GREEN
CLIMATE
FUND

Working with Local Private Entities, Including Small and Medium-Sized Enterprises

GCF/B.08/14
8 October 2014

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

Recommended action by the Board

It is recommended that the Board:

(a) Take note of the information presented in document GCF/B.08/14 *Working with local private entities, including small and medium-sized enterprises*; and

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

Working with local private entities, including small and medium-sized enterprises

I. Introduction

1. As stated in the Governing Instrument, the Green Climate Fund will have a private sector facility that enables it to directly and indirectly finance private sector mitigation and adaptation activities at the national, regional and international levels. As per paragraph 42 of the Governing Instrument, the operation of the facility will be consistent with a country-driven approach. As per paragraph 43 of the Governing Instrument, the facility 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 SIDS and LDCs. As per paragraph 44 of the Governing Instrument, the Board will develop the necessary arrangements, including access modalities, to operationalize the facility.

2. At its fourth meeting the Board reemphasized that the Private Sector Facility (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, and in small island developing States and least developed countries. Modalities will be developed for consideration by the Board (decision B.04/08, paragraph (c)). The Board furthermore emphasized that the Fund needs to 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 fifth meeting, the Board established the Private Sector Advisory Group (PSAG) to make recommendations to the Board on the Fund-wide engagement with the private sector and modalities to that end (decision B.05/13). The PSAG's mandate is to make recommendations to the Board on promoting the participation of private sector actors in low-emission and climate-resilient development in developing countries, in particular local actors, including small and medium-sized enterprises and local financial intermediaries.

4. At its seventh meeting, the Board requested the PSAG to provide advice on the implementation of decision B.04/08 for consideration at the eighth meeting of the Board, with a focus on modalities to promote the participation of private sector actors in developing countries, in particular local actors, including small and medium-sized enterprises and local financial intermediaries in small island developing States, least developed countries and Africa, and with a special emphasis on adaptation (decision B.07/08).

5. The purpose of this document is to outline how the Fund can promote participation of private sector actors in climate change programmes and projects in developing countries, including local financial intermediaries, developers, private companies, etc.

II. Linkages with other documents

6. Many of the approaches outlined in the document GCF/B.08/13, *Potential Approaches to Mobilizing Funding at Scale,* will be relevant for private sector actors in developing countries. However, this document will focus on the additional needs of the local private sector in developing countries and how the Fund can respond to them.

7. This document also 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) *Financial Terms and Conditions of Grants and Concessional Loans* (GCF/B.08/11);

(d) *Use of Other Financial Instruments* (GCF/B.08/12); and

(e) *Simplified Processes for the Approval of Proposals for Certain Activities, in Particular Small-scale Activities* (GCF/B.08/22).

III. Private sector actors in developing countries, and barriers to climate investments

8. A key feature of the private sectors and financial sectors in developing countries is their diversity, scale and scope. In some cases, private sector actors in developing countries are on a par with or ahead of those in developed countries, while in other developing countries these actors may be small or have inadequate capacity to undertake climate-related investments. Some markets may be global, while others may be too small to assure the financial return of certain attractive investments. Financial sectors may be too shallow to assure debt financing of adequate maturity or may not provide appropriate financial instruments. The policy or regulatory environment in the country may disincentivize investors because of market distortions or investment uncertainty.

9. This document will seek to outline four types of support that the Fund can provide to private sector actors in developing countries that can adapt to their different country conditions. These are as follows:

(a) Providing concessional resources to MSMEs to offset lack of access to financial markets (MSME Support Programme);

(b) Project development and capacity-building resources (the Private Sector Project Development/Capacity-Building Programme);

(c) Use of financial instruments (including the provision of grants in innovative ways); and

(d) Streamlined approval processes for the private sector.

10. A decision by the Board would be required to implement the first two types of support. The second two support mechanisms are outlined in the documents *Use of Other Financial Instruments* (GCF/B.08/12) and *Simplified Processes for the Approval of Proposals for Certain Activities, in Particular Small-scale Activities* (GCF/B.08/22), respectively.

