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Review of the initial modalities of the Private Sector Facility – Addendum II

Consideration of modalities to support activities to enable domestic and international private sector actors to engage in GCF activities in least developed countries and small island developing States

Summary

This document proposes modalities that will facilitate the engagement of private sector actors in least developed countries and small island developing States, based on Private Sector Advisory Group (PSAG) recommendations. It further benefits from (i) experience gained by the Private Sector Facility in its current engagements with least developed countries and small island developing States; (ii) knowledge and insights gained while articulating the Private Sector Facility's long-term strategy to engage the private sector in developing countries as relevant for GCF operations; and (iii) an analysis of the Private Sector Facility's current portfolio and pipeline.

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I. Introduction

1. The Governing Instrument for the GCF, paragraph 43, made provision for a Private Sector Facility (PSF) to "support activities to enable private sector involvement in LDCs and SIDS." At its nineteenth and twentieth meetings, the Board, through decisions B.19/18, paragraph (b) and B.20/03, paragraph (b)(vi), requested "the Secretariat to develop modalities, based on the recommendations from the Private Sector Advisory Group (PSAG), to support activities to enable domestic and international private sector actors to engage in GCF activities in least developed countries and small island developing states." The recommendations from the PSAG were presented to the Board at its nineteenth meeting (document GCF/B.19/31 titled "PSAG recommendations on the development of modalities to support activities enabling private sector involvement in LDCs and SIDS").

2. The objective of this document is to propose modalities that will facilitate the engagement of private sector actors in least developed countries (LDCs) and small island developing states (SIDS), based on PSAG recommendations. It further benefits from:

(a) Experience gained by the PSF in its current engagements with LDCs and SIDS;

(b) Knowledge and insights gained while articulating the long-term strategy of PSF to engage the private sector in developing countries as relevant for GCF operations; and

(c) An analysis of the current portfolio and pipeline of the PSF.

3. This paper is organized as follows:

(a) Section 2 provides the background and context on LDCs and SIDS – on the climate change challenges – as well as specific economic and social vulnerabilities;

(b) Section 3 presents a brief analysis of the portfolio and pipeline in LDCs and SIDS of the PSF, which allows the stocktaking of lessons learned thus far; and

(c) Section 4 draws on the above to provide concrete recommendations for the Board's consideration of additional actions that PSF and GCF should undertake based on its current approach, as well as future modalities that will support activities devised to enable the domestic and international private sectors to engage in climate-related activities in LDCs and SIDS with GCF support.

4. This paper presents six modalities to be prioritized by the GCF to support activities that enable domestic and international private sector involvement in LDCs and SIDS. The first three will be implemented through existing GCF channels:

(a) Strategic use of readiness support, Project Preparation Facility (PPF) and public sector "climate policy" lending instruments;

(b) Better utilization of current instruments to support the private sector in adaptation in LDCs and SIDS; and

(c) Prioritize strong institutions in accreditation that can support private sector projects in LDCs and SIDS.

5. The remaining three consist of new, specific investment vehicles and modalities that will support private sector investment to support LDCs and SIDS in leapfrogging and transitioning towards low emission and climate-resilient development:

(a) Piloting local currency funding for LDCs and SIDS;

(b) Early incubation for seeding climate-focused and centres of excellence; and

(c) Mobilizing private sector finance for adaptation via targeted endowments at country level.

II. Background and context

6. Information presented in this section will further the understanding of the LDCs and SIDS context relevant to stimulate climate investments by presenting the grouping status and definition, setting the context of the state of climate change, providing the socio-economic characteristics, as well as financial information relevant for the engagement of both domestic and international private sector actors in these countries.

2.1 Grouping status and definition

7. **Least developed countries.** The Committee for Development Policy[1] defines LDCs as low-income countries suffering from the most severe structural impediments to sustainable development. The Committee for Development Policy uses three criteria to classify countries as LDCs: per capita gross national income, Human Asset Index, and the Economic Vulnerability Index. According to the United Nations Office of the High Representative for Least Developed Countries, Landlocked Developing Countries and Small Island Developing States, the countries currently included in the official LDC list represent the poorest and weakest segment of the international community. They currently comprise more than 880 million people, which is about 12 per cent of the world population, but account for less than two per cent of world gross domestic product (GDP). The low level of socioeconomic development in these countries features weak human and institutional capacities, low and unequally distributed income, as well as scarcity of domestic financial resources. These factors constitute major impediments to the adaptive capacity of these countries and represent a very high factor of their vulnerability to climate variability, as well as to the already observed and projected changes in the climate. The current list of LDCs consists of 47 countries, with 33 in Africa, 12 in Asia-Pacific, and 1 in the Caribbean.

8. **Small island developing States.** Located in some of the most disaster-prone regions in the world (mostly the Caribbean, the Pacific, the Atlantic, the Indian Ocean, the Mediterranean and the South China Sea), SIDS represent two-thirds of countries with the highest relative annual losses due to disasters. There are 38 United Nations members identified as SIDS, 7 of which are also LDCs. The list of SIDS also includes 20 other non-United Nations members/associates of regional commissions.

2.2 Climate change context

9. Although climate change impacts are already being felt globally, future changes in climate patterns are expected to have even more adverse implications, most importantly for developing countries that are unfortunately ill prepared to face those challenges. Climate change is expected to impact countries differently, depending on such factors as their location and level of development. These specificities can potentially constitute significant structural barriers to development in LDCs and SIDS.

10. These countries are in regions of the world that are among the most vulnerable to climate change and are projected to experience high multiple interrelated climate risks, at any

[1] The Committee for Development Policy of the United Nations Economic and Social Council is responsible for reviewing, on a triennial basis, the list of LDCs and to recommend countries for inclusion into or graduation from the list.

level of global warming, from the current level of approximately 1 °C of global warming above pre-industrial levels registered since 2017. It affects, among others, the mean as well as the temporal and spatial distribution of temperature and precipitation, the intensity and frequency of storms as well as sea levels and could further increase climatic hazards such as heat waves, droughts and flood, reduced freshwater availability and increased ground-level ozone. The following sections will present a summary of key climate change issues, including impacts on economic sectors in LDCs and SIDS.

11. Many LDCs and SIDS are situated in regions of the world expected to be severely affected by temperature and precipitation changes. In the majority of LDCs, climate-sensitive economic sectors, such as agriculture, are more important for the generation of economic output and income than in other countries. Due to their low level of development, climate change is already increasing the existing climate vulnerability in LDCs, making them less resilient to negative externalities and leaving them with lower capacity to adapt than other developing countries. As a result, climate change vulnerability can be regarded as a structural impediment to development and as a vulnerability amplifier, as it may drastically aggravate existing handicaps. Climate change will amplify natural disasters in LDCs, from climatological (e.g. drought and extreme temperatures), hydrological (e.g. floods) and meteorological (e.g. storms) origin.

2.3 Socio-economic characteristics

12. **Least developed countries.** GDP per capita varies in LDCs, with the lowest being USD 320 (Burundi) and the highest being USD 4,170 (Angola). In 26 LDCs, the GDP per capita falls below USD 1,000, while that for the world stands at USD 10,714.5. A closer look at the GDP composition indicates that agriculture tends to play a crucial role in many LDCs: 28 LDCs have an agriculture sector that is contributing between 15 to 60.3 per cent of their GDP, while that for the world is 6.4 per cent. This renders LDCs more vulnerable to climate change impacts, such as unpredictable changes in weather patterns. United Nations Conference on Trade and Development data shows that extreme weather events increased fivefold from the period of 1970–79 to 2000–10, resulting in over USD 14 billion in losses. Coupled with ineffective management and operations, the various segments of the agriculture sector in LDCs, including cropland, livestock, forestry and fishing, are likely to suffer. Reduced agricultural productivity, production stability and incomes in areas with already high levels of food insecurity put LDCs at risk. Finally, high political risk acts as a further obstacle towards the implementation of climate projects in LDCs. Some of them are fragile states and/or affected by their conflict or post-conflict status, including Central African Republic, Somalia, South Sudan and Yemen, which results in high rates of displacement of people across war zones and creates further vulnerabilities.

13. **Small island developing States.** This grouping of countries tends to encounter similar constraints in their sustainable development efforts, which include, among others: (a) Narrow resource base depriving them of the benefits of economies of scale; (b) Small domestic markets and heavy dependence on external and remote markets; (c) High costs for energy, infrastructure and transportation; (d) Long distances from export markets and import resources; (e) Little capacity for resilience to natural disasters; (f) High volatility of economic growth; limited opportunities for the private sector and a proportionately large reliance of their economies on their public sector; and (g) Fragile natural environments. All but two SIDS (Singapore and Bahamas) had a GDP per capita below USD 20,000 in 2017, with the lowest being Guinea-Bissau, at USD 724. Based on the World Bank's latest thresholds for income level classifications, 8 of the SIDS are high income countries, while 25 are middle income and 3 are low income countries.

2.4 Financial indicators

2.4.1. Least developed countries

14. Financing in LDCs is not readily available to address climate change risks. In the majority of LDCs, the underdeveloped capital markets and the lack of a financial system reflect on the range of options in terms of financial instruments and products offered locally. This is combined with a lack of appropriate and clear banking regulations and adequate institutional arrangements to support the development of climate mitigation and adaptation projects and programmes on a national level. This has practical implications on the appetite of the private sector (project developers, investors and financiers) to invest in LDCs. As a result, LDCs are dependent on aid to finance infrastructure development and capacity-building. According to the Organisation for Economic Co-operation and Development, concessional finance represents the bulk of external financial resources, standing at 62 per cent, in contrast to 11 per cent for the rest of the world. Therefore, LDCs generally have limited capacity to attract flows beyond aid. This is also proven by the fact that out of the 47 LDCs, 29 were ranked as below average (bottom 25 per cent) in the Ease of Doing Business 2018 index.[2] Due to weak policies and institutions, these countries also have lower debt-carrying capacities and lack access to an adequate level of financing. Coupled with high political risk and the immaturity of markets, investment in LDCs is typically much riskier. Compared to the 2016 world average of 128.9 per cent in terms of domestic credit to private sector as a percentage of GDP, most LDCs ranged from 3.47 per cent to 37.37 per cent in 2017.[3]

2.4.2. Small island developing States

15. While several market-driven financing mechanisms have become available globally, they are not equally and easily accessible to all SIDS. Foreign direct investments and other flows of private finance to SIDS are highly volatile and contribute only 12 per cent to SIDS' external sources of financing from 2012 to 2015. Remittances remain the largest flow of external financing. At the same time, such limited concessional finance to SIDS is unevenly distributed: 54 per cent of the total volume of concessional finance was directed to just five SIDS.[4] Out of the 38 countries, only Singapore is classified as "very easy" in the World Bank's 2018 Ease of doing business index, where it is placed only after New Zealand.[5] Low levels of domestic credit to the private sector as a percentage of national GDP is another indication of the existing barriers in terms of access to finance in general, as well as the low baseline of private sector development and financial markets infrastructure.

16. The analysis presented above indicates the multiple challenges of private sector (domestic and international) engagement and investment in climate mitigation and adaptation, in the context of LDCs and SIDS, considering the wide range and diversity of LDCs and SIDS, as well as their specificity in terms of climate vulnerabilities, economic conditions, growth perspective, depth of capital markets, etc. The proposed modalities will require a strategic approach to support these countries in attracting additional investment and innovation in terms of modalities and business models to achieve effective and efficient climate interventions. They should be informed by experiences the GCF has had in engaging the private sector in LDCs and

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[2] World Bank Group. 2018. *Doing Business 2018*. Available at: <http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2018-Full-Report.pdf>. Ranking table found at Wikipedia, <https://en.wikipedia.org/wiki/Ease_of_doing_business_index>.
[3] Ibid.
[4] OECD. 2018. Making Development Co-operation Work for Small Island Developing States. Available at <http://www.oecd.org/publications/making-development-co-operation-work-for-small-island-developing-states-9789264287648-en.htm>.
[5] Ibid.

SIDS. The following section will present a summary of GCF interventions to date in LDCs and SIDS, with a focus on efforts to engage the private sector.

III. GCF Intervention in LDCs and SIDS

3.1 GCF portfolio analysis

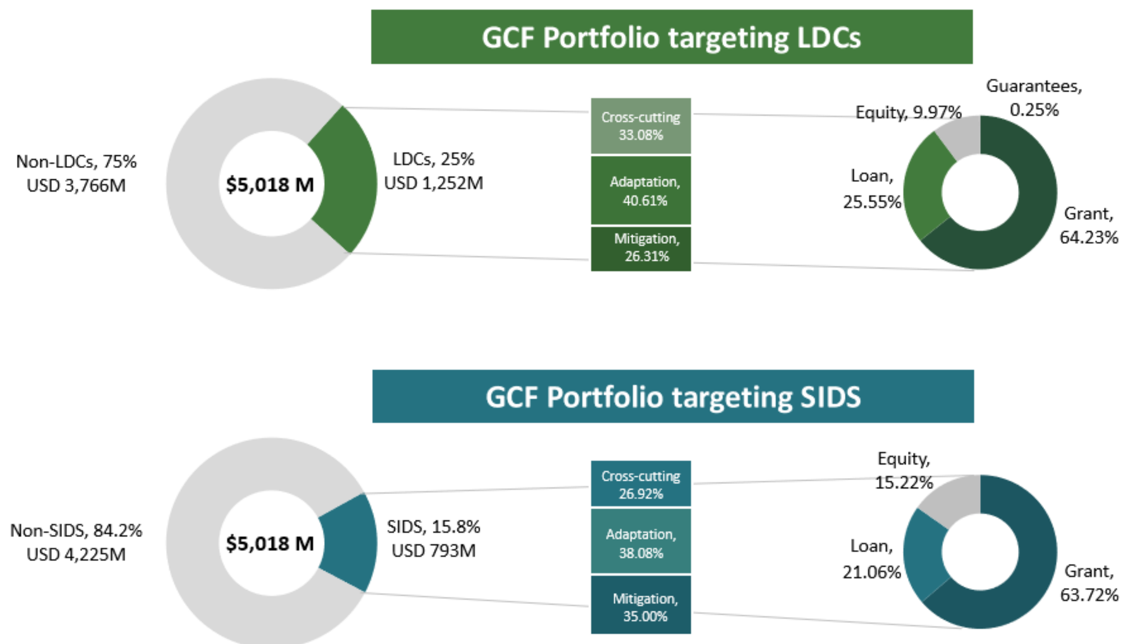
17. Since the first consideration of approved projects by the Board in November 2015 at its eleventh meeting, the Board has approved 102 projects. As of 30 April 2019, approved GCF funding amounts to USD 5.0 billion, totalling USD 17.6 billion when taking co-financing into account.

3.1.1. GCF portfolio analysis on LDCs and SIDS

18. Of the 102 GCF approved projects, 38 projects totalling USD 1.25 billion (25 per cent) of the total GCF funding are dedicated to LDCs. On a thematic basis, 40.61 per cent of GCF LDC funding is allocated to adaptation projects, 33.08 per cent to cross-cutting projects and 26.31 per cent to mitigation projects. The GCF LDC portfolio is financed by 64.23 per cent grants, followed by 25.55 per cent loans, 9.97 per cent equity and 0.25 per cent guarantees.

19. Of the 102 GCF approved projects, 22 projects totalling USD 793 million (15.80 per cent) of the total GCF funding is dedicated to SIDS. As for the breakdown by the thematic areas, 38.08 per cent is allocated to adaptation projects, 35 per cent to mitigation projects, and 26.92 per cent to cross-cutting projects. The GCF SIDS portfolio is financed 63.72 per cent by grants, 21.06 per cent by loans and 15.22 per cent by equity.

Figure 1: GCF portfolio analysis on LDCs and SIDS



Abbreviations: CN = concept note, LDCs = least developed countries, M = million, SIDS = small island developing states.

3.1.2. Private sector portfolio analysis

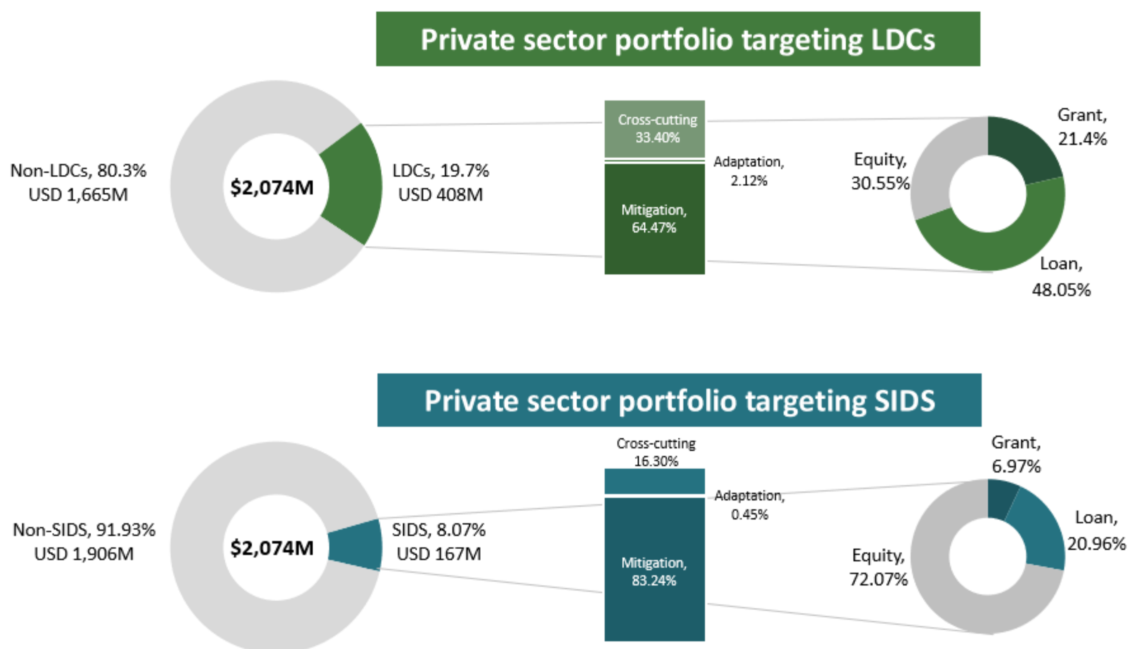
20. The GCF portfolio is comprised of 23 private sector projects with a GCF funding amount of USD 2.1 billion and total financing of USD 8.1 billion when taking co-financing into account. This section of the document will provide an overview of the private sector portfolio analysis on LDCs and SIDS.

3.1.3. Private sector portfolio analysis on LDCs and SIDS

21. Of the 23 private sector approved projects, 11 projects totalling USD 408 million (19.70 per cent) of the total private sector portfolio is dedicated to LDCs. On a thematic basis, 64.47 per cent of the private sector LDC portfolio is allocated to mitigation, followed by 33.40 per cent cross-cutting and 2.12 per cent adaptation. In terms of the financial instruments, loans have the largest share with 48.05 per cent, followed by 30.55 per cent equity and 21.40 per cent grants.

22. Four private sector projects totalling USD 167 million (8.07 per cent) are dedicated to SIDS. On a thematic basis, 83.24 per cent of the private sector SIDS portfolio is allocated to mitigation, followed by 16.30 per cent cross-cutting and 0.45 per cent adaptation. In terms of the financial instruments, equity covers 72.07 per cent followed by 20.96 per cent loan and 6.97 per cent grants.

Figure 2: Private sector portfolio analysis on LDCs and SIDS



Abbreviations: LDCs = least developed countries, M = million, SIDS = small island developing states.

23. Further analysis on the pipeline covering both funding proposals and concepts notes is presented in the annex of this paper.

3.2 Results of analyses

24. The analyses conducted in the two preceding sections outline the need to better match GCF support and private sector engagement with a priority placed on climate actions in LDCs and SIDS. They stress the need to take countries' priorities and aspirations into consideration and to ensure that implementation of the proposed modalities adhere to core GCF investment criteria related to country ownership, prioritizing responsive and demand-driven approaches. Currently, GCF private sector interventions in LDCs and SIDS have predominantly been in the renewable energy sector, with few interventions to support adaptation and build resilience for agriculture and food security. A key lesson from this observation is the need for more targeted efforts to diversify the private sector portfolio, with the objective to ensure a shift of focus in the private sector pipeline development to align better with the main climate priorities for LDCs and SIDS.

25. Such a shift could further consider the need to address challenges associated with the uptake of climate change technologies for adaptation and low emission strategies, including innovative adaptation technologies in the sectors that are the most vulnerable to climate change, as well as lower-carbon technologies and practices to improve emission reduction in the land use sector and support a paradigm shift in their electricity systems.

26. In the draft private sector strategy roadmap, a comprehensive supply and demand analysis has been undertaken to better understand key areas of potential interventions where key climate change priorities in developing countries, including LDCs and SIDS, intertwine with private sector interests and GCF results areas. These overlapping areas indicate the existence of a potential niche for GCF to work with private sector actors and foster climate investment activities in LDCs and SIDS. The demand supply analysis also highlights additional areas for consideration, which complements the proposed modalities:

(a) Project preparation is a major gap in LDCs;

(b) A proactive approach is needed to better align national designated authority demand and nationally determined contributions, particularly from LDCs and SIDS;

(c) Focusing on financial institutions and capital markets is not likely to be as well suited for LDCs and SIDS;

(d) In Africa, there is a need to help build local markets for a broader set of LDCs, particularly those that receive less direct foreign investment attention. This includes targeted readiness support to create conducive enabling environments in countries with incipient markets; and

(e) Caribbean SIDS need greater support to reach micro, small and medium-sized enterprises; climate proofing mitigation investments should be a high priority in the region; and extensive support is required to build/strengthen enabling environments and regulatory frameworks to promote private sector investments.

27. Additional considerations in proposing the modalities include strategic use of readiness, with the view to support further capacity, collaboration, co-learning and cross-fertilization of knowledge, as well as policy innovation to foster opportunities to steer investment decisions towards low-carbon and climate-resilient development, alongside project development and specific investment modalities.

IV. Proposed framework for potential modalities

28. The Secretariat is currently proposing six modalities to engage the private sector in areas of highest impact based on PSAG recommendations. The climate contexts in LDCs and SIDS call for significant attention to the need for engaging the private sector in more adaptation-oriented activities along the agriculture, water and energy nexus, as well as facilities to support

resilience in tourism and other sectors that form the backbone of economies in LDCs and SIDS. Agriculture will have to be looked at broadly to include both fisheries and livestock. The recommendations also embrace areas where the private sector has expressed strong interest in engaging, based on an external survey undertaken by the PSF, as a critical part of its strategy development. Finally, as noted in the PSAG recommendations, the Board is requested to consider facilitating capacity-building and allowing for a prioritized access modality for private sector and other key institutions that can bring about transformation in LDCs and SIDS.

29. Of these six modalities, three could be implemented under existing GCF channels, thus falling under the existing Board's mandate and hence could be implemented straight away. The remaining three are new modalities that will require dedicated efforts. The following section details each of the proposed modalities. One additional modality under consideration, concerning insurance, is briefly discussed in section 4.3 and will be subject to future Board consideration.

4.1 Modalities to be implemented within the mandate of the current Board

4.1.1. Modality 1: make strategic use of readiness support, Project Preparation Facility and public sector "climate policy" lending instruments

30. As is becoming increasingly clear, it is key that the revised strategy for readiness approved by the Board at its twenty-second meeting and public sector interventions allocate specific funds to support the engagement of the private sector in filling the key gaps left by the public sector. This can include and involve readiness funding in the following areas:

(a) Support capacity-building of the national designated authority in its understanding of the private sector; include additional private sector staff at the national designated authority;

(b) Engage readiness on mapping private sector actors (local and international) that can support the country to meet its overall goals;

(c) Design a roadmap on how to engage the private sector over short, medium and long terms and develop a comprehensive public sector strategy around how to support engagement of the private sector;

(d) Use readiness to also map out the legal and regulatory support that the country needs to engage the private sector;

(e) Use readiness to design several targeted climate policy and frameworks lending support to the relevant public sector institutions, in partnership with key accredited entities;

(f) Design climate policy programmes that can be submitted by the country or multiple countries to GCF mitigation and adaptation (public sector) division for policy action;

(g) Target readiness events in LDCs and SIDS to support private sector engagement in climate actions; and

(h) Ensure the PPF continues to provide support to entities operating in LDCs and SIDS, including private sector entities, to develop projects that exhibit high impact and paradigm shifting potential in these countries and facilitate their access to GCF resources.

4.1.2. Modality 2: better utilize current instruments to support the private sector in adaptation in LDCs and SIDS

31. To attract private sector capital into climate change adaptation in LDCs and SIDS, whose financial sector has limited depth and high-risk perception, tailored structured instruments and modalities need to be developed. These modalities will have to be designed to ensure that the private sector has the right incentives to invest and to optimally operate the assets. Additional considerations for developing these structures from a long-term sustainability perspective would include a transparent and predictable regulatory approach and an appropriate structural design to minimize any potential moral hazard problems that may affect an underdeveloped financial sector.

32. An example of some of the tailored approaches that can be developed in SIDS, where the tourism sector dominates the economy, include business models developed around the industry to ensure that adaptation activities are mandated by legislation – any new resort or hotel will have to invest in adaptation related activities, with larger community benefits. These could, inter alia, include coral reef protection, conservation of local eco-systems and desalination. Local communities can be involved gainfully in developing these projects, through long-term employment. Furthermore, the community will benefit from being engaged in the upkeep of these interventions. These activities will result in an enhanced value proposition for incoming tourists, which will translate into higher revenues from activities such as tourism in coral reefs. This incremental revenue represents an additional cashflow stream for tourism businesses which can be monetized upfront through funding from GCF.

33. Another approach to make greater use of the instruments already in place is through a review of the concept notes submitted to the earlier requests for proposal. This allows GCF to tap into existing ideas targeting LDCs and SIDS and develop projects accordingly.

4.1.3. Modality 3: prioritize strong institutions in accreditation that can support private sector projects in LDCs and SIDS

34. PSAG has also identified and iterated multiple times the accreditation barrier for private sector engagement with GCF, which is mainly demonstrated by the uncertainty and unpredictability involved in the process. Since accreditation forms an important prerequisite in most, if not all, cases of seeking GCF funding, this could particularly impact the deliverability of solutions and support in the context of LDCs and SIDS.

35. The need for dedicated outreach to enhance the institutional capacity of organizations operating at scale in LDCs and SIDS is strong. Once accredited, these entities could mobilize a large fraction of GCF resources, thereby promoting a paradigm shift towards climate-resilient pathways in LDCs and SIDS.

4.2 Proposed new modalities

4.2.1. Modality 4: pilot local currency funding for LDCs and SIDS

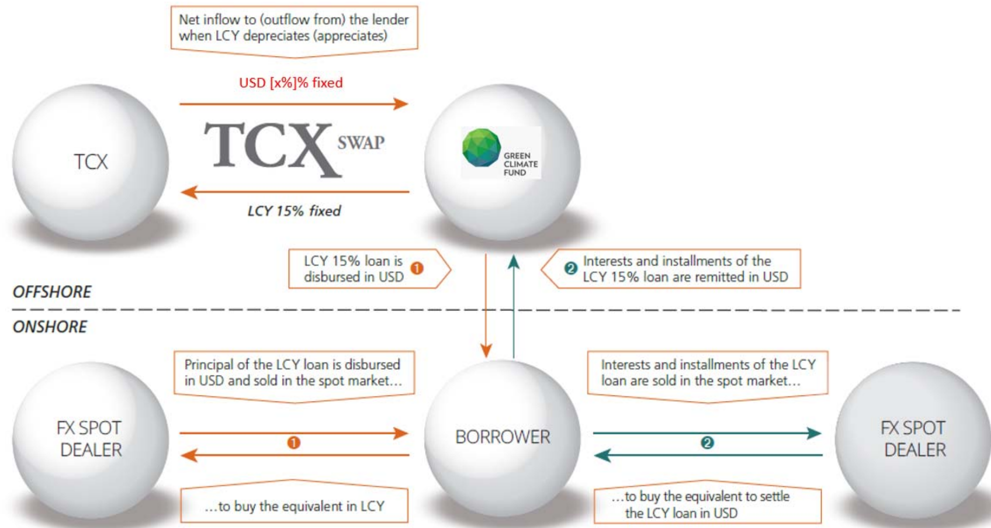
Background on the modality

36. Developing long-term local currency financing solutions is a challenge in many developing countries, particularly in SIDS and LDCs where, on its own, GCF cannot operate without the proactive cooperation and support of the respective governments. Two approaches could be considered in the efforts to promote local currency funding mechanism to support climate change interventions in LDCs and SIDS.

Proposed GCF pilot on private sector local currency financing[6]

37. The first approach to local currency financing is to enable GCF to hedge against potential currency fluctuations by transferring the foreign exchange risk to the Currency Exchange Fund (TCX), which specializes in non-commercial hedges for over 70 currencies and is used by many development finance institutions. This pilot is part of a larger initiative by the Secretariat to explore local currency instruments that can expand the catalysing role of GCF.

Figure 4: Illustration of pilot programme's local currency hedging mechanism



Abbreviations: FX = foreign exchange, LCY = Local Currency, TCX = The Currency Exchange Fund.

38. Through this programme, GCF will be able to support countries' climate ambitions by removing existing obstacles of currency fluctuations. Specifically, acknowledgement of local currency issues addresses direct access entity needs and reduces the transaction costs of submitting proposals.

39. TCX has invited GCF to be an affiliated member to supply hedges in local currencies. GCF will explore up to three hedging solutions and confirm the benefits to our clients who need local currency products. Once the pilot is tested and proven, GCF may choose to use TCX services on a formalized basis. GCF can initiate a pilot that will be driven by a cross-divisional team in GCF, which will manage the programme, obtain legal clearance, sign an International Swaps and Derivatives Association Account Control Agreement, and open any related accounts. This requires GCF to confirm its capacity for the implementation, and to pose counterparty collaterals from time to time. GCF will select three projects – both public and private sector – for the pilot programme. After three hedging transactions are completed, the cross-divisional team will evaluate the pilot programme and report to the Board for considerations and any necessary follow-up actions.

[6] Pending Board approval of the implementation of this modality, it is important to note that its application is relevant beyond LDCs and SIDS. Both PSAG recommendations on the development of modalities to support activities enabling private sector involvement in LDCs and SIDS, and the private sector strategy (all inputs to the review of the initial modalities of PSF) recommended this modality. Furthermore, it is obvious that its application is also relevant for public sector lending activities.

Focused local currency financing solution through climate investment vehicles

40. A complementary and a longer-term institutional approach would be to increase availability of capital from local banks and financial institutions towards climate projects.

41. This approach is more suitable for those countries where local banks and financial institutions possess some depth, but specific barriers and constraints restrict their ability to provide capital in local currency to climate projects. These barriers could be in the form of a general risk aversion, lack of availability of risk capital and inability to provide long tenor finance which can be partly mitigated by GCF providing a credit enhancement. This approach could also be used for some regions dominated by SIDS and LDCs which employ common regional currencies: e.g. East Caribbean Dollar, West African CFA Franc or Central Africa CFA Franc.

42. Additionally, some countries, particularly LDCs and SIDS, rely on regional or international currencies as their legal tender. These currencies are relatively robust and belong to countries which have sufficient depth in their financial systems. Examples include the following:

(a) South African Rand covering Lesotho, which is an LDC and other potential GCF recipients (Namibia, Eswatini and potentially Zimbabwe)

(b) Indian Rupee covering LDCs Bhutan and Nepal

(c) Australian Dollar covering SIDS of the pacific – Kiribati, Nauru and Tuvalu

(d) New Zealand Dollar covering SIDS of the pacific – Cook Islands and Niue

(e) United States Dollar covering Pacific SIDS (Federated States of Micronesia, Palau), Asian LDCs (Timor-Leste) and other potential GCF recipients (Ecuador, El Salvador, Panama)

43. The proposed approach is to set up local investment vehicles that address these specific barriers by providing a financial solution. These vehicles would be set up with patient equity share capital from GCF, some of existing AE partners and ideally, a minority share by the national governments. These would co-participate with local banks and financial institutions in climate loans, and through tailored instruments, they would strip a specific asset risk from the balance sheet of the local banks and financial institutions for e.g. tenor or collateral requirement.

44. For avoidance of doubt, the investment vehicle will have a clear mandate – minimum investment thresholds (to ensure that the vehicle focuses on systemic impact at scale), clear climate focus (aligned with GCF's result areas), targeted mix of mitigation and adaptation in the portfolio, standard and customary E&S and compliance requirements.

45. These vehicles over the initial 3-5 years could raise additional capital in the form of equity, from domestic pension and sovereign wealth funds. Thus, over a period, as this vehicle develops a loan/investment portfolio of performing projects through local currency financing, the liability structure which is skewed towards equity and equity like instruments, and the diversification benefit on account of pooling of loans/investments, allow the vehicle to manage the credit risk and the currency risk more effectively. As the investment/loan portfolio of the vehicle matures over 5-7 years, the vehicle can get itself rated and issue debt securities/ bonds to local banks and institutional investors, in local currency.

46. Thus, as a distinct legal entity, it will be able to leverage on GCF's investment by attracting equity co-investment and crowding-in debt financing from the bond markets, hence producing a multiplier effect in terms of impact and mobilization.

47. The proposal to establish the vehicle will be submitted under a regular submission window by an AE. If needed, the GCF PPF will be used to prepare a robust funding proposal, which will include details about the market and the sectors, as well as the proposed structure and co-investors. It may be pertinent to note that a direct investment approach may be appropriate in countries/cases where the anchor investor is not an existing AE, but a strong financial institution that has a solid track record of investing in the local markets. Using the principles of a programmatic approach, stringent eligibility criteria shall be employed, and such eligibility criteria to screen climate projects will be ingrained in the constitutional documents of the vehicle.

48. In the meantime, there is an ongoing Secretariat-wide effort regarding local currency/guarantee in the context of the review of financial terms and conditions. The Board decision and operationalization of this modality should be consistent with the policy outcomes of this review. Upon conclusion of the review, the Secretariat will present its approach for Board consideration.

4.2.2. Modality 5: early incubation for seeding climate focused and centres of excellence

Background on the modality

49. Both incubators and accelerators have proven to be effective modalities to support businesses throughout various development stages from early days.

50. The specific goal of a business incubator and accelerator is to provide new entrepreneurs with an array of targeted resources and services to support their business. The ultimate purpose is to identify, spur, fund, advise, and help grow potential business ideas and start-ups that are not yet bankable, providing them with seed, as well as technical and business advice, to help them develop into stronger businesses, providing, as needed, space and critical resources for initiatives and MSMEs to establish businesses. This component can be grant funded to support new businesses to be established quickly and efficiently.

51. The accelerator component seeks to achieve the same overall goal of helping to improve the success rate for start-ups, but in a unique way. This is generally by making an investment in the companies enrolled in their programmes to accelerate the trajectory and path of the business.

52. Both the incubator and accelerator components have been proven useful in the climate sector to support innovative solutions and the development and expansion of new business models, innovative financial structures and so on. Climate business incubators and accelerators will primarily focus on investing in climate-resilient and low emission start-ups and early-stage companies for services, engineering and manufacturing.

53. Some of the areas where these local entrepreneurs need support are: networking activities; marketing assistance; market research; help with accounting/financial management; access to local financing, including local currency loans, guarantees and equity; links to strategic partners; access to angel investors and venture capital; advisory boards; and help with regulatory compliance.

Proposed GCF pilot on early incubation for seeding climate focused and centres of excellence

54. A two-stage approach is envisioned to implement the incubation and acceleration of early-stage climate technologies and start-ups for climate solutions addressing both mitigation and adaptation, with the view to test the market through an initial phase and document learning followed by a direct investment modality.

55. Firstly, an incubator/accelerator facility supported by a growth fund will be established with the mandate to source early-stage start-ups and climate technologies from developing countries around the world, with a specific focus on LDCs, SIDS and African States. The incubator/accelerator facility will focus on start-ups that are in line with the eight GCF strategic results areas. Existing climate centres of excellence will support this programme. Some are located in universities in developing countries or in environment ministries.

56. Readiness can be provided for a delivery partner and a simple financial model will be designed to examine both the initial cost of setting up the centres of excellence as well as the maintenance costs. Principles of sustainability will be considered. The centres will be the focal points in several countries acting as a region to prepare the future generation of policymakers, as well as to prepare people for employment in areas that enhance resilience to climate change.

57. Country ownership will be key throughout the lifecycle. The approach will strengthen policies for an enabling ecosystem at the country level and will be supported by financing and appropriate commercial structuring of early-stage incubators and accelerators, thereby leading to greater impact in addressing the need for incubating and accelerating early-stage climate technologies.

58. Potential challenges might also undermine the outcomes of interventions, including:

(a) Institutional limitations:

  (i) Accreditation model: the current GCF business model requires it to work only through accredited entities. Due to the high-risk perception associated with early-stage incubation and acceleration and the early stage in general, as well as liquidity, it is difficult to have an effective approach that would enable the ecosystem for early-stage incubation and acceleration. In addition, the limitation in terms of geography and the use of financial instruments are barriers that are associated with the current accreditation model; and

  (ii) Non-objection letters: although the effort of GCF in developing early stage climate start-ups and technologies would, in essence, strengthen country ownership, due to the lengthy process of incubation and acceleration and the generally market-driven origin of new technologies, GCF could be limited as non-objection letters are issued according to pre-identified projects and programmes. In the case of incubators and accelerators, project development and investment proceed hand in hand. A pre-defined criterion for start-ups and climate technologies would ensure early alignment with country ownership; and

(b) Market limitations:

  (i) Scarcity of finance: due to high cost and the lengthy incubation and acceleration process, facilities around the world struggle with the availability of capital to sustain their operations. In addition, due to the high risks associated with early-stage start-ups and climate technologies it has been observed that there is immense difficulty in attracting capital to invest in this line of business;

  (ii) High-risk perception by investors: the high-risk perception in terms of capital, technological, political and other market risks are some of the greatest barriers to private capital in the area of early-stage technologies and incubation and acceleration of start-ups in general. Therefore, interventions by GCF would enable investors to have enough comfort in terms of risk-mitigation to deploy capital in this area; and

  (iii) Lack of ecosystem: the lack of institutional frameworks and incentives to encourage the development of new climate technologies are some of the main

barriers that need to be addressed. GCF is well positioned to have a combination of both public and private interventions that would enable countries to build a stronger ecosystem in relation to early stage start-ups and climate technologies.

59. GCF would like to initiate a pilot programme creating an incubator/accelerator associated with a growth fund using the current modality, namely by encouraging funding proposals to be supported by accredited entities. These proposals will be submitted for Board consideration and would enable GCF to learn and further scale the pilot programme at a later stage. Later, based on the lessons learned, modalities will be established to enable PSF to develop a dedicated approach to early stage start-ups and climate technologies through the private sector direct investment modality, if adopted.

60. Reporting and evaluation for this modality will be based on a pre-defined baseline and mechanism. If a funding proposal is to be presented through the GCF current funding modality, an accredited entity will conduct the direct reporting and evaluation process on behalf of the GCF. However, if GCF is to establish a new modality, where a dedicated team within the PSF is mandated to work directly with incubators and accelerators, a well-planned mechanism that is in line with the in-house reporting and evaluation processes will be established.

4.2.3. Modality 6: mobilize private sector finance for adaptation via targeted endowments at country level

Background on the modality

61. The private sector is engaging in adaptation when there is a desire to protect their assets and livelihoods from climate change and is willing, if finances are available, to spend money on goods and services that provide this protection. Most private sector action on climate change has gone to “climate-proofing” operations. Companies are relocating buildings to low-risk areas, purchasing weather insurance, and reducing water and energy use – which are all good practices that protect them against climate hazards.

62. Endowments are long-term funds generally owned by operating non-profit institutions and other organizations involved in charitable activities. Donors establish endowments by making gifts with the stipulation that periodic spending distributions from the fund be used to pay for programmes and that the principal value of the gift can be preserved in perpetuity.

63. Hence, by design, the objective of endowments is to provide a long-term significant, stable, and sustainable stream of spending distributions. This mirrors the long-term adaptation needs of the countries and requirements of regular and stable periodic financial support. All SIDS located in the Caribbean and Pacific and African LDCs are projected to likely benefit from such a financial modality.

64. The endowments can be invested in an investment portfolio that provides distributable returns and also capital gains, which help in maintaining the purchasing power of the corpus. The distributable returns can then be collected into a periodic distribution pool for meeting the spending needs of countries towards adaptation. In order to ensure long-term sustainability and country ownership, it is also pertinent that the countries supplement the endowment resources with their own financial resources, through dedicated trust funds or investment vehicles at the country level.

Proposed GCF pilot to mobilize private sector finance for adaptation via targeted endowments at country level

65. The proposed endowment for adaptation will see initial contributions from GCF and other philanthropic investors. The endowment’s initial corpus will be invested in an investment

portfolio consisting of stocks, bonds, cash and alternative investments, which are aligned with the sustainable development and climate change goals The investment objective of the endowment will be twofold: (1) to provide stable distributable returns by investing a part of the portfolio/corpus in income-generating, low risk investments like government green/climate/resilient bonds, high dividend yielding stocks, etc; and (2) to maintain the purchasing power of the corpus, by investing a certain portion of the portfolio in stocks and alternative investments that generate capital gains. The distributable returns would be collected into a periodic distribution pool for meeting the spending needs of countries.

66. To mobilize private sector capital, it is also important to develop self-sustaining revenue generating business models, and the proceeds of endowments can play a catalytic role by providing the first layer of risk protection. However, over the long term, it is also crucial to reduce the reliance of countries solely on grants and endowments to fund adaptation needs. It is therefore important that the countries supplement the endowment resources with their own financial resources. This could be particularly challenging for some LDCs and SIDS, which may lack the financial capacity.

67. It is also important that these resources, endowments and each country's own financial resources are pooled and invested in private sector projects in adaptation through reflow instruments such as debt, reimbursable grants or equity. This is not only capital efficient from a private sector point of view but will also reduce reliance on periodic contributions.

68. To implement this, it is proposed that the countries use existing national adaptation funds, structured either as a trust fund or a pooled investment vehicle, to finance adaptation projects in the country in coherence with the national priorities as outlined in their national adaptation plans.

69. These adaptation funds will be capitalized by grants/endowments from the spending distribution pool of the endowment with additional contributions coming from the countries themselves, through budgetary allocations and appropriations, tax on fossil fuels, fees or levies and through innovative alternative instruments like debt swaps. The national adaptation funds will use a mix of instruments for financing adaptation projects in the country, such as debt, reimbursable grants or equity. The reflows would flow back to the adaption fund to make it self-sustaining and less reliant on endowments or the country's financial resources in the long run. Some of the ways in which the countries can consider mobilizing funds to capitalize the national adaptation fund, are as follows:

(a) Fees/levies on foreigners: Palau and Bhutan provide interesting examples of how governments can provide mechanisms to handle funding challenges. For example, Bhutan charges foreign tourists a sustainable development fee of USD 65 per day that goes towards free education, free healthcare and poverty alleviation for its citizens.[7] Similarly, Palau requires airlines to include a "Pristine Paradise Environmental Fee" of USD 100 in the price of every international airline ticket into Palau.[8] These levies provide a long-term source of revenue, which can be used for regularly capitalizing the trust fund;

(b) Debt swaps: as per the United Nations Development Programme,[9] a debt-for-nature swap is defined as an agreement that reduces a developing country's debt stock or service in exchange for a commitment to protect nature from the debtor government. It

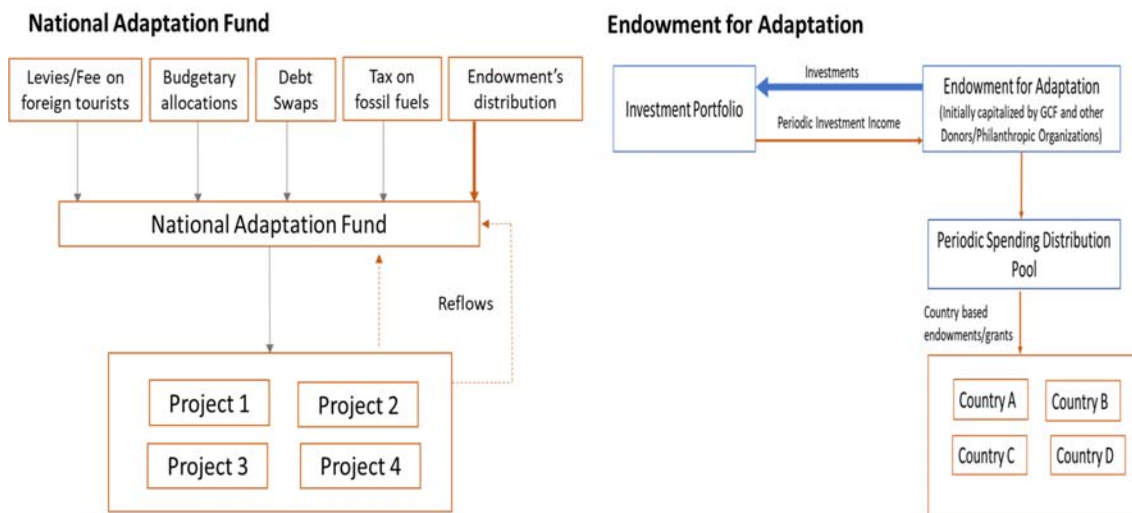
[7] Tourism Council of Bhutan, FAQs. Available at <https://www.bhutan.travel/page/frequently-asked-questions>.
[8] Public Notice on Palau Pristine Paradise Environmental Fee. Available at <http://www.palaucustoms.org/files/common_unit_id/c8672894-ba61-43f7-b6c4-6a69acbd1b61/PUBLIC%20NOTICE.pdf>.
[9] Information on the United Nations Development Programme debt-for-nature swap is available at <https://www.undp.org/content/dam/sdfinance/doc/Debt%20for%20Nature%20Swaps%20_%20UNDP.pdf>.

is a voluntary transaction whereby the donor(s) cancels the debt owned by a developing country's government. The savings from the reduced debt service are invested in conservation projects; and

(c) Foreign exchange savings through decarbonization: the SIDS and LDC economies are hugely dependent of fossil fuel imports for meeting their energy needs. Decarbonization of the energy and transport sectors can lead to substantial savings. Although the mandate of the national adaptation fund would be to invest in adaptation projects only, a certain allocation (e.g. 10 per cent) can be made to mitigation projects as well. The resulting savings from avoidance of importation of fossil fuels can be pooled and flowed back into the trust fund.

70. It is proposed that the investment process and the spending decisions are managed in-house by the endowment. Hence, an adequate governance system with appropriate governance structure and decision-making processes would need to be developed.

Figure 5: Proposed endowment structure



71. However, there are a number of challenges and barriers to implement the modality, which principally include: (a) Adequacy of the returns from the endowment for meeting the spending needs; (b) Availability of capital from donor(s) at the country level agreeing for debt swaps; (c) Availability of financial resources within countries to contribute to national adaptation funds; and (d) Monitoring and evaluation.

72. The endowment approach aims to achieve the following objectives:

(a) Mobilize philanthropic and patient capital for adaptation at the endowment level;

(b) Provide a long-term stable and periodic cashflow to contribute to the national adaptation funds;

(c) Mobilize donor capital at the level of the national adaptation fund, through innovative alternative financial instruments such as debt swaps; and

(d) Mobilize private sector capital at the project level.

73. Principally, the implementation would entail the following:

(a) Quantification of the adaptation financing needs of each country;

(b) Structuring the endowment as follows:

(i) Determining the initial size of the endowment;

(ii) Identifying sources of philanthropic capital;

(iii) Determining the risk-return objectives of the investment portfolio;

(iv) Developing the right governance structure; and

(v) Determining legal and regulatory aspects.

(c) Staffing the endowment; and

(d) Capitalization of the endowment.

74. In parallel, the countries intending to avail grants from the endowment would be required to set up their own national adaptation funds.

4.3 Further considerations: insurance and capitalizing climate disaster risk funding mechanisms[10]

75. The insurance and re-insurance sectors play a very important role in allowing risk transfer. However, many studies show that global warming has increased the severity and frequency of natural disasters. Hence, it is necessary to build innovative solutions to improve global climate-risk resilience. Climate Wise, a network of 29 leading insurance industry organizations formed in 2008, recommends insurers to support "green bonds, resilience impact bonds and investments in resilience-enhancing infrastructure".

76. Without effective and affordable insurance, catastrophic losses destroy livelihoods, communities and make countries unstable. Large, unpredictable and costly disasters are inevitable – but global reinsurance provides a mechanism to compensate insured parties for their losses, using the premiums they and others have paid beforehand under an agreed contract. Global reinsurers can offer this service to insurers because they pool their risks and capital globally and thus gain the benefits of diversification.

77. LDCs and SIDS face a higher propensity for climate disasters, and therefore insurance premiums are higher. Often, they are unaffordable. GCF has an opportunity to make insurance and reinsurance premiums more affordable by creating risk-sharing facilities with both insurance and reinsurance companies. Effectively diversifying the pool of contracts lowers the risk and allows insurance/re-insurance to absorb more shocks and sustain long-term investment.

78. Under current consideration, this modality could be implemented through a two-stage approach. The first stage will identify and track climate risk via a public database. The second stage will create a private sector risk-sharing facility with insurance and reinsurance, based on the identified risks. The Secretariat will continue to support the development of this modality and will present targeted papers outlining options for the Board at its twenty-fifth meeting.

[10] A separate paper on insurance is currently in preparation within the Secretariat. More details will be reported there.

Annex I: Status update of GCF interventions in LDCs and SIDS

I. Pipeline analysis

1. As at 30 April 2019, the GCF pipeline is comprised of 83 public and private funding proposals, which requests total GCF funding of USD 3.8 billion to support projects and programmes and totals USD 17.5 billion when taking co-financing into account. As for the concept notes, 254 public and private concept notes request total GCF funding of USD 11.7 billion, which totals USD 37.7 billion when taking co-financing into account.

Table 1: GCF pipeline overview

		GCF pipeline (USD million)
Funding proposals	Number of funding proposals	83
	GCF requested amount	3,790
	Co-financing amount	13,746
	Total amount	17,536
Concept notes	Number of concept notes	254
	GCF requested amount	11,749
	Co-financing amount	25,969
	Total amount	37,718

1.1 GCF pipeline analysis on least developed countries and small island developing States

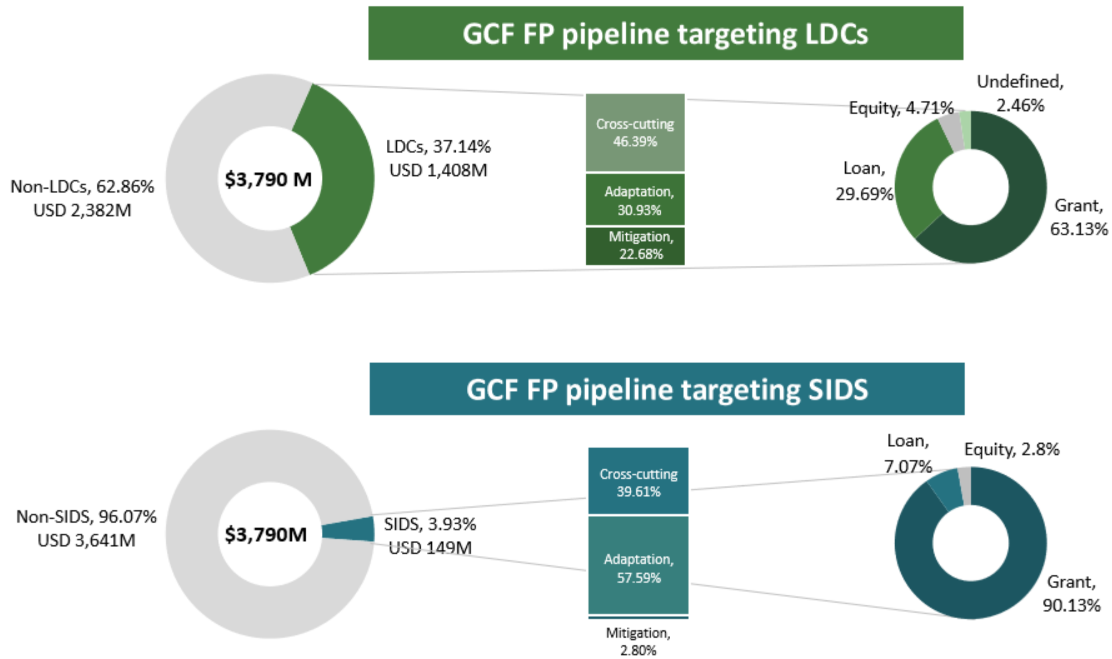
1.1.1. Funding proposals

2. Of the 83 public and private funding proposals, 34 totalling USD 1,408 million (37.14 per cent) target least developed countries (LDCs).[11] Thematically, 46.39 per cent of funding proposals target cross-cutting projects, 30.93 per cent adaptation projects and 2.68 per cent mitigation projects. Grants represent the largest share with 63.13 per cent, followed by loans at 29.69 per cent, equity at 4.71 per cent and undefined at 2.46 per cent.

3. Ten funding proposals target small island developing States (SIDS), totalling USD 149 million (3.93 per cent) from the GCF funding proposal pipeline. Thematically, 57.59 per cent of funding proposals target adaptation projects, 39.61 per cent cross-cutting projects and 2.80 per cent mitigation projects. Grants are the largest share with 90.13 per cent, followed by loans at 7.07 per cent and equity at 2.8 per cent.

[11] For pipeline analysis of multi-country programmes, evenly allocated country percentage or the country allocation percentage information by the accredited entities have been used. The information on LDCs and SIDS therefore includes GCF funding for the projects that target LDCs and SIDS and the portion of LDCs and SIDS within the multi-country programme.

Figure 1: GCF funding proposal pipeline analysis on least developed countries and small island developing States

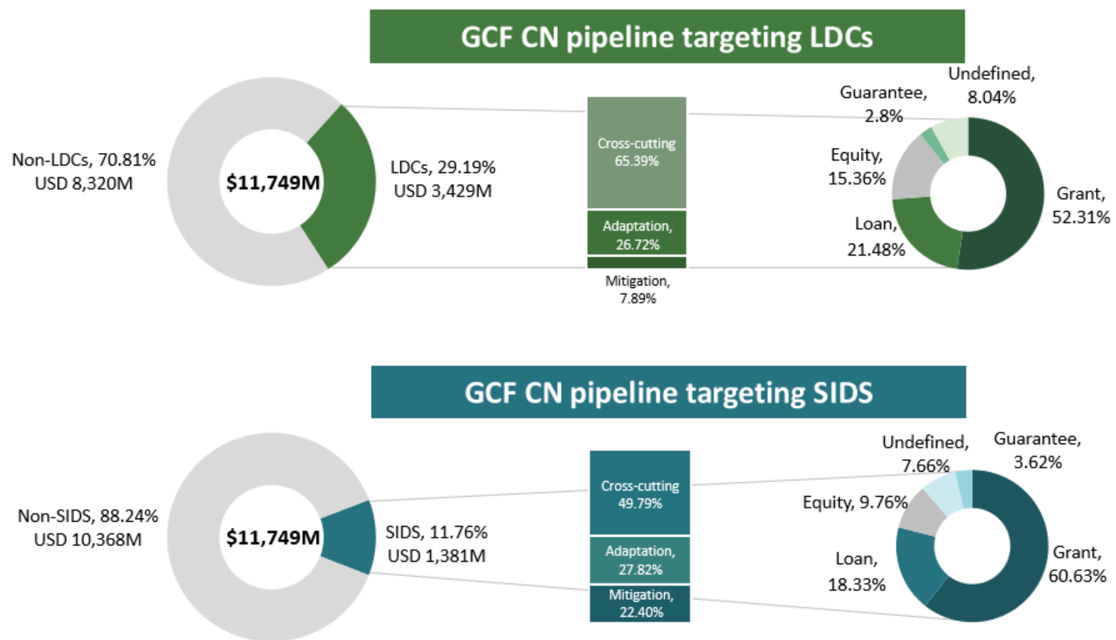


Abbreviations: FP = funding proposal, LDC = least developed countries, M = million, SIDS = small island developing States.

1.1.2. Concept notes

4. For the concept notes analysis, the GCF pipeline consists of requested funding of USD 3,429 million (29.19 per cent) targeting LDCs. For SIDS, the GCF concept notes pipeline consists of requested funding of USD 1,381 million (11.76 per cent). Details of the analysis on themes and financial instruments are show in the figure below.

Figure 2: GCF Concept notes pipeline analysis on least developed countries and small island developing States



Abbreviations: CN = concept note, LDC = least developed countries, M = million, SIDS = small island developing States.

1.1.3. Private sector pipeline analysis on least developed countries and small island developing States

5. The private sector pipeline is comprised of 17 funding proposals requesting total GCF funding of USD 1.1 billion and totals 9.8 billion when taking co-financing into account. The private sector pipeline consists of 72 concept notes with a total GCF funding of 4.6 billion and total amount of 18.1 billion when taking co-financing into account. The overview of the GCF and PSF pipeline analysis on LDCs and SIDS is provided below.

Table 2: Private sector pipeline overview

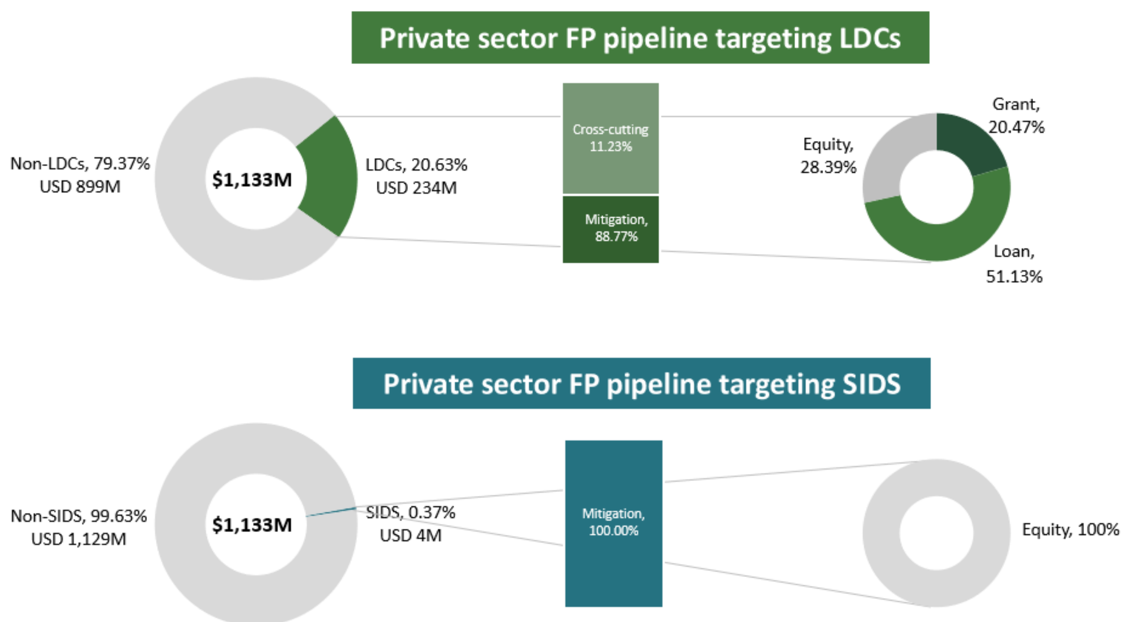
		Private sector pipeline (USD million)
Funding proposals	Number of funding proposals	17
	GCF requested amount	1,133
	Co-financing amount	8,664
	Total amount	9,797
Concept notes	Number of concept notes	72
	GCF requested amount	4,648
	Co-financing amount	13,461
	Total amount	18,109

1.1.4. Funding proposals

6. Within the 17 private sector funding proposals, six funding proposals totalling USD 234 million (20.63 per cent) target LDCs. The LDC pipeline consists of 88.77 per cent mitigation projects and 11.23 per cent cross-cutting projects. By financial instruments, loans take the largest share with 51.13 per cent, followed by equity, grants and guarantees.

7. One out of the 17 funding proposals targets SIDS, totalling USD 4 million (0.37 per cent). The project is a mitigation project with equity as a financial instrument.

Figure 3: Private sector funding proposal pipeline analysis on least developed countries and small island developing States

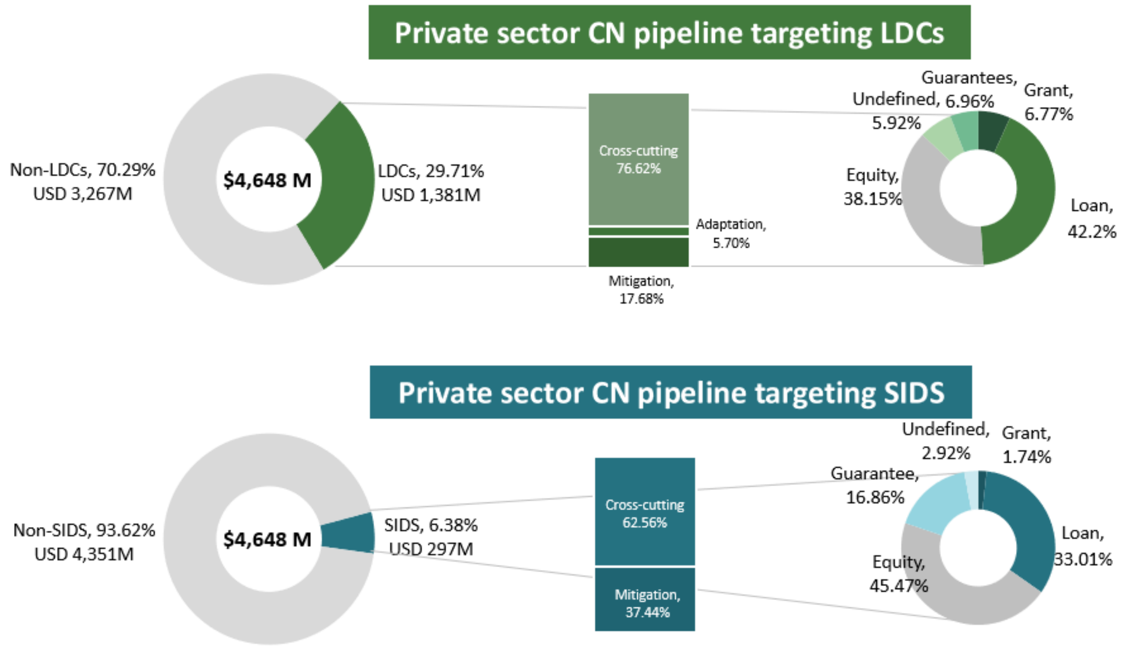


Abbreviations: FP = funding proposal, LDC = least developed countries, M = million, SIDS = small island developing States.

1.1.5. Concept notes

8. The private sector concept notes pipeline targeting LDCs consists of GCF requested funding of USD 1,381 million which accounts for 29.71 per cent of the private sector concept note pipeline. For SIDS, the private sector concept notes pipeline consists of GCF requested funding of USD 297 million which is 6.38 per cent of the pipeline. Details of the analysis on themes and financial instruments are shown in the figure below.

Figure 4: Private sector concept notes pipeline analysis on least developed countries and small island developing States



Abbreviations: CN = concept note, LDC = least developed countries, M = million, SIDS = small island developing States.