CLIMATE INVESTMENT FUNDS

CTF/TFC.15/5
April 16, 2015

Meeting of the CTF Trust Fund Committee
Washington D.C.
Tuesday, May 12, 2015

Agenda Item 5

PROPOSAL FOR PRICING POLICIES FOR THE CTF TRUST FUND

PROPOSED DECISION

The CTF Trust Fund Committee reviewed documents CTF/TFC.15/5, *Proposal for Pricing Policies for the CTF Trust Fund,* and agrees that:

i. the CTF should not change its lending terms at this time; and

ii. the CIF Administrative Unit and Trustee should continue to monitor the CTF's lending terms and review these terms again in the future if there is a significant replenishment of CTF funds, and rise in interest rates.

I. Introduction

1. The CTF was established to provide scaled-up financing to middle income countries to contribute to the demonstration, deployment and transfer of low carbon technologies with a significant potential for long-term greenhouse gas emissions savings. CTF concessional financing focuses on large-scale, country-led projects in renewable energy, energy efficiency and transport, and on larger transactions in a smaller number of countries. The CTF aims to drive down technology costs, stimulate private sector participation, and catalyze transformative change that can be replicated elsewhere.

2. At the inception of the CTF, the CTF adopted lending terms similar to the IDA for its public sector loan operations as the IDA's terms were regarded as offering the appropriate balance in the concessionality of funding.

3. At the November 17, 2014 meeting, the CTF Trust Fund Committee reviewed the *Proposal for a Specific Target for the Margin between Projected CTF Net Income and Projected Loan Losses*. A key issue arising from the discussions was the flexibility of the CTF's current lending terms, and the potential impact of changes in these terms on the CTF's projected net income/loan losses and margin. The Committee requested that the CIF Administrative Unit, working with the MDBs and the Trustee, prepare a paper on pricing policies for the CTF.

4. Because guarantees and equity-like instruments represent small fraction of the concessional financing which the CTF offers, this paper focuses on the CTF's lending terms.

5. The purpose of this paper is to examine whether the CTF's current lending terms remain appropriate, whether opportunities exist to increase the CTF's net income by modifying the current lending terms, and the impacts of any further alignment of these terms with the IDA's lending terms.

II. Enterprise Risk Management and Tightening the CTF's Lending Terms

6. Enterprise risk management (ERM) refers to a structured, consistent and continuous process across the whole organization for identifying, assessing, monitoring and responding to opportunities and threats *which affect the achievement of its objectives*.

7. It is essential for ERM to begin with a clear understanding the enterprise's objectives. Because no two organizations are identical, individual enterprises have unique strategies and objectives, therefore face different types of risk, and have different options available to them for responding to risk. An organization's objectives provide the necessary context and direction for ERM to be successful. Failing to incorporate an organization's objectives into risk management efforts can cause more harm than good, and undermine the ability of an organization to achieve, or even pursue, its objectives.

8. From a risk management perspective, the CTF is an unusual organization because its objectives are so fundamentally different from those of most private sector enterprises. The CTF was established as a trust fund, and, as such, functions differently than an investment fund. The

CTF is funded by contributors rather than investors, and, as mentioned above, the CTF was created to provide concessional financing to middle income countries focusing on projects in renewable energy, energy efficiency and transport, rather than to maximize returns for investors.

9. Failing to keep the CTF's strategic objectives at the forefront of ERM efforts, and instead focusing on goals which conflict with the CTF's objectives, can lead to the pursuit of opportunities which may prevent the CTF from achieving its objectives.

10. While tightening the CTF's lending terms represents a potential opportunity to increase the CTF's net income to cover potential losses, the strategic objectives of the CTF necessitate that it extend concessional financing to middle income countries. If the lending terms can not be tightened without remaining sufficiently concessional for the CTF to achieve its objectives, then revising the lending terms would not be prudent.

III. FLEXIBILITY OF CURRENT CTF PRIVATE SECTOR FINANCING TERMS

11. The CTF uses private sector initiatives to address two primary market challenges: i) a dichotomy between perceived risks and real risks; and ii) the disincentive for private investors created by the high costs and risks associated with being a first mover in a new market. In both cases, private investors are discouraged from entering a new sector on their own. CTF private sector initiatives seek to achieve scale-up (a significant proliferation of the types of projects being supported – without a subsidy) by demonstrating, and creating a track record with a few initial investments. Once the private sector can observe the real market risks, and/or the costs of the new technology decrease, replication is expected and a subsequent scale-up in the market.

12. Advances in technologies and opportunities for high impact GHG-reducing private sector initiatives change over time, requiring an interactive and fluid approach to strategy development. Imposing restrictions on the terms of private sector loans would hinder the MDBs flexibility to address the highly customized financing needs of this sector.

13. Additionally, because private sector loans generally involve more limited concessionality, it is unlikely that the CTF could reduce the concessionality of these loans without impeding the CTF's ability to achieve its strategic objectives. For these reasons, limiting consideration for modifying lending terms to only public sector loans would be most prudent.

IV. FLEXIBILITY OF CURRENT CTF PUBLIC SECTOR LENDING TERMS

14. A key feature of the CTF is its ability to provide the MDBs with the instruments to blend CTF resources with other sources of financing to tailor terms to a target level of concessionality, which will vary depending on project-specific factors. When funding is approved for a given project, CTF funds are blended with financing from the MDBs, and, in the case of private sector operations, CTF funds are also blended with funds from other private sector financiers (e.g., lenders, project sponsors, etc.). This increases the overall financing for a project while diluting the concessionality of the CTF's contributions.

