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Private Sector Facility

Review Note

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Contents

Introduction 2
Mobilizing funds at scale from institutional investors and leveraging 3
IIED Comments & Inputs 6
Working with Local Private Entities, Including SMEs 8
IIED Comments & Inputs 10

Introduction

As part of its business model the Green Climate Fund (GCF) is planning to raise money from private sectors actors. The Private Sector Facility (PSF) is to address barriers to private sector investment in both adaptation and mitigation activities, so as to mobilise private capital and expertise at scale in accordance with national plans and priorities. This will include facilitating and enhancing the participation of national, regional and international private sector actors in developing countries. In particular, the PSF will look to involve local actors, including small and medium sized enterprises (SMEs), and local financial intermediaries. The Facility will also support activities to enable private sector involvement in Small Island Developing States (SIDS) and least developed countries (LDCs)[1].

As such, the Board has been working on the following elements, so that decision can be made at the 9th Board Meeting:

- Modalities for mobilizing funds at scale from institutional investors, outlining various products and structures that could be used, such as green bonds, commercial paper and syndicated products;
- Modalities for mobilizing funds at scale from institutional investors and the local and international private actors by leveraging participants in projects or programmes financed by the Fund;
- The important role of different types of private sector actors and reliance on diversified pool of accredited entities, including international commercial banks, impacts investors and private equity funds; and
- The potential of using crowd funding to mobilize funds from individual contributors[2].
- How the Fund can promote the participation of private sector actors in in climate change programmes and projects in developing countries including local financial intermediaries, developers and private companies[3].

The following paper scrutinises both the documents presented by the Board for discussion:

[1] Decision B.8/04, Decisions of the Board – Fourth Meeting of the Board, 26- 28 June 2013 GCF/B.04/17 3 July 2013
[2] See Private Sector Facility: Potential Approaches to Mobilizing Funding at Scale, GCF/B.09/11/Rev.01, 6 March 2015
[3] See Private Sector Facility: Working with Local Private Entites, Including Small and Medium-Sized Enterprises, GCF/B.09/12, 5 March 2015

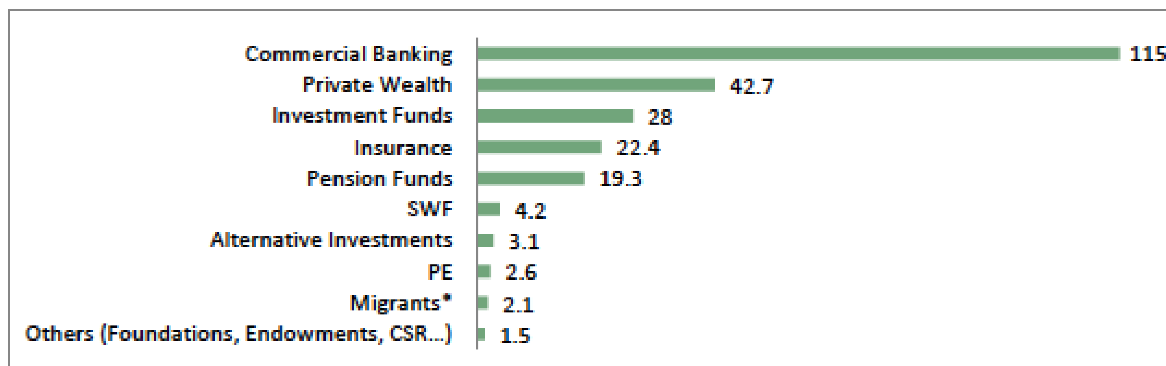
KEY POINTS

- The term 'Funding at Scale' must be closely defined as a first step.
- The Fund should focus more on risk management than on liquidity when devising instruments and products. Credit enhancement and liquidity should be second priority to reducing risk.
- Risk reduction will help ensure that private sector finance is invested in ambitious transformative projects. The private sector should be incentivised into areas that are transformational.
- Country ownership and direct access should inform the structure of the PSF. This must not slip off the agenda, particularly with regard to accrediting private sector entities.
- The SME Pilot Programme must not rely too heavily on intermediaries.

