Recommendations from the Private Sector Advisory Group: Private Sector Facility: Instruments to Mobilize Private Sector Resources[1]

GCF/B.08/38

6 October 2014

Meeting of the Board
14-17 October 2014
Bridgetown, Barbados
Agenda item 12

[1] On document GCF/B.08/12 *Use of other financial instruments.*

Recommended action by the Board

The Private Sector Advisory Group recommends that the Board:

(a) Take note of the information contained in the GCF/B.08/38 *Recommendations of the Private Sector Advisory Group: Private Sector Facility: Instruments to Mobilize Private Sector Resources*;

(b) Consider these recommendations in its deliberations on the Agenda Item on Use of other instruments.

Recommendations from the Private Sector Advisory Group: Private Sector Facility: Instruments to Mobilize Private Sector Resources

Introduction

The Annex of this document contains recommendations from the Private Sector Advisory Group (PSAG) on document GCF/B.08/12 *Use of other financial instruments*. These recommendations are included as received from the PSAG without changes or editing, including the title of the document.

Annex

Recommendations from the Private Sector Advisory Group: Private Sector Facility: Instruments to Mobilize Private Sector Resources

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)).

2. At its seventh meeting, the Board decided that it will consider further work on the modalities of the Private Sector Facility, including modalities for mobilizing private sector resources at scale by the Private Sector Facility at its eighth meeting (Decision B.07/08 paragraph (e) (i)). The Board requested the Private Sector Advisory Group to make recommendations on modalities and instruments to mobilize private resources at scale including through special financing vehicles or instruments, including risk mitigation instruments (Decision B.07/08 paragraph (f) (ii)).

3. This document contains the recommendations of the Private Sector Advisory Group to the Board in accordance with its mandate to make recommendations to the Board on Fund-wide engagement with the private sector and modalities to that end (Decision B.04/08 paragraph (i)). These recommendations were endorsed by the PSAG at its second meeting of the PSAG took place from 10 to 12 September 2014 in Cape Town, South Africa.

Annex I: Recommendations of the Private Sector Advisory Group: Private Sector Facility: Instruments to Mobilize Private Sector Resources

1. **PSF should be 'open for business'**, ready to make allocations, at the same time that the overall GCF becomes operational.

2. **Intermediaries as Implementation Partners:** While the long term vision of the function of GCF may be to become a financial entity in its own right, today and in the initial operating stages of the Fund, the GCF will not be able to directly contract with clients or structure financial instruments itself in most countries where its funding is intended to be invested. Thus, the PSAG recommends that in the initial stages of the PSF's operations, its partner 'accredited intermediaries' will be accountable for the execution of structuring financial instruments with projects. Partner intermediaries will bear legal liability to projects for the financing it provides. These entities will also bear accountability to GCF to deliver according to the obligations as an "accredited intermediary".

3. **Intermediaries should follow Principles for Deploying Instruments with the Private Sector:** For any funding allocated under the PSF to accredited intermediaries, the PSAG recommends the following Principles as key drivers for decision making and structuring of funding (in any financial instrument) by accredited intermediaries. These principles include:

   (i) "Additionality", meaning GCF funding should not finance anything that can otherwise be financed by the market at commercial terms;

   (ii) Ability to "crowd-in" private investment;

   (iii) Potential for commercial sustainability; and

   (iv) Minimizing the concessionality within instruments. These criteria are important, and should be aligned with country strategies and a supportive enabling environment for private sector investment.

4. **Intermediaries should have the flexibility to deploy any instrument they have capacity and expertise to deploy***:* Intermediaries should have the ability to do this as soon as they are accredited, and the PSF is made operational. There is no need to phase-in instruments in the initial stages when working through intermediaries.

5. Additional guidance for selecting PSF intermediaries should be considered: Selecting and accrediting intermediaries that wish to access PSF should be fully consistent with the accreditation process for GCF as a whole. The PSAG recommends that accredited intermediaries accessing PSF should be selected with additional considerations, including:

   (i) Timing for deployment of funding;

   (ii) Ability to bring in co-financing and/or play a catalytic role as an arranger for certain instruments;

   (iii) Ability to deploy instruments at scale (both in number and volume); and

   (iv) Ability to pilot innovative instruments and share lessons of experience.