15. CTF funds are expected to leverage other resources, specifically from the MDBs, and other financial institutions. Indeed, the *Revised CTF Results Framework* (January 2013) lists, "Volume of direct finance leveraged through CTF funding" as a core performance indicator of the fund. When adjudicating whether to approve a project, MDBs are to consider the degree of leverage that will be achieved. Reducing the concessionality of the CTF's lending terms would further reduce the already diminished ability of the CTF's contributions to leverage financing from other non-concessional sources.

16. Between 2008, when the CTF was established, and 2015, interest rates have dramatically declined. U.S. 6-month LIBOR reached 3.87% in October 2008, and has since fallen to 0.40% in March 2015. Because many potential recipient countries borrow in the commercial markets for their infrastructure financing needs without exhausting their credit lines with IBRD and other multilateral financiers, and because lending terms offered by MDBs and other financiers are usually indexed to LIBOR, the ability of the CTF's lending terms to provide concessionality (or to provide significant subsidy value) has decreased dramatically. This has left the CTF with substantially diminished flexibility to tighten its lending terms without threatening the CTF's ability to achieve its strategic objectives.

V. IMPACTS OF CHANGES TO CTF PUBLIC SECTOR LENDING TERMS

17. As noted in the Development Committee paper *Strengthening the World Bank's Engagement with IBRD Countries* (2006), while MDBs would be ready to provide additional lending for projects and programs related to the Millennium Development Goals and global public goods (such as climate change mitigation activities), governments are reluctant to borrow on non-concessional terms for projects and programs that generate little additional revenue. Concessional forms of finance are intended to help unlock demand for the financing of such projects and programs. Blending CTF resources and MDB loans augments the volume of financing available, and better tailors concessionality to needs, with the degree of concessionality calibrated to achieve transformative investments which would otherwise not proceed.

18. CTF loan products provide financing to fill the investment gap in projects and programs that contribute to the demonstration, deployment and transfer of low carbon technologies, with concessionality related to the additional costs and risks of such deployment. Concessional lending from the CTF is intended to be used to make low carbon investments financially attractive by improving the internal rates of return on such investments. Lending on concessional terms will contain a grant element, which is defined as the difference between the loan's face value and the sum of the present value of debt service to be made by the borrower, expressed as a percentage of the face value of the loan.

19. The IDA's lending terms were updated in October 2014. Table 1 displays the estimated grant element under the CTF's current lending terms, and compares the CTF's Softer and Harder public sector lending terms with the current IDA Regular and Blend lending terms. It is important to note that the grant element under the CTF's public sector lending terms has already declined by ~10 percentage points due to the current interest rate environment.

Table 1. Lending Terms Comparison

		Maturity (Years)	Grace Period (Years)	Principal Repayments		Commitment Charge (%)	Service Charge (%)	Interest Rate (%)	Estimated Grant Element[1]
CTF	Softer Concessional	40	10	2% (yrs 11-20)	4% (yrs 20-40)	0.18	0.25	0	60%
	Harder Concessional	20	10	10% (yrs 11-20)		0.18	0.75	0	35%
IDA	Regular	38	6	3.125% (yrs 7-38)		0	0.75	0	50%
	Blend	25	5	3.3% (yrs 6-15)	6.7% (yrs 16-25)	0	0.75	1.25	25%

[1] Grant element is calculated using the IDA methodology assuming a 5% discount rate, an 8-year disbursement period and semiannual principal repayments).

20. Presently, approximately 90% of the CTF's paid-in contributions have already been approved for projects. Additionally, during the next six months, the remaining 10% is projected to be approved. Even if the CTF Trust Fund Committee were to approve a change to the lending terms immediately, it is unlikely that the CTF could implement the aforesaid lending terms within six months. Therefore, changes to the CTF's lending terms are unlikely to affect the CTF's net income, loan losses and margin significantly until the CTF has been substantially replenished.

21. Table 2 compares the CTF's projected net income, loan losses and margin, as of December 31, 2014 under the current lending terms vs. under the IDA's terms if implemented by the end of November 2015. Under the IDA's terms, the CTF's margin increases by $13MM, and the margin relative to potential losses increases by seven percentage points to 71%.

Table 2. Financial Components of CTF Net Income and Potential Losses (USD millions)

	Under Current CTF Terms Dec-14	Under IDA Terms Dec-14	*Difference Dec-14*
CTF Net Income	**183**	**203**	***20***
Investment Income	238	244	*6*
Assumption on Investment Income Return Rate, %	*0.77*	*0.77*	*-*
Assumption on Average CTF Cash Balance (Jan 2009 - June 2028)	*1,421*	*1,477*	*56*
Budget Expenses	(108)	(108)	-
Interest Received on outgoing loans and guarantee fees in excess of 0.75%	52	67	*15*
Potential CTF loss amount	**111**	**118**	***7***
Average Loss rates, %			
Public sector	5	5	*0*
Private Sector	10	10	*0*
CTF Net Income Excess over Potential Loss Amount	**71**	**84**	***13***
as % of Potential Losses	64%	71%	*7%*
Potential Losses to CTF Net Income Ratio	61%	58%	*-3%*

22. The modest level of funds which have not yet received project-level approval, limits the impact that a change in lending terms could have on the CTF's net income relative to potential losses. Also, the dramatic decline in interest rates since the CTF was established has already significantly eroded the concessionality of the CTF's public sector loans under its current lending terms, thereby substantially limiting any flexibility to tighten these terms. Tightening

the CTF's lending terms would jeopardize the CTF's ability to leverage financing from other non-concessional sources and achieve its strategic objectives. Therefore, although the IDA's lending terms have hardened since the CTF was established, maintaining alignment with the IDA's terms would not be prudent at this time.