CLIMATE INVESTMENT FUNDS

CTF/TFC/12/9
October 12, 2013

Meeting of the CTF Committee
Washington D.C.
October 28, 2013

Agenda Item 10

USE OF LOCAL CURRENCY FOR PRIVATE SECTOR PROJECTS UNDER THE CTF TRUST FUND: PROPOSED TOOLS AND INSTRUMENTS TO SUPPORT LOCAL CURRENCY OPERATIONS

PROPOSED DECISION

The CTF Trust Fund Committee, having reviewed the document (CTF/TFC/12/9), *Use of Local Currency for Private Sector Projects under the CTF Trust Fund: Proposed Tools and Instruments to Support Local Currency Operations*:

a) Agrees that the CIF MDBs may employ Tools 1 to 4 proposed in the document as a way to facilitate local currency operations for private sector projects under the CTF. These include hedging tools (tools 1 and 2) and guarantee tools for domestic clients (tools 3and 4).

b) In this regard, the Committee agrees that:

   i. the CTF Trust Fund will bear any residual losses from foreign exchange rate fluctuation not covered under Tools 1, and 2 as proposed in the document; and

   ii. the CTF Trust Fund will bear the additional costs associated with the use of Tools 1 and 2, as proposed in the document provided that, when an MDB expects to employ any such tool in a particular program or project, the use of the tool and the costs should be specified in the program or project proposal submitted for approval of CTF funding. If the cost of the tool cannot be specified at the time that CTF funding for the proposal is approved, the proposal should include an estimate of the cost. For Tools 1 and 2, this cost will be within the 2% per annum cap. When an estimate of the cost is specified at the time of the Committee's approval of CTF funding, the MDB will inform the Committee as soon as the actual cost is known. If immediately prior to the execution of the hedge the expected hedge costs exceeds the estimate provided to the Committee, the MDBs should inform the CIF Administrative Unit and the Trustee of the revised hedging cost before executing the hedge. Approval from the CTF Trust Fund committee will be provided on a no objection basis with 48 hours of receipt of the information from the MDB as long as the revised hedging costs is still within the 2% per annum cap.;

c) Requests the MDBs to report annually, in the CTF semi-annual operational report, on the use of the tools and their costs;

d) further requests the CIF Administrative Unit and the MDB Committee to prepare an assessment of the use of the tools, their cost and effectiveness in facilitating the engagement of the private sector in CIF-funded activities for review by the Committee in October/November 2015; and

e) requests the CIF Administrative Unit to revise the *CTF Financing Products, Terms and Review Procedures for Private Sector Operations* and the Trustee to work with the CTF Contributors to process the necessary amendments to the legal documents, as described in the document.

I. INTRODUCTION

1. At its meeting in May 2013, the CTF Trust Fund Committee requested the CIF Administrative Unit, working with the MDBs and the Trustee, to prepare a paper for review and approval by the CTF Trust Fund Committee on the approach for using local currency in private sector projects.

2. On August 16, 2013, received document entitled “Use of Local Currency for Private Sector Projects under the CTF Trust Fund: Proposed Tools and Instruments to Support Local Currency Operations”, was circulated for approval. Committee members submitted comments and requested clarifications on the tools and instruments that could be used to support local currency operations, and requested that the document be revised taking into account their comments. This revised document addresses comments and questions received from Committee members.

3. The objective of this paper is to outline the principles for each tool and the situations in which they would add most value. However, full details on the terms and conditions of the transactions are difficult to present in the abstract, and cannot be generalized across the pilot countries with heterogeneous financial markets. Once the CTF Trust Fund Committee has agreed on the proposed “toolkit”, the MDBs would present transactions project by project with additional details on structure and cost estimates. The CTF Trust Fund Committee would approve the use of each tool, and the cost estimates of individual operations as they are presented to the Trust Fund Committee.

4. Section II presents a revised menu of CTF tools and instruments. Section III illustrates how the costs, fees and expenses that are to be borne by the CTF Trust Fund would be shared among the CTF Contributors. Section IV sets out the amendments that would be necessary to the CTF legal documents to allow for the use of such tools and instruments.

II. TOOLS AND INSTRUMENTS TO SUPPORT LOCAL CURRENCY OPERATIONS

5. Local currency lending can enhance the ability of projects/borrowers to repay loans, providing greater assurance to local banks and increasing the potential to mobilize further private sector funding. All of these factors can improve the risk profile of the CTF investment. Table 1 below presents a menu of six tools that MDBs could use to facilitate the use of local currencies in CTF lending or promote local currency lending with commercial banks in private sector operations.

