Climate Investment Funds

CTF-SCF/TFC.8/8
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Joint Meeting of the CTF and SCF Trust Fund Committees
Washington, D.C.
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Agenda Item 9

PROPOSAL FOR ADDITIONAL TOOLS AND INSTRUMENTS TO ENHANCE PRIVATE SECTOR INVESTMENTS IN THE CIF

Proposed decision by the Joint CTF and SCF Trust Fund Committees

The joint meeting of the CTF-SCF Trust Fund Committees welcomes the paper document CTF-SCF/TFC.8/8, *Proposal for Additional Tools and Instruments to enhance Private Sector Investments in the CIF*, and reconfirms its commitment to promoting private sector investments within the CIF countries.

More specifically, the meeting:

a) recommits to the fundamental principles of providing concessional funding for private sector investments with meaningful levels of subsidy elements and allowing tools and instruments that could match their delivery expectations and result in positive and catalytic change, including allowing subordination if needed in all the CIF programs, and for floor pricing and flexibility that consider changing market conditions;

b) encourages countries and the MDBs, in preparing new investment plans or revising/updating existing plans, to allocate up to 30% of the CIF funding to private sector investments;

c) invites the CIF Administrative Unit and the MDBs to develop specific operational guidelines for financial instruments currently permissible under the CIF where such guidelines would help promote more diversity in instruments used in the CIF portfolio;

d) reconfirms that CIF funding can be utilized in equity investments;

e) requests the CIF Administrative Unit and the Trustee, in collaboration with the MDB Committee, to prepare a detailed proposal as to how to facilitate the use of local currencies in CIF-funded projects and programs, where appropriate; and

f) regarding Section V of the paper, on future options for new private sector funding vehicles, invites the CIF Administrative Unit and the MDBs to further develop proposals for […......].

I. SCOPE

1. The scope of this paper is limited to investments financed by the private sector arms of the Multilateral Development Banks (MDBs). The instruments and tools used for private sector investments delivered through public sector projects as well as associated issues are not discussed here.

2. This paper, acknowledges that there are significant CIF funds channeled through governments to support private sector investments either through provision of financing (loan, grants, results based financing, etc.) and guarantees, or through creating enabling environments. However, it recognizes that private sector investments delivered by the private sector arms of the MDBs face a different set of commercial and business risks in the absence of sovereign guarantees and thus need a range of financial instruments and structures appropriate to mitigate various risk profiles and reward investors and lenders accordingly.

3. A separate note discussing how public sector operations are used to support private sector investments is currently under preparation.

II. INTRODUCTION

4. During its November 2011 meeting, the Joint CTF-SCF Trust Fund Committee approved the document CTF-SCF/TFC.7/4, *Proposed Measures to Improve the Operations of the Climate Investment Funds.* This document underscored that the CIF will utilize the skills and capabilities of the MDBs to raise and deliver concessional climate financing at a significant scale to unleash the potential of the public and private sectors to achieve meaningful reductions of carbon emissions and greater climate resilience.

5. The CIF Administrative Unit, in collaboration with the MDBs was requested by the Joint CTF-SCF Trust Fund Committee to provide an overview of the current use of financial instruments and to make proposals for additional tools and modalities that could be tested through the CIF to enhance private sector participation and engagement in its programs. This paper was produced by the CIF private sector working group in response to that request.

6. Experience so far has shown that the deployment of CIF funds in supporting private sector investments has not reached its target potential, particularly in the case of the SCF programs (FIP, PPCR, SREP).

7. While the underlying reasons for underutilizing private sector investment are multiple and complex, one dimension could be related to not using a wider range of available financial instruments, including those that are higher risk and which would be appropriate for reducing certain barriers to private sector investment in some of the CIF's industries and sub-sectors. Thus, understanding why not all financial instruments that are theoretically available under the CIF's current design have been used for private sector investments or included in country investment plans, is key for enhancing the impact of the CIF's operations in augmenting private sector engagement and for future climate funding within the CIF or outside.

8. In this paper, two questions will be addressed:

a) First, under the current design of the CIF, what are the instruments used so far under each of the CIF programs, and specific reasons for not using the remaining instruments **(See Section III and IV)**. This question aims at producing a set of proposals for improvements that could be introduced to the current design of the CIF programs immediately.

