



GREEN
CLIMATE
FUND

Financial Terms and Conditions of the Fund's Instruments

GCF/B.09/08

17 February 2015

Meeting of the Board

24-26 March 2015

Songdo, Republic of Korea

Agenda item 10

Recommended action by the Board

It is recommended that the Board:

- (a) Take note of the information presented in document GCF/B.09/08 *Financial Terms and Conditions of the Fund's Instruments*; and
- (b) Adopt the draft decision presented in Annex I to this document.

Financial Terms and Conditions of the Fund's Instruments

I. Introduction

1. The Governing Instrument, paragraph 54, states that:
"The Fund will provide financing in the form of grants and concessional lending, and through other modalities, instruments or facilities as may be approved by the Board."
2. At its fifth meeting, the Board adopted the principles and factors for the terms and conditions of grants and concessional loans for the initial operationalization of the Green Climate Fund (decision B.05/07, Annex III). 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 maintain the flexibility to receive financial inputs on an ongoing basis, 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 requested the Secretariat to revise document GCF/B.06/16 *Financial Terms and Conditions of Grants and Concessional Loans* for the seventh Board meeting, taking into account the ongoing work on the financial risk management and investment frameworks (decision B.06/12).
5. At the seventh Board meeting, it was agreed that, to allow Board members to focus on the remaining essential requirements for the commencement of the resource mobilization, the revision of *Financial Terms and Conditions of Grants and Concessional Loans* was deferred to the eighth meeting of the Board.
6. At the eighth Board meeting, the policies for contribution to the Green Climate Fund were endorsed (decision B.08/13). At the same meeting, document GCF/B.08/11 *Financial Terms and Conditions of Grants and Concessional Loans* was considered. Board members gave guidance and feedback but no decision was taken under the agenda item.
7. It was also decided at the eighth Board meeting that the Fund will work through accredited implementing entities and intermediaries, who may deploy the resources in approved projects and programmes by using financial instruments, focusing on grants, concessional loans, equity, and guarantees (decision B.08/12).
8. The purpose of this document is to outline options for the financial terms and conditions to be adopted by the Board for grants and non-grant instruments to be initially provided by the Fund.

II. Constraints on the range of possible financial terms and conditions for the Fund's provision of grants and non-grant instruments

9. Certain prior Board decisions will set boundaries on the financial terms and conditions that the Fund can apply to its grants and other financial instruments. These include the guiding principles and factors for determining terms of financial instruments, the Fund's financial policies (comprising financial risk policies and investment policies) and contribution policies, as further described below.

2.1 Guiding principles and factors for determining terms of financial instruments

10. According to the guiding principles and factors for determining terms of financial instruments (decision B.05/07, Annex III), when determining terms of financial instruments applicable to both public and private operations, the following factors will need to be taken into account:

- (a) The average concessionality or grant element of the financial inputs to the Fund and the average concessionality or grant element of financial instruments of the Fund;
- (b) The grant element of concessional finance will be tailored to provide the appropriate incentive to facilitate the implementation of mitigation and adaptation activities;
- (c) Concessional forms of finance will be designed to minimize market distortions and potential disincentives to private investment;
- (d) The expertise and capacity of financial intermediaries and implementing entities; and
- (e) The risk sharing between public and private investment, when relevant.

2.2 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.

2.3 Contribution policies

11. The policies for contributions were endorsed by the Board at its eighth meeting. These policies outline the parameters for financial inputs to the Fund:

- (a) **Amount of funding mobilized:** At the time of writing, US\$ 10.2 billion equivalent has been pledged to the Fund;
- (b) **Percentage of non-grant pledges** (in nominal terms): At the time of writing and subject to final contribution agreement, US\$ 381.3 million equivalent has been pledged in the form of loans. The remaining US\$ 9.8 billion equivalent has been pledged in the form of grants. Therefore the percentage of non-grant pledges to total pledges is 3.7 per cent;

- (c) **Cost of funding** (i.e. terms of incoming contributions): At the time of writing, US\$ 381.3 million¹ equivalent has been pledged with an interest rate of zero per cent with 25 years of maturity, including a 5-year grace period;
- (d) **Initial prudential debt limit** (i.e. ratio of loans to total funding received at portfolio level): A maximum level of 20 per cent of loans to total funding on an aggregate basis was endorsed. Individual contributors must provide loan amounts that are no greater than 40 per cent of their total contribution. At the time of writing, the individual debt limit has not been reached for any contributor and the Fund’s loan to total funding is within the limit at 3.7 per cent;
- (e) **Loan cushion** (i.e. loan cushion required alongside loans received): A level of 20 per cent loan cushion was endorsed. At the current level of loans received, US\$ 76.26 million equivalent (20 per cent of US\$ 381.3 million equivalent) is to be set aside as loan cushion and cannot be used to provide grants or loans; and
- (f) The policies for contributions specify that contributions may be received in major convertible currencies. The Fund will have multiple holding currencies.² In order to manage exchange risk related to multiple currencies, it was agreed that the Fund will, wherever possible, extend non-grant instruments in the same currencies as the contributions received.
12. The financial terms and conditions for grants and non-grant instruments proposed in this document for consideration by the Board align with these prior constraints.

III. Financial terms and conditions of grants and non-grant instruments

13. As outlined in the guiding principles and factors for determining terms of financial instruments (decision B.05/07, Annex III), the Fund will seek the right level of concessionality, so as not to displace investments that would otherwise have occurred, including for private-sector investment, and will avoid crowding out commercial financing.

14. Terms will be structured on a case-by-case basis to address specific barriers and the Fund will apply due diligence to assess the risk of the investment. Furthermore, the Fund will consider levels of indebtedness capacity of the recipient so as not to encourage excessive indebtedness. The terms of financing must promote the long-term financial sustainability of the Fund.³

15. The policies for determining financial terms and conditions of grants and non-grant instruments as outlined in this document have been developed based on best practice of other relevant institutions. An overview of this best practice is outlined in Annex III to this document.

¹ GCF/B.08/16, Annex IV, “Indicative grant equivalence of the Fund loan contributions”.

Maturity	Grace Period	Interest Rate	Discount Rate	Grant Equivalence
25	5	0.00% p.a.	2.65% p.a.	27.57%

² Currently US dollar, Euro, Yen, GB pound.

³ Decision B.05/07, Annex III.

3.2 Financial terms and conditions of outgoing grants

16. Financing will be tailored to cover the identifiable additional costs of the investment necessary to make the project viable.⁴ 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.

17. The terms and conditions of such repayable grants would be determined on a case-by-case basis. All grants will be repayable by the recipient in cases involving corruption or other non-compliance with integrity or fiduciary standards.

18. The financial terms and conditions of grants are outlined in Table 1.

Table 1: Financial terms and conditions of outgoing grants

	Currency	Repayment terms*
Grants	Major convertible currency	Grants without repayment contingency: no repayment required Grants with repayment contingency: terms adapted to the requirement of the project or programme

* All grants will be subject to an obligation for repayment if the recipient is found to be in material breach of its contractual obligations towards the Fund or involved in a material violation of the Fund's integrity or fiduciary standards, including those on corruption and fraud.

3.3 Financial terms and conditions of outgoing concessional loans to the public sector

19. For projects and programmes with loans to public sector recipients, the Fund will use differentiated terms: deeply concessional terms will be offered to vulnerable countries, while less concessional terms will be offered to other countries as follows:

Table 2: Financial terms and conditions of outgoing loans to the public sector

	Currency	Maturity (Years)	Grace period (Years)	Annual principal repayment years 11-20/6-20 (% of initial principal)	Annual principal repayment years 21-40 (% of initial principal)	Interest
To vulnerable countries	Major convertible currency	40	10	2%	4%	0.25%
To other recipients	Major convertible currency	20	5	6.7%	N/A	0.75%

20. This proposal is in line with the Global Environment Facility (GEF) recent policy of extending loans to the public sector, but it is recommended to have a 5-year grace period for other recipients, rather than 10 years as adopted by the GEF.

21. The classification of a country as a vulnerable country will be determined if it falls into the vulnerable countries category by one or more of the reference criteria listed in Annex IV to this document.

⁴ Governing Instrument, paragraph 54.

22. 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 resource mobilization costs.

IV. Options for financial terms and conditions of outgoing non-grant instruments for the private sector

23. Resources that the Fund provides to the private sector may be extended at concessional rates. Much of the literature on the economics of climate change has demonstrated that the choice of interest rate when making investment decisions relating to climate change is very uncertain. Because of the effects of compounding, and because many of the benefits of such investments will not be felt until many years in the future, the interest rate has extreme effects on investment decisions. A high interest rate dampens the effects of positive climate change impacts, whereas a lower interest rate will amplify the benefits (or costs) that are felt very far into the future, and will make climate change investments seem more attractive than their fossil-fuel alternatives. Therefore, climate change investments are less likely to take place when investors are using a high interest rate.

24. Martin L. Weitzman,⁵ a prominent climate change economist, proposes to err on the side of caution and use an interest rate that is lower than the market rate as a form of "catastrophe insurance" to ensure that investments with climate change benefits take place now. This "catastrophe insurance" is needed to offset low-probability but potentially catastrophic climate events which have extremely negative effects on economic growth that are difficult to compensate by ordinary savings. The Fund will take these considerations into account when determining its financial terms of outgoing non-grant instruments for the private sector.

25. The Fund can offer the following financial instruments through intermediaries to climate change projects and programmes:

- (a) Concessional loans (senior and subordinate);
- (b) Equity; and
- (c) Guarantees.

26. When providing non-grant instruments to the private sector, the Fund will tailor its terms to cover the incremental cost or risk premium required to make the investment viable. In doing so, the Fund will avoid crowding-out of commercial sources of financing and will seek to achieve its objectives while catalysing other investments. This practice is also in line with the Fund's guiding principles and factors for determining terms of financial instruments and with the GEF policy of extending non-grant instruments to the private sector.

27. Terms will be structured on a case-by-case basis, and will take into account the risk and return profile of a project or programme, including its potential for meeting the Fund's paradigm shift objectives. Instruments will be extended in major convertible currencies.

28. The terms that the Fund offers to the private sector will not be more concessional than those offered to the public sector. They will incorporate the least concessional interest rate offered to the public sector. They will also include a credit risk premium that does not take into account sovereign risk, and will also include a concessionality premium that is commensurate with the potential that the project or programme has in advancing the Fund's objectives.

⁵ Weitzman, M.L., 2007, *A Review of The Stern Review on the Economics of Climate Change*.

Weitzman, M.L., 2011, *Fat-Tailed Uncertainty in the Economics of Catastrophic Climate Change*.

Interest rate =

*Least concessional interest rate offered to the public sector
(e.g. 0.75 per cent or cost of borrowing whichever is greater)*

+ Credit risk premium (excluding sovereign risk)

– adjusted for concessionality premium commensurate with impact

29. The concessionality of the Fund's non-grant instruments to the private sector will therefore decrease as credit risk increases, but will increase as the impact potential of the project increases. Since the terms that the Fund offers to the private sector will not be more concessional than those offered to the public sector, the concessionality premium can never be greater than the credit risk premium.

30. Maturity periods will be kept to a minimum in order to prevent inefficient allocation of resources and the locking-in of recipients into debt for too long. The maximum maturity for private sector loans is therefore 20 years and the maximum grace period is 5 years.

31. In addition to charging an interest rate on extended non-grant instruments, 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 resource mobilization costs.

V. Recommendations and next steps

32. 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.09/08 *Financial Terms and Conditions of the Fund's Instruments*:

- (a) Notes that the Fund will provide grants both with and without repayment contingency;
- (b) Decides that the terms and conditions of grants with repayment contingency would be determined on a case-by-case basis;
- (c) Also decides that the Fund will use differentiated terms for non-grant instruments to the public sector: highly concessional terms will be offered to vulnerable countries as defined in Annex IV to this document, while less concessional terms will be offered to other countries;
- (d) Adopts the financial terms and conditions for grants and concessional loans as contained in Annex II to this document;
- (e) Decides that the financial terms and conditions of non-grant instruments to the private sector will be less concessional than those to the public sector and will be determined on a case-by case basis. Financial terms will be calculated based on:
 - (i) The least concessional interest rate offered to the public sector;
 - (ii) A credit risk premium that does not take into account sovereign risk; and
 - (iii) A concessionality premium that is commensurate with the potential that the project or programme has in advancing the Fund's objectives;
- (f) Requests the Secretariat to develop a pricing methodology for private operations that takes into account the three factors in paragraph (e) and to present it for consideration by the Board at its tenth meeting.

Annex II: Financial terms and conditions of grants and non-grant instruments

1. The Fund's financial terms and conditions of grants and concessional loans are outlined in the tables 1-3.

Table 1: Terms and conditions of outgoing grants

	Currency	Interest rate	Maturity	Grace period
Grants	Major convertible currency	Grants without repayment contingency: no reimbursement required ¹ Grants with repayment contingency: terms adapted to the required concessionality of the project or programme		

All grants will be subject to an obligation for repayment if the recipient is found to be in material breach of its contractual obligations towards the Fund or involved in a material violation of the Fund's integrity or fiduciary standards, including those on corruption and fraud.

Table 2: Terms and conditions of outgoing concessional loans to the public sector

	Currency	Maturity (years)	Grace period (years)	Annual principal repayment years 11-20/6-20 (% of initial principal)	Annual principal repayment years 21-40 (% of initial principal)	Interest	Service fee	Commitment fee
To vulnerable countries	Major convertible currency	40	10	2%	4%	0.25%	0.50% p.a.	0.75% p.a.
To other recipients	Major convertible currency	20	5	6.7%	NA	0.75%	0.50% p.a.	0.75% p.a.

The terms and conditions for non-grant instruments to the public sector, other than concessional loans, will be established on a case-by case basis.

Table 3: Terms and conditions of outgoing concessional loans to the private sector¹

	Currency	Maturity (years)	Grace period (years)	Interest	Service fee	Commitment fee
To the private sector	Major convertible currency	Up to 20	Up to 5	0.75% + credit premium – concessionality premium	0.50% p.a.	0.75% p.a.