6. The tools and instruments have been grouped into three categories:

   A. Hedging Tools (e.g. cross currency swaps)
   B. Guarantee Tools for domestic clients
   C. Other tools designated for the purpose of supporting local currency lending

7. The tools in **category A** are known instruments to the MDBs, but would be new for the CTF. The tools in **category B**, however, are currently available under the existing procedures

and guidelines for private sector operations. The purpose of being presented here is to clarify the conditions under which they can be used and address the cost/risk issue. The implementation of tools described in **category C** depends on financial limits being set. It is understood that it would be premature to reach a decision on the exact limits for these tools in the absence of the ERM system currently being developed for the CIFs. Therefore, they are included here only to illustrate the full range of possibilities for local currency financing. A full discussion and decision on category C will come at a later date.

Table 1: Menu of Tools and Instruments to Support Local Currency Operations

Tool	Description of Proposed Tool	Expected Costs, Fees and Expenses * to be Borne by the CTF Trust Fund	Expected Costs, Fees and Expenses * to be Borne by the borrower/ recipient	Comments
A. Hedging Tools				
1	The borrower executes the hedge on the CTF resources lent by the MDBs	CTF Trust Fund to bear costs of executing the hedge up to 2% per annum of the hedged amount	Borrower to bear costs associated with a potential prepayment, redeployment or unwinding/ breakage	
2	MDB executes the hedge on CTF resources lent by the MDBs	CTF Trust Fund to bear costs of executing the hedge: up to 2% per annum of the hedged amount	Borrower to bear costs associated with a potential prepayment, redeployment or unwinding/ breakage (except unwinding/ breakage in the case of default of the borrower where CTF Trust Fund would bear the costs, if requested)	Tool 2 cannot be executed by some MDBs. Tool 2 could be relatively less expensive than Tool 1.

Tool	Description of Proposed Tool	Expected Costs, Fees and Expenses *		Comments
		to be Borne by the CTF Trust Fund	to be Borne by the borrower/ recipient	
B. Guarantee Tools for Domestic Clients				
3	MDBs use CTF funds to provide a credit Guarantee in USD supporting a local currency loan	No additional costs will be charged to the CTF Trust Fund		Tool 3 is available only in certain markets. The Beneficiary could be a domestic borrower such as a corporate beneficiary, a FI, or SPV...
4	Risk sharing facility in local currency to allow a local financial intermediary to sell a portion of the risk associated with a portfolio of climate related assets.	No additional costs will be charged to the CTF Trust Fund		Exposure to be capped in USD. This tool is more adapted to local Financial intermediaries (LFIs).

**Expected costs presented in this table represent maximum estimated costs for the proposed tools. Specific country/currency related costs will be presented by MDBs in the project/program proposals for approval by the CTF Trust Fund Committee.*