3.1 Key private sector actors in developing countries

11. This document will consider four broad categories of private sector actors in developing countries, two at the intermediary/implementing entity level and two at the executing entity level:

3.1.1 Intermediary/implementing entity level:

(a) **Private financial intermediaries and implementing entities in developing countries** that are accredited by the Fund, such as investment and commercial banks; insurance companies; leasing companies; and investment funds;

(b) **Microfinance entities**, both formal and informal microfinance institutions. If these are not accredited by the Fund, they would need to operate through an accredited intermediary;

3.1.2 <u>Executing entity level:</u>

(a) **Project sponsors and commercial enterprises in developing countries** that operate in the formal economy. Currently, such executing entities would need to work through an accredited intermediary rather than directly with the Fund. However, the Board may at some stage wish to consider whether due diligence can be executed at the approval level rather than the accreditation level to ensure actors meet the Fund's financial, environmental and social standards. This would streamline assistance to private sector actors in developing countries;

(b) **Micro, small and medium-sized enterprises**[1] (MSMEs), both those in the formal economy and at the household or informal economy level. Given the small unit size of MSMEs and the high transaction costs as a result of interacting directly with such actors, it will be difficult for the Fund to interact directly with such players. The Board may wish to establish a programme-based approach to reach these players in a way that is cost-effective through intermediaries that would be responsible for approving and assuming the administrative management of the exposure to each MSME.

3.2 Key barriers to climate-related investments

12. The barriers to increased private sector investment in climate-related projects and programmes can exist at several levels:

(a) **Policy and regulatory environment constraints**. These typically introduce market distortions which reduce the economic and financial attractiveness of investments (e.g. price and tariff controls) or increase the uncertainty relating to investment outcomes (policy uncertainty).

It is not proposed that the Fund would directly address such policy and regulatory constraints[2]. Rather, if the Fund were to address such barriers (e.g. if requested by national authorities or the NDA), it would do so through policy support (grants or concessional lending) to governments and government agencies. Such support would take the form of policy-based grants or concessional loans from the Fund's mitigation or adaptation windows to finance the cost of such policy changes.

(b) **Information gaps leading to market failure**. Investors and financial intermediaries may not pursue attractive investments because of inadequate information concerning available technologies, resource availability (e.g. geothermal resources, energy savings potential), financing possibilities or other information gaps.

(c) **Weak or shallow financial markets**. Many developing countries lack debt or equity markets that can match domestic savings to the long-term financing needs of infrastructure investments, and they may also lack important financial products needed to successfully finance climate-related investment (e.g. leasing financing, venture capital,

[1] The Fund uses the IFC's definition of MSMEs, which can be found at http://www.ifc.org/wps/wcm/connect/de7d92804a29ffe9ae04af8969adcc27/InterpretationNote_SME_2012.pdf?MOD=AJPERES.

[2] The PSF has been designed to work with the private sector. While policy and regulatory issues affect private sector actors in developing countries, addressing such barriers would require action by governments, which is a task that would be more appropriate for the mitigation and adaptation windows of the Fund to undertake.

secondary markets to provide take-out finance for investors). These constraints mean that financially viable investments do not obtain the financing they need.

(d) **Capacity constraints**. Some developing countries may not have certain specialized skills in the local economy (e.g. to develop or appraise complex projects) needed to successfully develop climate-related investments.

(e) **Market size and transaction costs.** While certain investments may have very significant positive climate outcomes and would be financially viable in large or industrialized countries, they may not be viable elsewhere, either because of the small market size or excessive transaction costs, which render the investment less attractive. It should be noted that the Fund's structure itself could add significantly to the transaction costs for a developing country investor.[3]

IV. The Fund's role in addressing key barriers to private sector investment

13. In order to fulfil its function of supporting private sector climate investments in developing countries, the Fund must use mechanisms of support for developing country actors that will address the barriers outlined above. As indicated above, it should be noted that policy and regulatory environment constraints will be addressed through the Fund's mitigation and adaptation windows:

(a) *An information-related market failure* will require the use of concessional resources to assist developing country actors in overcoming the information gaps;

(b) *Weak or shallow financial markets* can be tackled successfully by the use of additional financial instruments. The use of such financial instruments is addressed in the accompanying document *Use of Other Financial Instruments* (GCF/B.08/12). However, for small actors such as MSMEs, tailored approaches – for example providing concessional resources deployed through accredited intermediaries – would be more appropriate;

(c) *Capacity constraints* will need to be addressed by the provision of concessional resources (expert consultants, studies, other forms of technical assistance);

(d) *Transaction costs* that are not the result of the Fund's intervention can be offset through the Fund's concessional financing terms, which are better than market terms and thus make the project or programme financially viable. The Fund's own transaction costs would need to be addressed through a streamlined approval process such as the one outlined in the document entitled *Simplified Processes for the Approval of Proposals for Certain Activities, in Particular Small-scale Activities* (GCF/B.08/22) and by the introduction of direct financing for the Fund.

14. In order to cover these four areas, the Board will need to consider providing the following forms of assistance:

(a) A mechanism for MSMEs to offset their lack of access to financial markets (MSME Support Programme);

(b) Project development and capacity-building concessional resources (the Private Sector Project Development/Capacity-Building Programme);

[3] The issue relating to the Fund's own transaction costs is relevant not only to private sector actors in developing countries, but also to international private sector actors.

(c) Use of financial instruments (including the provision of grants in innovative ways) as outlined in the document entitled *Use of Other Financial Instruments* (GCF/B.08/12); and

(d) Streamlined approval processes applicable to the private sector and to private actors in developing countries as outlined in the document entitled *Simplified Processes for the Approval of Proposals for Certain Activities, in Particular Small-scale Activities* (GCF/B.08/22).

15. Descriptions and examples of the use of the four assistance mechanisms are provided in the table below.

ASSISTANCE MECHANISMS	DESCRIPTION	EXAMPLE OF USE
MSME Support Programme	Provision of concessional resources to MSMEs through accredited intermediaries on a programme/portfolio basis	Examples: • Concessional resources for conversion from biomass (wood fuel) to solar or electrification • Concessional resources for solar water heaters • Concessional resources for energy efficiency programmes • Concessional resources for irrigation, to enable farmers to adapt to climate change
Private Sector Project Development/Capacity-Building Programme	Fund to provide capacity-building and project development	Examples: • Capacity building grants to provide project development skills • Project/programme pipeline development • Prototyping new pilots in developing countries
Use of Financial Instruments See *Use of Other Financial Instruments* (GCF/B.08/12)	Providing, through accredited intermediaries, tailored concessional financial instruments to offset shallow domestic financial markets	Examples: • Concessional lending to offset excessive transaction costs in small markets and capital market gaps in general
Streamlined Approval Process See *Simplified Processes for the Approval of Proposals for Certain Activities, in Particular Small-scale Activities* (GCF/B.08/22)	Approval process adapted to the private sector's project development cycle	Examples: • Ability to approve (or reject) a project proposal within a quick timeframe that is consistent with private sector investment decision processes

4.1 Support programmes proposed for the private sector

16. Two of the assistance mechanisms outlined above (use of financial instruments; and streamlined approval processes) are covered in other documents that will be presented for consideration by the Board. This section outlines the two other mechanisms, on which the Board will be required to make a decision based on the information in this document. These mechanisms will be used in line with the Fund's eight Fund level impacts towards which it will channel its resources (decision B.07/04), the Fund's policies and procedures for the initial allocation of Fund resources (decision B.06/06), and will be consistent with a country-driven

approach, as per paragraph 42 of the Governing Instrument. This will ensure that the Fund is maximizing its climate change impact and contributing to the Fund's objectives.

4.1.1 MSME Programme

17. In order for the Fund to achieve its objective of promoting a paradigm shift towards low-emission and climate-resilient development, demand from micro, small and medium-sized enterprises (MSMEs) for climate change activities will be of key importance. The Fund will use its concessional resources to improve MSMEs' access to finance through its MSME Programme.

18. This is in line with paragraph 43 of the Governing Instrument, which stipulates that the Private Sector Facility will promote the participation of private sector actors in developing countries, in particular local actors, including small and medium sized enterprises.

19. MSMEs play a particularly important role in the economic fabric of developing countries and in contributing to the growth and prosperity of said developing countries; particularly MSMEs that export. MSMEs represent more than 50 per cent of gross domestic product (GDP) in OECD countries as opposed to less than 20 per cent in developing countries.[4] Yet, they are restricted in accessing capital, even in its simplest form as bank loans. When they are able to access bank financing, it is under highly unfavourable and sometimes debilitating conditions. There are more than US$ 2 trillion of unmet MSME credit needs in developing countries.[5]

20. The Fund has a unique opportunity to address the aforementioned issue while addressing climate change. In particular, the Fund can mobilize MSMEs towards pursuing both climate change mitigation and adaptation. Mitigation could be achieved through, for example, the financing of energy efficient equipment, weather stripping of premises, upgrading of heating and ventilation equipment, reductions in water use, and improvements to transportation logistics, etc. Adaptation could be achieved, for example, through the financing of continuity of business plans that help MSMEs better prepare for and adapt to the adverse climate change impacts on their businesses' revenues and costs.