To note, in parallel to this paper, a second paper titled "*Proposal for Improvement Measures for the CTF Private Sector Operations*", document (CTF/TFC.9/7), prepared by the CIF private sector working group, is being proposed at the CTF Trust Fund Committee meeting for its review and approval, with the objective of tackling an immediate set of procedural improvements, some of which are proposed in this paper. Further improvements and additions could be introduced further to the CTF Trust Fund Committee review and approval of this paper.

b) A second question aims at proposing a longer-term view and options for new financing vehicles and structures that could be used under a scenario of additional funding under the CIF, or for a new fund such as the Green Climate Fund (GCF) **(See Section V)**. This will lead to a set of initial options and proposals for further discussion by the Trust Fund Committee.

9. It should be noted that proposing improvements to the use of financial instruments available under the current CIF design would not necessarily by itself lead to an increased CIF private investment volume. There are a multitude of causes that influence the volume of private sector investments.

10. First and foremost, the investment plans are by design country-driven and are inspired by national governments' programming priorities, and thus a lower private sector component in an investment plan is a reflection of the country's priorities. Furthermore, private sector volume of investment in a single country is very much dependent upon the overall stage of maturity of the private sector investment climate within the country (See paragraph 14 (ii)), especially the enabling environment and regulatory framework.

III. FINANCIAL INSTRUMENTS AVAILABLE UNDER THE CURRENT CIF DESIGN BUT UNUSED

11. Under the current design of the CIF's programs, financial instruments available for private sector investments by the private sector arm or the MDBs include: grants, guarantees, loans, equity and quasi equity[1]. The following are the instruments that have not been used (See annex I: Instruments that are used, planned to be used, and are not being used, and Annex II: List of instrument used in CTF projects):

a) Under the CTF: Equity, quasi equity, and local currency loans.

[1] Quasi equity, mezzanine financing and convertible loans fall under the same risk hierarchy (between a straight loan and an equity) but are used in different structuring scenarios depending on the specificities of a transaction.

b) Under the FIP: Equity, quasi equity, local currency loans, and guarantees.

c) Under the PPCR: Equity, quasi equity, local currency loans, and guarantees.

d) Under the SREP: Equity, quasi equity, local currency loans and guarantees.

12. To date, out of 17 approved CTF private sector investment proposals for projects and programs, two private sector facilities are structured using guarantees (risk sharing facilities) and the remainder is structured to provide concessional loans. While it is too early to assess whether there is a pattern or not given the large proportion and variety of program structures for private sector investments under the CTF, the clear trend thus far is leaning toward the use of concessional loans.

13. Equity investments could be used in higher risk profile projects, such as those associated with innovative technologies and first market movers, and equity investments are appropriate in markets with an up-side potential promising higher reward compared to other instruments (debt and mezzanine). Equity is useful to promote investments in innovative technologies that depart from "business as usual". However, the *CTF Investment Criteria for Public Sector Operations* stipulate that CTF funding should be dictated by the technology phase criteria and should finance proven technologies only[2]. If the CTF was to invest equity in start-ups or in a pre-commercial phase for example, it could promote innovation through small scale equity investments.

14. Also quasi equity, convertible loans and mezzanine financing are three categories that present medium risk instruments compared to a "straight" equity, with similar risk mitigating effect, a more modest return expectation, and can be used in medium to large scale innovative projects, which is appropriate to many of the CTF, SREP and FIP programs and projects.

15. Use of concessional loans has been limited to US dollars and Euro, while there is demand among the CIF private sector clients for local currency loans and guarantees as well.

16. Based on evidence from the MDBs, some of the reasons for not using the above instruments could be summarized as follows:

a) *Risk appetite of the CIF's Trust Fund Committee and Sub-Committees*

One of the reasons CIF instruments that carry higher risk, such as equity and quasi equity investment have not been used is that some members of the CTF Trust Fund Committee, through the review process of existing projects and programs, have conveyed a reluctance to endorse the higher risk instruments and structures and adequate concessional terms as proposed by the MDBs based on analysis of the underlying risk-reward profile of projects to be financed. Also, members have on occasions requested that the CIF funding component be structured on a pari passu basis with the MDBs co-financing, and that results in

[2] See Paragraph 6, *Clean Technology Fund, Investment Criteria for Public Sector Operations*

limiting the potential for the CTF funds to be used for operations outside of the MDBs' business as usual.

