

CLIMATE INVESTMENT FUNDS

CTF-SCF/TFC.10/6

April 12, 2013

Joint Meeting of the CTF and SCF Trust Fund Committees

Washington D.C.

April 29-30, 2013

Agenda Item 7

**INTERIM PROPOSAL RELATED TO THE USE OF LOCAL CURRENCY LOANS
FOR PRIVATE SECTOR PROJECTS
UNDER THE CTF TRUST FUND**

(SUMMARY)

PROPOSED DECISION

The joint meeting of the CTF and SCF Trust Fund Committees welcomes document CTF-SCF/TFC.10/6, *Interim Proposal Related to the Use of Local Currency Loans for Private Sector Projects under the CTF Trust Fund* and:

- a) notes the MDBs' request to commence negotiation with their clients on the possibility of utilizing local currency loans under CTF private sector projects and programs approved by the CTF Trust Fund Committee in the following countries for which financing agreements with clients have not yet been signed:
 - i. Colombia, USD 5 million, implemented by IDB;
 - ii. Mexico, USD 42 million, implemented by IDB;
 - iii. Philippines, USD 10 million, implemented by IFC;
 - iv. South Africa, USD 42.5 million, implemented by AfDB;
 - v. Thailand, USD 44 million, implemented by ADB, and USD 50 million implemented by IFC; and
 - vi. Vietnam, USD 28 million, implemented by IFC.
- b) agrees that for the two year period from May 1, 2013 to May 1, 2015 , CTF resources in the amount of up to [USD 100 million][USD 150 million][USD 221.5 million] may be utilized to provide local currency lending to the projects and programs in those countries noted in (a) above and that any currency exchange losses related to such local currency lending will be borne by the CTF Trust Fund;
- c) [agrees that [USD X million] of CTF resources should be reserved to generate investment income to help offset potential losses related to repayments of local currency loans due to foreign exchange rates fluctuations under the arrangement described in paragraph (b) above];

or

[agrees that it is not necessary to reserve any CTF resources to generate investment income to help offset potential losses related to repayments of local currency loans due to foreign exchange rates fluctuations under the arrangement described in paragraph (b) above;]
- d) [requests the CIF Administrative Unit and the MDB Committee to agree upon the allocation of the funding available for local currency lending

among the programs and projects in the countries noted in (a) above, basing such allocation on readiness/needs of the projects and programs] ¹

- e) requests the CIF Administrative Unit to include in the semi-annual operational reports to the CTF Trust Fund Committee updates from the MDBs on the allocation and utilization of the local currency lending;
- f) requests the Trustee to coordinate with the Contributors to the CTF Trust Fund to amend the Contribution and Loan Agreements/Arrangements to include provisions for sharing of losses or gains due to foreign exchange rate fluctuations on the outgoing loans; and
- g) agrees that if the MDBs require additional amounts to be deployed in local currency above the [USD 100 million][USD 150 million][USD 221.5 million] allocation, the MDBs may present proposals to the CTF Trust Fund Committee for approval of additional local currency lending on a case-by-case basis. These proposals should include a full analysis of local currency needs for specific project(s) and/or program(s) and potential additional losses.

¹ This paragraph would not be required if USD 221.5 million is approved under paragraph (b), since there would be sufficient resources to cover all projects and programs listed in paragraph (a).

I. INTRODUCTION

1. At its meeting in November 2012, the joint meeting of the CTF and SCF Trust Fund Committees (the “Joint Meeting”) requested the Trustee to work with the MDBs to prepare a proposal for an interim measure to facilitate local currency lending in CTF and SCF private sector projects and programs pending the development of the Enterprise Risk Management Framework. The Trustee was requested to base its quantitative analysis on the following information, to be disaggregated for the CTF and SCF Trust Funds, to allow the Committees to take an informed decision on this issue:

- a) the maximum amount that can be allocated to the MDBs to use for local currency lending;
- b) the amount of the foreign exchange reserve to cover potential foreign exchange losses; and
- c) projections of the number and size of potential local currency loans.

2. In the course of the research, analysis and discussions with MDB focal points, it was reiterated that there are significant differences in financial risks, risk tolerance and complexity in the CTF and SCF Trust Funds arising from the different financial structures of each of the Trust Funds. In order to provide the necessary space for the respective Trust Fund Committees to discuss and make independent decisions on the local currency issue, it was determined that it would be beneficial to separate the proposals for each Trust Fund. Therefore, the SCF and CTF interim proposals for authorizing local currency lending are being presented in separate documents.