Mobilizing funds at scale from institutional investors and leveraging

A number of sources are presented as potential options for unlocking private sector capital as presented in Figure 1. The richest sources of private capital are clearly commercial banks, investment funds, insurance companies, pension funds and sovereign wealth funds. Success in mobilizing funds at scale from these sources is centered around understanding how each of these players behave, so as to better understand how the Fund can capture their resources. The paper then sets out a number of considerations that the Board may wish to consider when trying to attract finance for each of these sources.

Figure 1: Global asset pools (US$ trillions)[4]



The Fund will ultimately seek to invite investors to place their funds at the Fund level. However, the Fund will first need to establish a credit rating and/or a track record through a

[4] Ibid

portfolio of investments and a balance sheet before inviting commercial banks and institutional investors to invest more that $500 million. As such, the Fund will look to the accredited entities through which it acts to structure climate change investments in a way that will attract and accommodate these commercial banks and institutional investors. It is envisaged that this will be done through using following products and structures:

- **Bonds –**are fixed income, liquid financial instruments that are easy to understand, and the finance raised by these 'green bonds' are dedicated exclusively to climate-mitigation and adaption projects. This provides investors an attractive investment proposition as well as an opportunity to support environmentally sound projects. Bonds are intended to provide green investment opportunities to a wider investor group, including those who wish to divest and diversify from fossil fuel-intensive portfolios[5]. They are generally long term in nature, and require long term capital commitment by private sector investors. They expose investors to a relatively material level of credit and interest rate risk, in part due to their medium-term/long-term nature[6]. It is stated that the GCF can work through international, national and regional accredited entities to issue, underwrite and/or make a market for project specific bonds. These entities would ring fence one or more assets/projects in a special purpose vehicle, against which bonds can be issued. These could be projects in which the Fund has already participated. Value could also be added by injecting credit and/or liquidity enhancing elements. Eventually the GCF will be able to attract private sector investors directly onto its "balance sheet" through bonds, at a reasonable rate, once it obtains a risk rating from a qualified rating agency[7].
- **Commercial Paper-** can be defined as an unsecured, short-term debt instrument that will be issued by the GCF, and can be seen as discounted promissory note issued to finance the short-term credit needs. Banks, corporations and foreign governments commonly use this type of funding[8]. They are particularly well suited to mobilizing funds at scale from banks and from high net worth individuals who are familiar with a local project and/or programme, and may, for example, present a great opportunity to crowd in private funds for small and medium-sized enterprise (SME) programmes/portfolios. Financial intermediaries could best achieve this if they ring fence the SME portfolio into a special purpose vehicle against which the CP would be issued. It is acknowledged in the document that Commercial paper is relatively ill-suited to helping the GCF mobilize funds at scale directly onto its balance sheet, in large part due to the fact their short-term nature does not suit the long-term nature of the Fund's requirements[9].
- **Syndications & club deals-** syndications are illiquid in nature, and don't offer investors an

[5] See Green Bonds Attracts Private Sector Climate Finance, January 5th 2015, World Bank website – available at http://www.worldbank.org/en/topic/climatechange/brief/green-bonds-climate-finance
[6] Supra Note 2
[7] Ibid
[8] See Investing Answers website – available at http://www.investinganswers.com/financial-dictionary/debt-bankruptcy/commercial-paper-1286
[9] Supra Note 2

easy way out. As such, investors will tend to expect higher returns than on bonds, and will limit their tenor exposure to five to seven years (10 years on rare occasions). They present two primary benefits, both emanating from the fact that syndicated loans are subject to a much lower regulatory/licensing hurdle than commercial paper and bonds – syndicated loans are not considered securities, and as such, fall under the same regulatory framework as loans. Therefore, they can be carried out with minimal transaction costs and thus be used to crowd in private sector funding on smaller scale projects. They are already used universally by banks to disseminate risk, and do not require a mature financial market. Syndications and club deals could be used to crowd in funds from local private sector banks for projects and programmes. The Fund can add material value by providing support to enhance credit (e.g. first or second loss guarantees) and/or tenor profile (e.g. bear the risk on the residual portion of a loan that extends beyond 10 years). The Fund can also add value by acting as the first mover/anchor investor on a deal; such an anchor is often required to catalyze the participation of banks[10],

- **Private Placement Programs-** represents an intermediary step between syndications (loans) and bonds/commercial paper (securities). The sale of securities to a relatively small number of select investors is a way of raising capital. Investors involved in private placements are usually large banks, mutual funds, insurance companies and pension funds[11]. Private placements can be used to crowd in funding from high net worth individuals and sovereign wealth funds[12].

