmes.