CLIMATE INVESTMENT FUNDS

January 15, 2016

CTF NEW FINANCIAL PRODUCT CLASSIFICATION CRITERIA

I. BACKGROUND

1. In November 2013 and in early 2014, discussions were held on proposals for the Dedicated Private Sector Programs (DPSP). Key issues arising from the discussions were the risk level of the proposed programs, sub-programs and projects and the ability of the CTF Trust Fund to repay loan contributions if it incurred losses on those sub-programs or projects. Members of the CTF Trust Fund Committee agreed that further information on potential losses and returns of the DPSP proposed sub-programs or projects would contribute to more informed funding decisions. However, the divergence of risk tolerances among the CTF contributors impeded decision making on the DPSP sub-programs and projects as well as on other private sector programs under the endorsed investment plans. This delay in decision making may thereby affect the ability of the CTF Trust Fund to achieve its strategic objectives.

2. In June 2014, CTF contributors met to discuss disparate risk tolerances amongst the CTF contributors and requested the CIF Administrative Unit and the Trustee, in collaboration with the MDBs, to explore approaches to accommodate such differences in the gain/loss sharing arrangements set out in the CTF contribution agreements. In response to the request, a note was prepared that presented ideas, including relevant implications, for consideration by the CTF contributors, and an agreement in principle was reached with the contributors.

3. On September 5, 2014, the Trustee circulated the document, *Further Elaboration on Risk Sharing to Support Contributors' Discussion on financial Products Used in CTF Programs and Projects* based on the consultations with contributor countries. The discussion note elaborated on an approach based on the exclusion of certain high risk financial products from the loss sharing calculation, and proposed categorizing the financial products which have been employed under the CTF program into two groups based on level of risk embedded in the structure of the product. The Contributors agreed to the following categorization of existing products which were subsequently incorporated as amendments to the Contribution Agreements.

Group 1 – financial products to be *included* in the CTF Net Income and loss sharing calculation:

a) Senior loans in USD or EUR
b) Senior loans in local currency hedged
c) Subordinated debt / mezzanine instruments with income participation (both straight debt, i.e. fixed return and variable income participation)
d) Second loss Guarantees (both single project and portfolio)

Group 2 – financial products to be *excluded* from the CTF Net Income and loss sharing calculation:

a) Equity
b) Subordinated debt / mezzanine instruments with convertible features
c) Convertible grants and contingent recovery grants
d) Contingent recovery loans
e) First loss Guarantees (both single project and portfolio)

4. Additionally, the CIF Administrative Unit, Trustee and MDBs agreed to develop a set of criteria to guide the determination as to whether any new financial product proposed under a program or project but not included in Group 1 or 2 should be included in or excluded from the CTF Net Income and loss sharing calculation (i.e., categorized under Group 2), for approval by the Contributors.

5. On July 27, 2015, the last remaining CTF contributor country signed the amendment to their Contribution Agreement, updating the gain/loss sharing arrangements amongst the CTF contributors. To facilitate the implementation of the revised risk sharing requirements, this paper proposes a set of criteria for categorizing new financial products.

II. Applicability and Scope

6. The proposed criteria are intended to pertain only to the risk embedded in the structure of new financing products. The risks associated with the technology underlying a project, and the credit risk associated with the funding recipient, may not be used as criteria for classifying a financial product as higher risk as this would undermine the ability of the CTF to achieve its objectives.

7. A key objective of the CTF is to provide positive incentives for the demonstration of low carbon development and mitigation of greenhouse gas emissions, and for developing countries to integrate nationally appropriate mitigation actions into sustainable development plans, providing lessons through learning-by-doing. Therefore the CTF may not classify a financial product as higher risk based on the underlying technology which will be implemented as this could undermine the CTF's goals of facilitating developing countries' integration of nationally appropriate mitigation actions and providing much needed learnings regarding the implementation of new or higher risk technologies. Additionally the risk associated with a low carbon technology is largely independent of a financial product's structure or type (i.e., it could cause a given transaction to be high/low risk regardless of the financial product employed).