It was decided at the last Board meeting that the Fund will work through accredited implementing entities (IEs) and intermediaries, who may deploy the resources in approved projects and programmes by using financial instruments, focusing on grants, concessional loans, equity and guarantees[13].

The document goes on to detail possible ways in which the Fund could support accredited entities and intermediaries including through the provision of risk bearing capacity and concessional resources with a view to improving their risk profile or liquidity. This would essentially position the Fund as Bank through, inter alia, extending lines of credit, extending repayment periods, providing early stage equity and provision of guarantees.

It was also suggested, that in addition to spontaneous submissions from accredited entities, the Fund could issue requests for proposals ("RFPs") to "auction out" a certain amount of concessional funding to IEs or intermediaries that present the most attractive alternative for using concessional resources to realize projects while attracting third-party funding at scale.

[10] Ibid
[11] See Investopedia website – available at http://www.investopedia.com/terms/p/privateplacement.asp
[12] Supra Note 2
[13] Decision B.08/12 Decisions of the Board – Eighth Meeting of the Board, 14-17 October 2014, GCF/B.08/45, 3 December 2014

Those entities would be subject to accreditation or would need to work through accredited entities. In so doing, the Fund expects private sector actors and intermediaries to create project- or programme-specific structures to crowd in third party investors.

At the United Nation's Framework Convention on Climate Change (UNFCCC) Conference of the Parties (COP) in Lima the Board was requested to accelerate the operationalization of the PSF by aiming to ensure that private sector entities and public entities with relevant experience of working with the private sector are accredited in 2015**.** Already, the World Bank has been authorized to seek accreditation; if accredited to the GCF, it is envisaged that The World Bank Group will be able to build on its experience of blending finance to leverage private sector development[14]. It is recommended that commercial banks (including multinational commercial banks with significant on-the-ground presence in the developing countries); private equity and investment firms; and impact/patient capital firms should be first in line for accreditation as they can best serve the objectives of the Fund i.e. mainstreaming low-emission and climate-resilient investments in the real sectors of developing countries' economies.

One innovative source of raising capital that has been suggested is through crowd sourcing, which essentially tries to raise money from the public via an online portal, that request money to support certain projects.

IIED Comments & Inputs

- **Define what is meant by 'scale' –** there is no indication of what 'funding at scale' actually means? Scale at the international level is very different from scale at the national and sub-national levels. This should be elaborated on.
- **Focus on risk, not liquidity -** the paper suggests that the GCF may wish to add value by injecting credit and/or liquidity enhancing elements when issuing bonds and for commercial paper, as well as enhancing credit for syndications and club deals. But, low-carbon and climate-resilient projects present new and unfamiliar risks as they involve investments in new technologies and geographies, and higher costs associated with new financial vehicles. These are often unacceptable to private actors and typically lead to higher perceptions of risk due to specific factors such as dependence on public policy and, often, the relative immaturity of technologies, markets, and industries[15]. As such, the role of the GCF must be to catalyse private sector funding through risk management, not lending. As well as providing grants, concessional loans and guarantees the PSF should

[14] See World Bank Group Approved to Apply for Green Climate Fund Accreditation (Feb 2015) on the World Bank website – available at http://www.worldbank.org/en/topic/climatechange/brief/green-climate-fund
[15] Buchner, B. et al., Operationalizing the Private Sector Facility of the Green Climate Fund: Addressing Investor Risk, CPI (2014), page 7

also look at other means of reducing risk. For example, this could include early stage funding for project development repaid from debt financing once the project becomes investable as has proved successful for Overseas Private Investment Corporation (OPIC); this in effect, takes on the project development risks. A mechanism under the PSF to offer technical assistance for policy formation at the national level in developing countries could also help reduce country-level policy risks, and build in-country capacity[16].