The terms in table 3 refer to concessional loans (both senior and subordinated). The terms and conditions of outgoing non-grant instruments, other than concessional loans, to the private sector will be developed based on the same principles as those for concessional loans, and will be determined on a case-by-case basis.

¹ In the event of private sector operations where the project sponsor is the obligor and the intermediary takes an agent role, the Fund may be required to pay a fee to the intermediary administering the funding. While such additional costs would be borne by the obligor, the terms of the funding would take these into account.

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

I. Clean Technology Fund

1. The Clean Technology Fund (CTF) offers grants and two loan products:
 - (a) The maximum preparation grant for investment plans or projects is US\$ 1 million. A fee of 5 per cent from the CTF Trust Fund for the fee of the multilateral development banks (MDBs) for administering and supervising individual preparation grants has been agreed;
 - (b) Highly concessional loans (0 per cent interest rate, 40 years maturity, 10-year grace period, 0.25 per cent service charge) for projects with:
 - (i) Negative rates of return; and
 - (ii) Rates of return below normal market threshold;
 - (c) Less concessional loans (0 per cent interest rate, 20 years maturity, 10-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 low-carbon technology will have higher opportunity costs;
 - (d) A fee of 0.18 per cent on the concessional loans has been agreed to cover the MBDs' 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 MDBs²

II. International Development Association

3. The lending terms of the International Development Association (IDA) 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 made less concessional to reflect their stronger financial capacity. The new terms combine the old blend terms (35-year maturities) for blend countries and new term credits (20-year maturities) for gap countries in a new blend credit with a 25-year maturity, 5-year grace period and 1.25 per cent interest rate (in addition to the standard service charge of 0.75 per cent and commitment charges); and
 - (b) The maturity of the IDA's less concessional credits was shortened from 35 years to 25 years, with a 5-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.

² Clean Technology Fund: Financing Products, Terms and Review Procedures for Public Sector Operations, November 2013.

Table 1: Summary of the International Development Association's current lending terms by product type in financial year 2013

Product type	Maturity (years)	Grace period (years)	Service charge¹ (%)	Interest (%)
Grants	NA	NA	NA	NA
Regular	40	10	0.75	NA
Blend	25	5	0.75	1.25
Less concessional term	25	5	0.75	1.5
Partial risk guarantee	NA	NA	0.75	NA

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

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

III. International Finance Corporation

4. The International Finance Corporation 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.

IV. Global Environment Facility³

5. The Global Environment Facility (GEF) is currently undertaking a non-grant instrument pilot to support the achievement of the GEF's objectives through the use of non-grant instruments for targeted investments that promote global environmental benefits. These instruments include *inter alia*:

- (a) Credit guarantee (partial/full);
- (b) Performance risk guarantee;
- (c) Structured financing;
- (d) Equity/investment fund;
- (e) Revolving equity fund;
- (f) Contingent loan;
- (g) Concessional loan; and
- (h) Revolving loan fund.

6. For projects/programmes with private-sector recipients, a relevant GEF partner agency will negotiate an appropriate concessional rate or return on investment, which, consistent with the agencies' regular practices, ensures a minimum level of concessionality; avoids displacing other finance; and catalyses other investments. GEF resources can take a junior or first-loss position if justified. The maximum maturity for private-sector loans is 20 years; the exit date for equity investments will be determined on a case-by-case basis.

³ GEF-6 Non-Grant Instrument Pilot and Updated Policy for Non-Grant Instruments, GEF/C.47/06.

7. For projects/programmes with loans to public-sector recipients, the pilot will use differentiated terms: highly concessional terms will be offered to the least developed countries and small island developing States, while less concessional terms will be offered to other countries. These are based on IDA terms and are as follows:

Table 2

Global Environment Facility concessional loans under its non-grant instrument pilot	Maturity (years)	Grace period (years)	Annual principal repayment years 11-20 (% of initial principal)	Annual principal repayment years 21-40 (% of initial principal)	Interest
To vulnerable Countries	40	10	2%	4%	0.25%
To other recipients	20	10	10%	NA	0.75%

Annex IV: Country classification

The classification of a country as a vulnerable country will be determined if it falls into the vulnerable countries category by at least one of the reference criteria contained in the table below.

Table 1: Vulnerable countries category

References	Vulnerable countries	Other recipient countries
United Nations Framework Convention on Climate Change (UNFCCC)	LDCs, SIDS	Non-Annex I countries not included in LDCs and SIDS
Organization for Economic Co-operation and Development (OECD)	LDCs, other low-income countries, lower middle-income countries and territories	Upper middle-income countries and territories
World Bank Group (WBG)	Low-income economies	Lower middle-income economies, upper middle-income economies
International Development Association (IDA)	IDA only countries	IDA blend countries*

* IDA-eligible but also creditworthy for some IBRD borrowing.