It is worth noting that the MDBs credit practice and rules tend to be conservative, which precludes the MDBs from undertaking riskier transactions utilizing their own funds. Moreover, the risk management frameworks for nearly all MDBs with private sector operations were further strengthened after the 2008 global financial crisis to ensure the credit quality of the MDBs remains robust and not subject to the same problems facing commercial banks. The CIF funding is; therefore, crucial to unlock new financing structures and markets by taking a limited position of higher risk. Use of subordination in financing structures can be a very powerful tool for mobilizing the MDBs' own sources and leveraging commercial sources of both debt and equity.

Also, with some CTF funding being contributed in the form of concessional loans rather than grants or equity, and recognizing that financing from the CTF needs to be no more concessional than the terms of contributions[3], it is difficult for the MDBs to structure products under concessional terms if they are to utilize this pool of loan contributions in the current market conditions.

b) *An inherent tendency for governments to focus on public sector investment priorities*

The private sector is expected to play an important role and have access to funding for the implementation of its projects. Yet, not all the CIF countries have presented a private sector component in their investment plans, particularly under the SCF programs where the portion reserved for private sector operations remains very small (a range of 5% to 15%). In the absence of a deep private sector pipeline under some of the SCF programs, it is rather difficult to use a range of the available financial instruments.

From initial lessons learned to date, reasons for limited private sector investments in the SCF could include:

i. a reluctance of the public sector to share "scarce" concessional funding from the CIF with the private sector;

ii. limited and inconsistent level of consultations with the private sector at the time of inception and design of the country investment plans, which resulted in a smaller pipeline of private sector projects;

iii. weak private sector presence in certain countries, combined with a weak r egulatory frameworks in place, and a lack of technical capacity, which limits the opportunities for intervention; and

[3] See Paragraph 3 (iii), *CTF Financing Products, Terms, and Review Procedures for Public Sector Operations*

iv. a perception that certain CIF sectors are less commercially driven, such as adaption work, which has been traditionally led by the public sector, such as the energy sector and infrastructure in general.

c) *Country context*

In some of the newer markets that the CIF intends to support, it is difficult to set up instruments like equity and quasi equity. Also, exercising put options is not allowed in certain jurisdictions, which limit investors exit strategy options to a trade sale only and thus discourage them from investing in these markets. Sometimes banking regulations in some countries restrict returns or repatriation of funds as well. Furthermore, not all markets have a swap market or in certain cases appropriate financial mechanism and rules allowing use of certain instrument. Small countries also face issues of risk of over exposure to one specific technology because of the relative small size of their investment in this specific sector.

d) *Lack of specific operational guidelines*

The lack of specific operational guidelines, terms and conditions associated with equity and quasi-equity investments limits the possibility of exploring them. The same applies to local currency loans and mezzanine financing/convertible loans. In the case of equity investments for example, to the extent the terms and conditions are not sufficient to develop an initial template term sheet for equity investments to provide to sponsors (e.g., hurdle rates for assuming risks as a shareholder, put options, affirmative rights as shareholder/board member, board representation, tagalong rights, mandatory exits, etc.), the MDBs will naturally gravitate towards products with simpler structures as well as instruments for which a precedence has been established with the Trust Fund Committee.

In the case of local currency loans, most MDBs have restrictions when arranging local currency loans so that any foreign exchange risk must be adequately hedged. While swaps are available for most middle income countries, hedging instruments are often limited in tenor and amount for other small markets that results in MDBs facing certain foreign exchange risks.

e) *MDBs own internal limitations*

Some MDBs have internal constraints on direct equity investments, and on mezzanine financing, which prevents them from considering deployment of CIF funds alongside their own funding. Also, local currency loans are not allowed by some MDBs given potential exposure to foreign exchange fluctuations risk, and due to unavailability of long-term hedging instruments in certain markets.

In some cases, MDB teams find loans and guarantees to be preferable to equity because they are less expensive and complex to implement; equity investments are lengthy to prepare and expensive to implement, administer and monitor.

Furthermore, given limited public resources and availability of concessional financing, some MDBs find that adequate transformative impact can be reached through the risk and cost lowering abilities of more common loan and guarantee operations. In that case and in order to have a meaningful effect, flexibility in the concessional use of these instruments is necessary.