21. The MSME Programme will provide concessional financing to MSMEs through intermediaries. These concessional resources could be useful when applied in the context of:

(i) Supply chain financing in the case of export-oriented MSMEs; and

(ii) Terms of trade financing (accounts receivables and inventory financing) in the case of domestically oriented MSMEs.

For example, a facility could be made available to make it possible for MSMEs selling solar panels to offer credit to their clients so as to have terms of trade that are in line with that of their conventional competitors. They could also be particularly useful for adaptation activities by financing continuity of business plans (e.g. financing a back-up operational site) for MSMEs.

22. The Fund will issue requests for proposals (RFPs) to intermediaries that are able to demonstrate:

(i) A track record of successfully working with and financing MSMEs;

(ii) An ability to monitor the results achieved through the MSME Programme; and

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[4] Ayyagari, Beck and Demirguc-Kunt, "Small and Medium Enterprises across the Globe: A New Database", World Bank

[5] Peer Stein, International Finance Corporation, Tony Goland, McKinsey & Company, Robert Schiff, McKinsey & Company, "Two trillion and counting - Assessing the credit gap for micro, small, and medium-size enterprises in the developing world". International Finance Corporation, McKinsey, October 2010.

(iii) An ability to use Fund resources to create a significant climate impact.

Particular attention will be paid to supply chain financing of MSMEs that have a sustained track record of supplying medium-sized and large corporations and/or governments. This will help ensure that Fund resources are directed towards financially/economically robust entities that have "staying power" and that can make the greatest impact in terms of reach and adaptation.

4.1.2 Private Sector Project Development/Capacity-Building Programme

23. The Private Sector Project Development/Capacity-Building Programme will aim to provide project development assistance and build the capacity of private sector actors in developing countries. Such support includes financial support for project or programme preparation, development advisory services, and targeted training, and will enable project sponsors to develop bankable climate change projects.

24. The Fund will work initially through national and regional intermediaries who have knowledge of national and regional markets and players, the geographic depth and breadth, and the necessary skills and teams required to build the required capacity.[6]

25. The Fund will issue RFPs to seek proposals from relevant entities so that the Fund can administer the Private Sector Project Development/Capacity-Building Programme resources efficiently and effectively.

26. Capacity building programmes will be contracted to an implementing entity or intermediary to ensure that the Fund is able to deliver capacity-building at scale to local actors without excessive delays. Such capacity-building will be in line with the two capacity-building frameworks adopted by the Conference of the Parties (COP) to the United Nations Framework Convention on Climate Change (UNFCCC), which provide a set of guiding principles and approaches to capacity building, including that it should be a country-driven process, involve learning by doing, build on existing activities and strengthen endogenous capacities at the subnational, national or regional levels, as appropriate.[7]

V. Emphasis on adaptation

27. The Fund is to approach adaptation in such a manner that a balance is sought between adaptation and mitigation, as per paragraph 3 of the Governing Instrument.

28. One of the key barriers to private investment in adaptation activities is that such activities often provide common goods or services without a clear or perceived revenue stream to match their economic benefits. The Fund will aim to change perceptions and provide incentives for the private sector to invest in adaptation activities. Furthermore, it will support national actors in converting economic benefits to financial streams (through fiscal, financial reporting or ownership rights changes) to overcome inadequate revenue generation. Support for adaptation may include:

(a) Sensitizing financial institutions and private sector companies to the direct and indirect costs of disaster recovery and continuity of business (COB) related to climate change (including supply chain disruptions). This would include sensitizing risk rating agencies that attribute a credit risk rating to local financial institutions and private sector

[6] To the extent that the nature of support may relate to readiness and preparatory activities for accessing the Fund, the PSF team will work closely with the Country Programming Division to carry out such work.
[7] Decisions 2/CP.7 and 3/CP.7. Other relevant decisions can be found at http://unfccc.int/cooperation_and_support/capacity_building/items/3022.php.

corporations so that companies who address adaptation-related risks derive two competitive advantages:

(i) Resilience; and

(ii) Lower cost of funding.