3. This document presents the proposal for the CTF Trust Fund. Section II elaborates the rationale for separating the proposals for the CTF and SCF Trust Funds. Section III discusses the summary background of the discussion to date on local currency lending in the CTF Trust Fund. Section IV discusses the approach taken to develop an interim proposal for local currency lending under the CTF Trust Fund. Section V presents the analysis of the proposed amounts for local currency lending. Further, this section presents information on the amount that could be set aside to help mitigate the risk of potential losses due to lending in local currency. Section VI presents an illustrative example of how losses related to the local currency lending would be shared among CTF contributors. Finally, Section VII outlines the approach to address a longer-term solution for local currency lending.

II. RATIONALE FOR SEPARATING THE PROPOSALS

4. One of the key differences between the CTF Trust Fund and the SCF Trust Fund is that the CTF Trust Fund allows for loan contributions in addition to grant and capital contributions. Thus, the CTF Trust Fund has liabilities to loan contributors and therefore must meet semi-annual debt service obligations, which is not the case for the SCF Trust Fund. Consequently, in the CTF Trust Fund, potential losses on local currency loans due to exchange rate fluctuations could impact the CTF Trust Fund’s ability to repay loan contributors any time up to the maturity

of the loan contributions. Under the SCF Trust Fund, the financial impact of potential losses due to exchange rate fluctuations on local currency loans would be limited to the calculated final shares of the SCF grant and capital contributors at the close of the SCF Trust Fund.

5. Given this fundamental difference between the two Trust Funds, different financial risk management and monitoring measures have been in place for each of the CIF Trust Funds. For instance, in the CTF Trust Fund, the following risk monitoring measures have been put in place: (a) maintaining a minimum liquidity reserve in order to ensure debt service payments to loan contributors can be met; (b) preparing quarterly projections on project repayments and possible loan loss rate scenarios on the overall portfolio to monitor the ability of the CTF Trust Fund to cover debt service payments to loan contributors; (c) simulating the loan loss/default sharing mechanism to determine the overall impact on the loan payout to loan contributors; and (d) keeping track of actual project interest rates to ensure that within the aggregate amount that is on-lent, there is at least an amount equal to the incoming loan contributions that is on-lent at equal or less concessional terms.

6. These measures are critical to the financial management and risk monitoring of the CTF Trust Fund. Therefore, the analysis needed to develop a proposal for the CTF Trust Fund is more complex than what is needed for the SCF Trust Fund. Based on this, it was determined that it would be beneficial to separate the proposals for each Trust Fund. The proposal for local currency lending in the SCF was approved by the Joint Committee in February 2013.²

III. BACKGROUND OF THE LOCAL CURRENCY DISCUSSION

7. In November 2011, the MDBs presented a paper titled, Climate Investment Funds: Lessons Learned from Private Sector Interventions through MDB Intermediaries (document CTF-SCF/TFC.7/CRP.1) to the Joint Meeting outlining a series of lessons drawn from its experience implementing CTF programs. As part of the learning from the MDBs during the early years of CTF operations, it has become increasingly evident that the type of private sector projects requiring financing from the CTF would benefit from lending in local currency (matching the currency of project revenues). This is in part due to the nature of eligible projects (e.g., “projects that wouldn’t otherwise happen without concessional finance”), and the inability of those projects to bear the foreign exchange rate risk of borrowing in hard currencies, such as dollars or Euros.³ The MDBs discussed the needs for local currency lending both informally and formally with the Trust Fund Committees of both the CTF and the SCF. During the November

² Proposal Related to the Use of Local Currency Loans under the SCF Trust Fund, January 15, 2013

³ The purpose of CIF funding to the private sector is to “catalyze investments that are not otherwise happening in the market” by providing concessional finance. MDBs structure such funds alongside their own mostly in the form of concessional loans and guarantees/risk mitigation facilities. Such concessionality is meant to address risk and cost barriers that prevent projects and investment from happening, and thus are meant, in practical terms, to fill the financing gap that results from those barriers. This flexibility underscores the purpose of the CIF’s additionality (beyond business as usual) and is fundamental to catalyzing investments that wouldn’t otherwise happen. CTF holds the funds received from contributors in two currencies (US dollars and Euros) and funding decisions by the CTF Trust Fund Committee are made and the funds are transferred to MDBs in these two currencies respectively. Under each of the CIF fund’s current frameworks, the risk of any foreign exchange losses would have to be borne by the MDBs, as the MDBs are required to return the reflows from the borrowers to the Trustee in the same currency in which the program/project was approved (i.e. in US dollars or Euros). This is in due to the inability at this time of the Trustee to hedge currencies. The paper “Estimated Cost of Hedging for Local Currency for CIF Trust Funds”, CTF-SCF/TFC.9/CRP.3, November 2, 2012, which outlines possible costs and other issues related to the implementation of a hedging strategy, was presented and discussed at the Joint Meeting.

2011 Joint Meeting, the MDBs were requested to prepare a paper for discussion on instruments that could enhance the effectiveness of CIF funding.

8. In May 2012, the Joint Meeting reviewed the document entitled, Proposal for Additional Tools and Instruments to Enhance Private Sector Investments in the CIF (document CTF-SCF/TFC.8/8), which outlined a number of proposals that could further enhance CIF effectiveness with the private sector, including the use of local currency lending. The Joint Meeting recommitted to the fundamental principles of providing concessional funding for private sector investments with appropriate levels of subsidy elements when market gap is demonstrated. Further, the Joint Meeting recommitted to allowing tools and instruments that could match their delivery expectations and result in positive and catalytic change. The Joint Meeting also requested that the CIF Administrative Unit, in collaboration with the MDB Committee, prepare a detailed proposal as to how to facilitate the use of local currencies in CIF-funded private sector projects and programs.⁴

9. In November 2012, the MDB Committee, in collaboration with the CIF Administrative Unit, presented a paper to the Joint Meeting entitled Use of Local Currencies in CIF Projects (document CTF-SCF/TFC.9/7) which outlined a proposal on how, and under what circumstances, the MDBs may be allowed to deploy CTF and SCF funding in local currencies for private sector projects and programs. During the same meeting, a proposal to develop a comprehensive Enterprise Risk Management Framework for the CTF and SCF Trust Funds was presented to the Joint Meeting. In connection with the discussion about the use of local currency lending, the Joint Meeting requested the Trustee to work with the MDBs to prepare a proposal for an interim measure to facilitate local currency lending in CTF and SCF private sector projects and programs pending the development of the Enterprise Risk Management (ERM) Framework.

10. In January 2013, and in parallel to the development of an interim proposal for the use of local currency lending in the CTF Trust Fund, a working group was convened following the decision of the Joint Meeting, of MDB representatives, the Trustee and the CIF Administrative Unit to begin work on an ERM Framework for the CIFs. The tasks of the Working Group, as set forth in the decision of the Joint Meeting, are to:

- a) identify priority risks to be addressed under the risk management framework;
- b) clarify what information is currently being gathered to manage those risks;
- c) undertake consultations with all interested members of the CTF and SCF Trust Fund Committees to ascertain their risk sensitivities;
- d) recommend at which level of the CIF such risks should best be monitored and managed; and

⁴ Some members of the Joint Committee have also requested that a Risk Management Framework be in place prior to enabling MDBs to transact in local currencies, in part so that they can more fully understand the risk to the overall portfolio if such instruments are used.

- e) prepare recommendations, for review and approval by the joint meeting, as to which risks should be a priority focus and the way forward for implementing a risk management framework.

11. The ERM working group will report back to the Joint Meeting at its next meeting in May 2013 on the above tasks undertaken by the working group. It is expected that the issue of lending in local currency will be more fully discussed in the context of a longer-term proposal during the discussion of the ERM Framework for the CIFs.

12. Notwithstanding the ongoing work by the ERM working group, the MDB Committee recognizes the importance of maximizing the ability of the MDBs to deploy CTF funding as quickly as possible, while supporting transformative projects. In the period leading up to a discussion on a longer-term solution for monitoring and managing risks associated with foreign exchange rate movements of local currency loans, the MDBs believe that an interim proposal on the use of local currency lending is critical to guard against the risk that private sector projects could drop out of the current pipeline if local currency lending is not approved in due course.

13. Following the November 2012 meeting, the MDBs provided to the Trustee an estimate of the possible demand for local currency lending for private sector CTF projects and programs pending the development of the ERM Framework.

14. Four MDBs have confirmed that they anticipate making use of local currency lending in the CTF Trust Fund in six countries whose private sector projects and programs have already been approved by the CTF Trust Fund Committee. The MBDs estimate that projects for a total amount of USD 221.5 million may require local currencies for lending. The MDBs' estimates for each country are listed in Table 1 below. The MDBs expect to be in a position to start negotiating the use of local currency loans with these clients immediately and conclude the respective financing agreements for the programs within the next 24 months. If a decision is taken to allow local currency lending and for the CTF Trust Fund to bear the potential losses, the MDBs will notify the Trustee that they have utilized local currency lending when submitting the final terms of the respective projects to the Trustee. The Trustee will present this information on a cumulative basis in the Trustee report.