IV. PROPOSALS – FOR IMPROVED USE OF FINANCIAL INSTRUMENTS UNDER THE CURRENT CIF DESIGN

17. There are a few adjustments to current practices in the CIF that could amplify the impact of the CIF funding in engaging the private sector:

Flexibility and Concessionality

a) Recommitment of the decision makers to the fundamental principles of providing concessional funding with meaningful levels of subsidy elements, and allowing tools and instruments that could match their delivery expectations and result in positive and catalytic change.

b) Allowing further flexibility in the investment parameters/terms and reporting requirements for each of the financial instruments, including those associated with concessionality threshold. Specifically: Allowing subordination if needed in all the CIF programs, and allowing for floor pricing and flexibility that consider changing market conditions.

Further emphasis on private sector allocation on the country level

c) Introducing a requirement that the country investment plans allocate a minimum amount of funds from a "country allocation" to catalyze private sector investments. This could be a flat minimum amount or a percentage of the total CIF funding allocation in the country.

Establish specific operational guidelines for all instruments

d) Introduction of specific operational guidelines for each of the CIF financial instruments, including the ability to use innovative structures to diversify risk. In the case of equity investments, acknowledging that delegation of loans is much easier than delegation of decisions on equity investment, it is important to define guidelines for use of equity under the CIF, including issues related to board oversight, and MDBs liability issues, exit strategies, use of the CIF funds vis-à-vis the MDBs resources (including hurdle rates), and a range of possibilities available in terms of preferred rights, divestment time, board oversight and representation, etc.

Also, elaboration of terms and conditions and clear operational guidelines for structuring investments using quasi equity and convertible loans.

Further risk diversification structures

e) Equity: Certain structures qualify under the current CTF guidelines but are not explicitly mentioned. *Confirming that funding can be utilized in equity*.

f) Local currency lending: *Introduce options to use local currency financing structures as laid out below*. Under the current structure, projects and beneficiaries must hedge the foreign exchange risk themselves, since neither the CIF nor the MDBs will bear the risk, and the cost of hedging, where it is possible, is borne by clients and ultimately decreases the subsidy element and attractiveness of the CIF funds. Options include:

   i. Guarantee for local currency lending.
   ii. Provide lending in local currencies with the risk and cost being borne by the CIF funds/contributors, and risk managed through hedging mechanisms by the CIF Trustee.

V. FUTURE OPTIONS FOR NEW PRIVATE SECTOR FUNDING VEHICLES [4] BEYOND THE CURRENT CIF DESIGN

18. The following presents a longer-term view with options for new financing vehicles and structures that could be proposed under a scenario of additional funding pledges to the CIF, in which case would require modifications to the CIF current design, policies and set of principles, or for a new fund such as the Green Climate Fund:

a) A **"Dedicated private sector fund**". Creation of a fund focused solely on private sector operations. This could have its own target countries/regions, or make itself available alongside the other CIF programs. Instruments included could be those discussed above. The review process would be different from public sector operations. Such a structure would eliminate the problem associated with a risk assessment approach and risk appetite as the expectations are agreed at the outset. In case of additional pledges to the CIF with a clear mandate to invest in private sector operations, introduction of operational guidelines, procedures, investment criteria specifically tailored to private investments with a distinct and simplified approval process through an investment committee, equivalent in decision making power to the Trust Fund Committee under the current CIF structure. [5]

b) A "**Regional private equity and/or mezzanine fund**" for any of the CIF sectors, which would allow creation of scale and risk diversification in the case of small countries. This could target one or multiple technologies (multiple technologies could also reduce technology risk concentration). Funds would be deployed through the relevant regional development bank and the IFC, as is the case in the CIF. The fund could provide equity and/or mezzanine financing.

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[4] Assuming either further pledges to the CIF or pledges to a new fund outside the CIF structure, such as the CGF

[5] In case there is a separate set of contributor countries willing to fund private sector allocations, the Trust Fund Committee for such a pool of funds could be managed separately.

c) A "**Regional guarantee fund**" for the CTF and SREP programs and their sub-sectors, which would allow creation of scale and risk diversification in the case of small countries. Funds would be deployed through the relevant regional development bank and the World Bank Group (IFC and MIGA).

d) A "**Global or regional technology fund**" that would be driven by technology potential and market opportunity (e.g. CSP in the MENA region or globally, and geothermal in East Africa or globally) with flexible instruments including debt, equity and mezzanine financing – the benefit of regional facilities is to mitigate country risk by diversifying exposure, while allowing leverage and synergy among countries and MDBs. This could be structured with two "ring-fenced" vehicles; one to finance Public-Private Partnerships, and a second to fund a purely private sector projects.