8. The CTF also strives to support effective mechanisms and enhanced means for the removal of obstacles to, and provision of financial and other incentives for, scaling up of the development and transfer of technology to developing countries in order to promote access to affordable environmentally sound technologies. This necessitates that the CTF not discriminate between financing recipients based on their financial strength. Doing so would contradict the CTF's goal of removing obstacles to the financing of low carbon technologies in developing countries.

9. For this reason the credit risk associated with financing recipients may not be used as a criterion for classifying financial products into either of the two groups. Rather, this credit risk is identified and assessed as part of the MDBs' due diligence processes in determining whether to submit a given project or program for approval, and the MDBs then monitor and mitigate this credit risk until the financing recipient has satisfied their obligations under the terms of the transaction.

10. The following section outlines the proposed criteria, pertaining to the risk embedded in the structure of new financing products, for classifying products into Group 2.

III. Criteria for Classifying New Financial Products[1]

11. A number of criteria affect the risk embedded in the structure of a financial product. New products which are classified as higher risk will be assigned to "Group 2" and will be excluded from the CTF Net Income and loss sharing calculation. Such products may not therefore be financed using loan contributions. New financial products will be assigned to Group 2 if they possess one or more of the following structurally embedded characteristics detrimental to the adequacy and certainty of the CTF's net income or liquidity (all other products will be assigned to Group 1).

    i. *Term Flexibility:* term is extendible without requiring CTF Trust Fund Committee's consent.

    ii. *Currency:* reflows to the CTF are in an unhedged currency other than USD or Euros.

    iii. *Amortization:* for loans (or guarantees on loans) with maturities greater than 10 years, principal is not repayable until final maturity.

    iv. *Grace Period:* Amortizing loans (or guarantees on loans) with grace periods greater than 10 years.

    v. *Contingency of Loan Reflows:* level or realizability of loan reflows (i.e., service charges, interest payments and principal repayments) is dependent on the occurrence or absence of a specified external event.

    vi. *Convertibility:* loan may be subordinated, or converted to equity or a grant, or the initial product is a Group 1 product which may be converted to a Group 2 product or to a product possessing any of the criteria listed in this section.

12. The CIF Administrative Unit will work with the Trustee and MDB Committee to submit the program/project, including a recommendation on whether to classify a new financial product into Group 2, for approval to the TFC. The Contributors will then have two weeks to request further information on the financial product's classification, after which time, and in the absence of any objections to the recommended classification, the product will be assigned to the corresponding category.

IV. Exceptions and Escalation Process

13. These criteria are intended to identify whether new financial products with unforeseeable features have higher risk embedded in their structures. Because it is impossible to predict all combinations of characteristics that a potential new financial product may possess, there remains a risk that:

    i. a new financial product with one or more of the above-mentioned criteria embedded in its structure is not, in fact, higher risk based on its structure; or

[1] Please note that, in addition to these criteria, the requirements outlined in the loan contribution agreements continue to apply (i.e. loan contributions may not be used to fund outgoing financial products yielding less than 0.75% or maturing in greater than 20 years).

ii. a new financial product with none of the above-mentioned criteria embedded in its structure is, in fact, still higher risk based on its structure.

14. If the CIF Administrative Unit, Trustee or MDB believes either of these situations may have occurred, any of these parties may request that classification of the new financial product be postponed until the MDB proposing the product has presented further analysis of the risks embedded in the structure of the product to the CIF Administrative Unit and Trustee. The CIF Administrative Unit, Trustee and MDB will review and opine on the analysis with the goal of agreeing on a classification of the financial product.

15. If an agreement is reached, then the CIF Administrative Unit will document the exception and/or update the above-mentioned criteria as necessary, and the approval process for the corresponding project or program will resume. If an agreement is not reached within two weeks, then the CIF Administrative Unit will submit the analysis of the risks embedded in the structure of the product, and rationale for escalating the decision, to the CTF Trust Fund Committee to determine the classification of the product within two weeks.