- **Risk must be reduced to ensure requisite ambition of funded projects -** leveraging tools do not offer incentives for initiating projects in areas where there is market failure and a lack of existing commercial incentives[17]. Without reducing the risk profile of projects will likely lead funding projects with low ambition levels, that are not truly transformative in nature.
- **Bonds must only be issued against truly green projects** – GCF/B.09/11 states that *'The Fund can work through international, national and regional accredited entities to issue, underwrite and/or make a market for project specific bonds. These entities would ring fence one or more assets/projects in a special purpose vehicle, against which bonds can be issued. These could be projects in which the Fund has already participated.'* However, this does not mandate that projects must be low-carbon climate-resilient. Furthermore, there is currently a lack of standardisation, on what constitutes a "green bond". Although a consortium of investors has recently put together Green Bond Principles, these are voluntary.
- **Country ownership must be included in design of financial instruments –** the suggested financial instruments encourages that risk is allocated to those entities best able to manage them i.e. MDBs and private sector entities. This challenges the notion of country ownership, and it is acknowledged that bonds not conducive to SMEs or for use in Small Island Developing States or the small Least Developed Countries. Commercial paper will also be funnelled through financial intermediaries[18]. The Board must ensure that the issue of country ownership does not slip off the agenda.
- **The competitive request for proposal process will need significant elaboration –** the process of how this will take place will need substantial elaboration. As it currently stands, auctioning out a certain amount of concessional funding to IEs or intermediaries that present the most attractive alternative for using concessional resources to realize projects while attracting third-party funding at scale. This may offer financial intermediaries – such as MDBs – a competitive advantage as they will be more able to attract third party funding. However, this this focus on attracting third party funding does not necessarily mean a focus on projects and programmes that will work towards a 'paradigm shift' or the needs of the intended beneficiaries, and does little to enhance direct access. Key

[16] Williams, J., The role of the Green Climate Fund in providing the missing 'Clean Trillion', Environment Finance (2014) – available at https://www.environmental-finance.com/content/analysis/cop-blog-the-role-of-the-green-climate-fund-in-providing-the-missing-clean-trillion.html
[17] Reyes, O., Critical Issues for Channelling Climate Finance Via Private Sector Actors, Bond (2014), page 6
[18] Supra Note 2

questions that need to be answered are how much concessional funding will be put aside for auctioning out? How will the GCF ensure that national IEs, particularly those that are newly accredited, are not left at a disadvantage compared to more experienced intermediaries? How will the Board ensure that the needs of beneficiaries are prioritised over the ability to attract third party funds?

- **Green Banks should be included as a potential investor –** the priority list for private sector entities omits Green Banks. However, such institutions have lot to add as they sit between public and private finance[19], as well as having a clear focus on accelerating the deployment of clean energy and energy efficiency, and working towards crowding-in private capital. Green Investment Banks are positioning themselves as a key driver of the commercial and efficient allocation of capital for deployment into global clean energy financing markets[20], which is more consummate with the ultimate objectives of the GCF.

Working with Local Private Entities, Including SMEs

Document GCF/B.09/12 sets out the ways in which the Fund can support private SME's in developing countries, mainly through provision of concessional resources.

A number of barriers to increasing private sector investment in climate-related investments are highlighted, as well as the suggested action by the Fund:

Identified Barrier to Climate-Related Investment	GCF Suggested Action
Policy and regulatory environment constraints - which reduce the economic and financial attractiveness of climate-related investments (e.g. price and tariff controls) or increase the uncertainty relating to investment outcomes (policy uncertainty).	If requested by the country, it is suggested that the Fund could to address such barriers through policy support (grants or concessional lending) to governments and government agencies. This could be via policy-based grants or concessional loans from the adaptation or mitigation windows to finance the cost of such policy changes.
Information gaps leading to market failure - inadequate information concerning available technologies, resource availability (e.g. geothermal resources, energy savings	Concessional resources to assist developing country actors in overcoming the information gaps and capacity constraints. A particular

[19] Supra Note 16
[20] See International Green Bank Summit brings together global clean energy financing institutions on the Green Investment Bank website (2014) – available at http://www.greeninvestmentbank.com/news-and-insight/2014/international-green-bank-summit-brings-together-global-clean-energy-financing-institutions/

potential), financing possibilities or other information gaps can stymie investment.	need identified is to assist SMEs in enhancing their audited financial reporting standards, business plans, risk studies and/or feasibility studies.
Capacity constraints - some developing countries may have shortage of specialized skills in the local economy (e.g. to develop or appraise complex projects) needed to successfully develop climate-related investments.	
Weak or shallow financial markets in developing countries –debt or equity markets cannot match domestic savings to the long-term financing needs of climate-related investments. They may also lack important financial products needed to successfully finance climate-related investment (e.g. leasing finance, venture capital, secondary markets to provide take-out finance for investors).	Can be tackled successfully by the use of additional financial instruments. The use of such financial instruments, including grants, concessional loans (senior and subordinated), equity and guarantees, is enabled by decision B.08/12. In addition, for small actors such as SMEs, tailored approaches – for example providing concessional resources deployed programmatically through accredited intermediaries – would be more appropriate.
Market size and transaction costs	The Fund seeks to minimize the transaction costs of working with SMEs by having accredited entities originate, approve, administer and manage SME financing for and on behalf of the Fund through a programmatic approach.