Annex I

Instruments that are used, planned to be used, and those are not being used

Financing Instrument	CTF	FIP	PPCR	SREP
Loans	Used	Planned	Planned	Planned
Guarantees	Used	Not used	Not Used	planned
Equity	Not used	Not used	Not used	Not used
Quasi-Equity	Not used	Not used	Not used	Not used
Mezzanine Financing	Used[6]	Planned[7]	Planned[8]	Planned[9]
Convertible Loans	Not used	Not used	Not used	Not used
Grants	Used	Planned	Planned	Planned
Local Currency Loans	Not used	Not used	Not used	Not used
Credit lines	Used	Not used	Not used	Planned

[6] In form of a subordinated loan
[7] In form of a subordinated loan
[8] In form of a subordinated loan
[9] In form of a subordinated loan

Annex II

Instruments used to date under the CTF projects

Project's Name	Country	MDB	Instrument
CTF Colombia Sustainable Energy Finance	Colombia	IFC	Grant
BancoSEF - Colombia	Colombia	IFCEX	PRIVATE SECTOR GUARANTEE
Waste Management Framework (KWMF) - Knowledge Management - Kazakhstan	Kazakhstan	EBRD	Grant
Kazakhstan CAEPCO District Heating Pavlodar and Petropaviovsk - Advisory Services	Kazakhstan	EBRD	Grant
Kazakhstan CAEPCO District Heating Pavlodar and Petropaviovsk - Investment	Kazakhstan	EBRD	PRIVATE SECTOR LOAN
Kazakhstan District Heating Modernisation Framework (DHMFF) - Knowledge Management	Kazakhstan	EBRD	Grant
Kazak Res PPG	Kazakhstan	EBRD	
Kazakh Railways - Sustainable Energy Program (Knowledge Management)	Kazakhstan	EBRD	Grant
Kazakh Railways - Sustainable Energy Program (Loan)	Kazakhstan	EBRD	PRIVATE SECTOR LOAN
EDF La Ventosa (Mexico PSWD)	Mexico	IFCEX	PRIVATE SECTOR LOAN
Assesment of Geothermal Potential in Mexico	Mexico	IADB	Grant
Private Sector Energy Efficiency Part I	Mexico	IADB	
Eurus Wind Project, part of Public-Private Sector CTF Proposal for Mexico's Renewable Energy CTF Program	Mexico	IADB	PRIVATE SECTOR LOAN
Study of macroeconomic and social impacts of the wind energy industry	Mexico	IADB	Grant
Capacity Building for NAFIN's Unit of Sustainable and Climate Change Projects	Mexico	IADB	Grant
Mexico RE AS CTF Project	Mexico	IFC	Grant
Philippines SEF II (Advisory Service)	Philippines	IFC	Grant
La Suerte - Philippines	Philippines	IFCEX	PRIVATE SECTOR LOAN
CTF Solar Power Company SPC 4-5	Thailand	IFCEX	PRIVATE SECTOR LOAN
BMUL EE	Thailand	IFCEX	PRIVATE SECTOR GUARANTEE
Finansl EE (Turkey CSEFP)	Turkey	IFCEX	PRIVATE SECTOR LOAN
Yapi Kredi Finansal Kiralama A.O.	Turkey	IFCEX	PRIVATE SECTOR LOAN
Turkish Sustainable Energy Financing Facility (TurSEFF) - Advisory Services	Turkey	EBRD	Grant
Turkish Sustainable Energy Financing Facility (TurSEFF)	Turkey	EBRD	PRIVATE SECTOR LOAN
Turkish Sustainable Energy Financing Facility (TurSEFF)	Turkey	EBRD	PRIVATE SECTOR LOAN
Ukraine Creating Markets for Renewable Power - Investment	Ukraine	EBRD	PRIVATE SECTOR LOAN
Ukraine Renewable Energy Direct Lending Facility - Knowledge Management	Ukraine	EBRD	Grant
ABBank CTF EE Loan Project	Vietnam	IFCEX	PRIVATE SECTOR LOAN
Vietnam Cleaner Production Energy Efficiency Project	Vietnam	IFC	Grant
Sacom Bank - Vietnam	Vietnam	IFCEX	PRIVATE SECTOR LOAN
Abengoa Ka Xu CSP - South Africa Sustainable Energy Acceleration Program	South Africa	IFCEX	PRIVATE SECTOR LOAN
Mercantile Bank (EUR) (South Aftrica EE Program)	South Africa	IFCEX	PRIVATE SECTOR LOAN