(b) Prototyping low-cost adaptation technologies and approaches with pilot and demonstration projects, for adoption by the local private sector;

(c) Investing in technology and infrastructure that address disaster recovery and COB (e.g. early warning systems such as weather information systems);

(d) Creating or leveraging existing financial players such as banks and micro-finance institutions used by local insurance and micro-insurance players as well as MSMEs;

(e) Promoting investments in supply chain management that incorporate climate adaptation risk management (e.g. supply source diversification, crop changes in agriculture, COB);

(f) Allocating concessional funding for private sector adaptation solutions, for example for incentivizing insurance companies to develop climate risk initiatives; and

(g) Promoting insurance solutions to enable bank and supply-chain (i.e. accounts receivable/payable) debt rescheduling in the face of business disruptions resulting from temporal material adverse climate changes.

29. The MSME Programme outlined above will be useful in supporting small-scale adaptation investments through the provision of concessional financing.

VI. Conclusion and next steps

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.08/14 *Working with local private entities, including small and medium-sized enterprises:*

(a) Decides to create a Micro, Small and Medium-Sized Enterprises Programme (MSME Programme) to provide grants and concessional loans to micro, small and medium-sized enterprises. Programmes that address mitigation and adaptation in a balanced way will be encouraged;

(b) Requests the Secretariat to issue requests for proposals (RFPs) to seek proposals from relevant entities so that the Fund can mobilize MSME Programme resources efficiently and effectively;

(c) Decides to create a Private Sector Project Development/Capacity-Building Programme to provide project development and capacity-building support to local private sector actors; and

(d) Requests the Secretariat to issue RFPs to seek proposals from relevant entities so that the Fund can mobilize Private Sector Project Development/Capacity-Building Programme resources efficiently and effectively.

Annex II: Barriers to private sector climate-related investment and support mechanisms

Barriers to Private Sector Climate-related Investment and Support Mechanisms			
	Private Sector Actors in Developing Countries	Barriers to investment in climate-related projects and programmes	Possible support mechanisms
Financial intermediaries and implementing entities	**Commercial private sector financial entities (accredited by the Fund)** Examples: – Investment and commercial banks – Insurance companies – Leasing companies – Investment funds	**Information constraints**: Lack of information about potential sector and project opportunities	– Project appraisal resources and toolkits
		Capacity constraints: Difficulty in carrying out the analysis and appraisal of potential climate-related investments to Green Climate Fund standards	– Project appraisal resources: assist accredited intermediaries with project analysis – Appraisal toolkits made available to all accredited intermediaries
		Market size constraints: Lack of local financial market depth	– The Fund provides equity and debt through accredited intermediaries to make up for weak local financial markets
	Microfinance programmes and institutions – Formal microfinance institutions – Informal microfinance institutions *If not accredited, MFIs will work with and through an accredited intermediary*	**Information constraints**: Lack of information about counterparties and climate-related investments	– Pipeline development resources and capacity-building grants – Project appraisal resources and toolkits
		Capacity constraints: Difficulty in carrying out the analysis and appraisal of potential climate-related investments to Green Climate Fund standards	– Project appraisal resources: assist MFIs with project analysis – Appraisal toolkits
		Transaction cost constraints: High unit cost of providing finance to microfinance borrowers (may or may not be due to inadequate market size)	– The Fund provides concessional resources to intermediaries who control a sufficiently large portfolio of MFIs

PROJECT SPONSORS AND OTHER EXECUTING ENTITIES	**Large-scale developing country operators** Examples: – Project developers – Production and service companies with ongoing operations *Will work through an accredited Intermediary*	**Information constraints**: Lack of information about climate-related business opportunities	– Pipeline development resources and capacity-building grants
		Capacity constraints: Developer may, in certain conditions, require capacity strengthening	– Capacity-building resources can provide assistance here
		Market size constraints: Lack of local market or inadequate pricing	– The Fund's provision of concessional resources and/or risk bearing can offset project-debilitating costs, perceived credit risk and liquidity shortfalls
	Micro, small and medium-sized enterprises Examples: – Cottage industries – Small enterprises – Households and small-scale farmers *Will work through an accredited Intermediary*	**Information constraints**: Lack of information about climate-related investments	– Pipeline development resources and capacity-building grants
		Capacity constraints: Lack of project development experience	– Capacity support to MSMEs for project appraisal
		Transaction cost constraints: High unit cost of providing finance to MSMEs	– The Fund provides concessional resources through an accredited intermediary that manages a material MSME portfolio

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