6. **Allocations by the Board under PSF should be against an intermediary's ability to deliver GCF objectives**. For allocations under the PSF to accredited intermediaries, the PSAG recommends that the Board should prescribe objectives when allocating PSF funding; Intermediaries will prescribe conditions and terms for projects under those allocations.

I. Background

1. A long term vision of the GCF is that it is a financial entity, operating as an investment fund, with the appropriate capacity and staff, including credit and risk functions, and rated accordingly by independent credit agencies on the functioning of its business and the risk posed by its investments.

2. While the long term vision of the function of GCF may be to become a financial entity in its own right, today and in the initial operating stages of the Fund, the GCF will not be able to directly contract with clients or structure financial instruments itself in most countries where its funding is intended to be invested. Thus, in the initial stages of the PSF's operations, its partner intermediaries will be accountable for the execution of financing to projects, and its partner intermediaries will bear legal and financial liability to projects for the financing it provides. These entities will also bear accountability to GCF to deliver according to the obligations as an "accredited intermediary". Thus, the GCF itself will be taking "intermediary risk" in the first instance, and the intermediaries will be taking project risk. Working through intermediaries also brings additional benefits to GCF, such as co-financing, as well as strong E&S and fiduciary standards.

3. The recommendations of the PSAG contained herein are not meant to preclude in any way the GCF evolving into a fully functioning financial entity with capability over time to structure its own investments directly with project recipients. Recommendations of the PSAG in this document are primarily based on the initial way the GCF will deploy its funding – through its partner intermediaries.

4. **Principles for Deployment of Financial Instruments w/the private sector :** For any funding allocated under the PSF to accredited intermediaries, the PSAG notes the following Principles as key drivers for decision making and structuring of funding (in any financial instrument) by accredited intermediaries. These criteria are important, and should be aligned with country strategies and a supportive enabling environment for private sector investment.

- ***Additionality is important***; GCF funding should not finance anything that can otherwise be financed by the market at commercial terms.
- ***Crowding-in additional capital, explicitly ensuring co-financing of deals by "intermediaries"/partners" is key***, especially for larger investments. Specifically, GCF debt (any type) should crowd-in additional debt; GCF equity should crowd-in additional equity.
- ***Potential for commercial sustainability should underscore investment decisions***: having a clear path to market driven financing. Instruments should be matched, but GCF should be at concessional terms. , same type of capital but at different terms;
- ***For private sector, minimizing the concessional element in instruments is extremely important***. The value of GCF's funding is in its ability to be concessional (relative to market based/priced financing available in the market), but given GCF wishes to catalyze projects that are expected to evolve to commercial viability, intermediaries investing GCF funding into private sector projects should thus structure instruments with the minimum amount of 'concessionality'.

5. These principles should inform the accreditation process for intermediaries seeking to access PSF funding, and should be incorporated into the legal arrangement between GCF and those accredited intermediaries.

6. In the long term, when GCF is fully functioning as a financial entity, these principles should drive the internal decision making and structuring by GCF PSF staff.

7. **Categories of Instruments under PSF:** In general, PSF funding could be deployed in the following instruments:

- Concessional Debt
- Equity, quasi-equity (patient equity)
- Guarantees & approaches that can provide credit enhancement
- [Climate] Insurance[2]

8. **Intermediaries should have the ability to deploy any instrument they have capacity and expertise to deploy**, as part of their normal course of business. Intermediaries should have the ability to do this as soon as they are accredited, and the PSF is made operational*.* There is no need to phase-in instruments in the initial stages when working through intermediaries. In the long term, when GCF is able to transact directly with project sponsors, it may be appropriate for GCF to deploy instruments according to their capacity and competence. This may result in practice in a "phased-in" approach to instruments whereby GCF makes its direct investments in the form of grants and debt in the first phase, and equity and other instruments when they have the capacity (technical, credit, legal) to undertake direct investments with these instruments.