It is suggested that an SME Pilot Programme can channel concessional resources to improve SME's access to finance through accredited entities. These concessional resources could be useful when applied in the context of supply chain financing and terms of trade financing.
The Fund will issue a request for proposals (RFP) to entities that are able to demonstrate:

- A track record of successfully working with and financing SMEs;
- The ability to monitor the results achieved through the SME Pilot Programme; and
- The ability to use Fund resources to create a significant climate impact.

Particular attention will be paid to SMEs that have a sustained track record of financial and commercial viability and that have weathered economic peaks and troughs. This will help to ensure that Fund resources are directed towards financially/economically robust entities that have "staying power" and that can make the greatest impact in terms of reach and outcome. (As the Fund requires that its resources are channelled through accredited entities,

respondents to the RFP must either become accredited in due course by the Fund or work through an accredited entity.)

Selected respondents to the RFP who will administer and manage the Fund's SME Pilot Programme will be allocated a capacity-building component to fund the appropriate and adequate preparation and auditing of financial statements and/or feasibility studies by the SMEs that require such capacity-building to access financing for use in climate-sensitive investments.

In line with the revised programme of work on readiness and preparatory support, the Fund will aim to allocate at least 50% of this capacity-building component to particularly vulnerable countries, including SIDS, LDCs and African States.

One of the key barriers to private investment in adaptation activities is that such activities often provide common goods or services without a clear or perceived revenue stream to match their economic benefits. However, it is noted that private sector companies that address adaptation-related have competitive advantages in resilience; and lower cost of funding (because of lower operational risk as measured and monitored by credit agencies). With this in mind, the SME Pilot Programme could promote the following type of investments into adaptation activities by SMEs in developing countries:

- Investments in supply chain management that incorporate climate adaptation risk management (e.g. supply source diversification, crop changes in agriculture); and
- Promoting guarantees to enable bank and supply-chain (i.e. accounts receivable/payable) debt rescheduling in the face of business disruptions resulting from temporal material/adverse climate change impacts.

IIED Comments & Inputs

- **Clarity is needed private sector actors and their role –** currently there is no indication of what is meant by an SME, meaning it is currently unclear which types of private sector enterprises will qualify for concessional funding. Micro enterprises are also not included in the definition. There is no universal definition, but the GCF should define what is actually meant so as to ensure uniformity in allocation of concessional resources. Any definition would also need to take account of the informal sector, as informal (M)SMEs in some developing countries outnumber formal MSMEs by 8 times[21]. Indeed, attempts by the Climate Investment Fund (CIF) funded Scaling up Renewable Energy Programme (SREP) shows that a lack of clarity surrounding who the private sector actors actually are can be a

[21] Kushnir, K., A Universal Definition of Small Enterprise: A Procrustean bed for SMEs? On the World Bank website – available at http://blogs.worldbank.org/psd/a-universal-definition-of-small-enterprise-a-procrustean-bed-for-smes

barrier to engagement[22].

- **The Fund must exercise caution in relying too heavily on intermediaries –** the SME Pilot Programme will provide concessional financing to SMEs through accredited entities, and the GCF has emphasized that it may rely on local financial intermediaries in SIDS, LDCs and African States, but one impact of this could be to weaken disclosure and accountability reporting standards on account of commercial confidentiality and possible regulatory requirements [23]. Experience from the International Finance Corporation (IFC), who channel a large proportion of IFC financing to private sector projects in developing countries through financial intermediaries also suggests that there can be a disconnect between the IFC's approach and government regulations which may limit direct financial interactions between large international agencies and local private banks[24]. It may be more appropriate to work the national development banks.

[22] Rai, N. et al., What can the Green Climate Fund learn from SREP's role engaging the private sector?, IIED (2014)
[23] Supra Note 18
[24] Supra Note 22