9. **Principles for Selecting PSF intermediaries.** Selecting and accrediting intermediaries that wish to access PSF should be fully consistent with the accreditation process for GCF as a whole. The PSAG notes that accredited intermediaries accessing PSF should be selected with the following additional considerations:

- PSF Intermediaries receiving allocations should be selected based on ability to deliver GCF objectives <u>and</u> ability to deploy in a timely manner (eg: no more than 9-18 months)
- Intermediaries should ability to deploy instruments at scale (number and $ volume), but also should be encouraged to deploy instruments in innovative ways, and consider prototyping new forms of concessional instruments (debt, equity, guarantees/credit enhancement, insurance). GCF should encourage and facilitate intermediaries to share lessons of experience from instruments across other financial actors in the market.
- For project financing, intermediaries should bring co-financing. Intermediaries should also be encouraged to play a catalytic role as an arranger of certain instruments (eg: green bonds*)* or developing refinancing facilities for operating assets.
- Terms of the instruments should be priced concessionally to attract other financing and to catalyze investments that wouldn't otherwise happen; The GCF Board/Sec should not prescribe financial terms and conditions for instruments that intermediaries structure. Intermediaries should price GCF instruments in

[2] While most financial intermediaries will have the capability to deploy concessional debt, equity and guarantee, insurance may require unique data modeling skills and structuring. An intermediary for this product may necessarily need to be an insurance company or similar institution with access to such resources.

an appropriate manner, which is consistent with the Principles for Deployment of Financial Instruments with the Private Sector (see above).

II. General Recommendations

- The GCF (its Board and Secretariat) need to be clear that in the initial operations, GCF will rely on intermediaries, and those intermediaries will structure and execute financial instruments with GCF funding, and on behalf of GCF.
- Emphasis should be on getting PSF going quickly, in an efficient manner. PSF should be 'open for business,' ready to make allocations, at the same time that the overall GCF becomes operational. Incentives to intermediaries receiving allocations should emphasize timing for deployment (eg: ability to deploy quickly), key objectives. Intermediaries should be given flexibility to deploy any instrument they are capable of structuring and deploying. The Board should not prescribe conditions/terms of those instruments.
- Board/governance structure and process needs to be predictable, efficient.
- The Board should prescribe conditions to allocate against GCF objectives; Intermediaries will prescribe conditions and terms for projects under those allocations. Options include doing so through a procurement process (procuring intermediaries to do XYZ), or others.

III. Timing of "new instruments"

- If GCF wants immediate action from the Fund, GCF should allow intermediaries to deploy debt and grant instruments flexibly - - eg: grants as equity, first loss; concessional debt in any level of seniority.
- In the absence of fully flexibility, start debt and grants first, and others as quickly as we can; nothing should prevent us from deploying GCF funding in additional instruments as soon as the Fund is operational.
- Time to disbursement should be a priority; not the instruments that are used to make the investments.

IV. Attractiveness of instruments

- Attractiveness should also consider the objectives of the fund, e.g.: CO2 abated, jobs created, etc.
- How much capital does an instrument bring in, in addition to GCF's funding is a better, more clear and simple measure than "leverage".
- Replicability is important.

10. **Ranking 'attractiveness' of instruments does not seem to be a useful exercise.** An instrument's attractiveness is relative to the project being financed, the sponsor/actor (e.g.: attractive to whom? SME, infra financing, financial service, agriculture, early stage companies/start up?)

V. Other Notes from the discussion

- Senior debt may not be attractive in some countries; with strong concessionality it may be more attractive (eg: Chile);
- Debt on concessional terms is highly valuable in some markets;
- Concessionality is key;
- More value for the fund to provide equity – MG;
- As a general matter, there are fewer sources of equity for projects that might be eligible for GCF funding;
- Both debt and equity have the same perspective on offtaker risk;
- Guarantee: PRG guarantee/insurance product. Would be a game changer if GCF was able to provide off-taker guarantee. PRG guarantee. This is often a credit committee requirement, regardless of the structure. Useful for large infrastructure; BUT: the execution needs to be quick (eg: a month);
- Completion support guarantee;
- Supporting micro-funds is important.