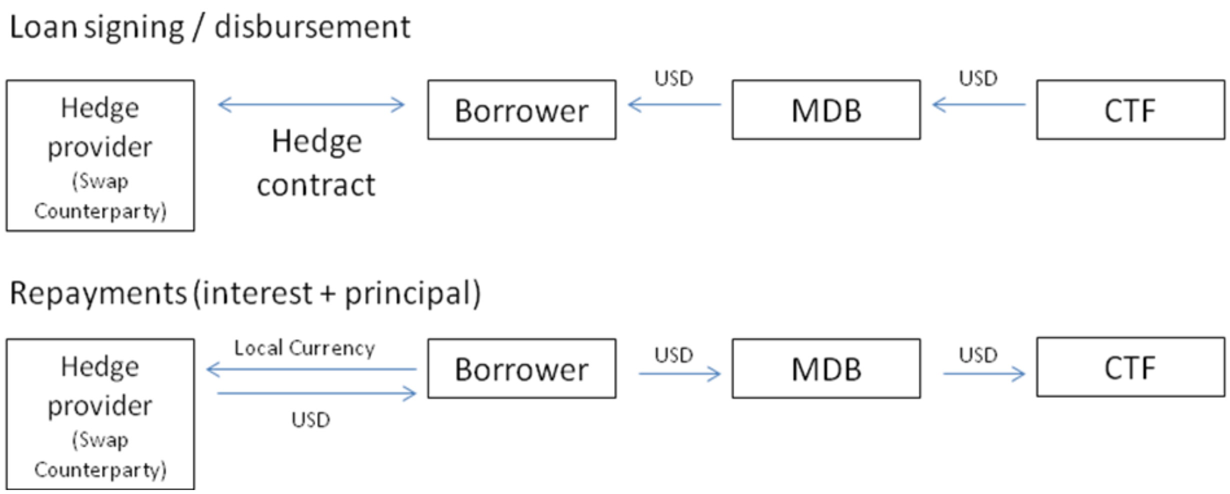
Tool	Description of Proposed Tool	Expected Costs, Fees and Expenses *		Comments
		to be Borne by the CTF Trust Fund	to be Borne by the borrower/ recipient	
*C. **Other Tools***				
5	Establish an envelope for the MDBs to use for local currency lending and allow the CTF Trust Fund to absorb losses	No additional cost for the CTF Trust Fund beyond the envelope amount		The envelope amount will be set to the level where the following formula holds: Projected CTF Net Income** minus projected potential loan losses due to defaults >= Potential losses due to exchange rate fluctuations from local currency lending *** CTF Net Income constitutes cumulative investment income on the CTF less cumulative administrative budget, plus interest received on outgoing CTF loans in excess of 0.75%, guarantee fees in excess of 0.75% and reflows from other financial products in excess of 0.75% after deducting the original principal amount.*
6	Use available grant contribution funding to provide unhedged local currency financing as reimbursable grants	No additional costs for the CTF Trust Fund		Committee members need to discuss the potential impact on CTF pipeline and Contributors how/whether to share reflows from reimbursable grants

A. Hedging Tools

8. **Tool 1: Hedge executed by the borrower.** Under this risk mitigation tool, the borrower executes a hedge with a commercial bank. Figure 1 depicts the generic funds flow in a project where the borrower would execute the hedge. The MDB would provide a USD loan, utilizing

CTF resources. The borrower would then enter into a hedge contract (cross currency swap) with a hedge provider (e.g. commercial bank), under which both parties would exchange interest and principal payments in different currencies. The borrower would receive periodic payments in USD from the swap counterparty (and with this repay its debt in such currency to CTF through the MDB); the swap counterparty would receive in exchange payments in local currency from the borrower (from local currency revenue generated from the borrower's business/investment). The availability of this instrument will depend on the acceptability by the swap counterparty of the credit risk of the borrower. CTF Trust Fund is not a direct party to this transaction.

Figure 1. Proposed Structure of Flow of Funds with Cross Currency Swap Executed by the Borrower



9. *Process for Tool 1:*

a) The MDB submits project/program proposal to the CTF Trust Fund Committee for approval, outlining the estimated costs and cost ceiling associated with hedging to be executed by the borrower;

b) CTF Trust Fund Committee approves funding for the proposed project/program and for the grant to cover costs of hedging;

c) The Trustee commits and transfers USDs to the MDB for the project and the costs of executing the hedge by the way of a grant using CTF grant contribution resources;

d) The MDB signs a loan agreement with the borrower in USD for the project amount with the stipulation that: (i) hedging for the loan must be put in place (on matching basis); and (ii) the funds must be repaid in USDs;

e) The borrower subsequently enters into a cross currency swap with a swap counterparty; and

f) The MDB transfers on a scheduled basis the appropriate cash amount from the CTF grant to the borrower.

10. *Bearing the Expected Costs, Fees and Expenses for Tool 1:*

a) The CTF Trust Fund would cover the costs of executing the hedge up to 2% per annum of the hedged amount.

b) The borrower would bear costs associated with a potential prepayment, redeployment, or unwinding/breakage.

11. *Advantages*: Tool 1 (a) enables borrowers to match local currency revenues with liabilities through the hedge, and (b) mitigates CTF Trust Fund's exposure to currency and interest rate risk related to CTF local currency operations. Further, Tool 1 supports the development of long term swap markets as well as of local financial institutions.

12. *Disadvantages:* In some cases, borrowers will not be able to arrange the hedge at all due to credit concerns. MDBs will mitigate counterparty risk according to their respective MDB policy. As the currency swap locks-in the USD value of local currency loans and the corresponding reflows, the CTF Trust Fund would forego potential gains from foreign exchange rate fluctuations, if any, that could incur if the currency swap were not done.

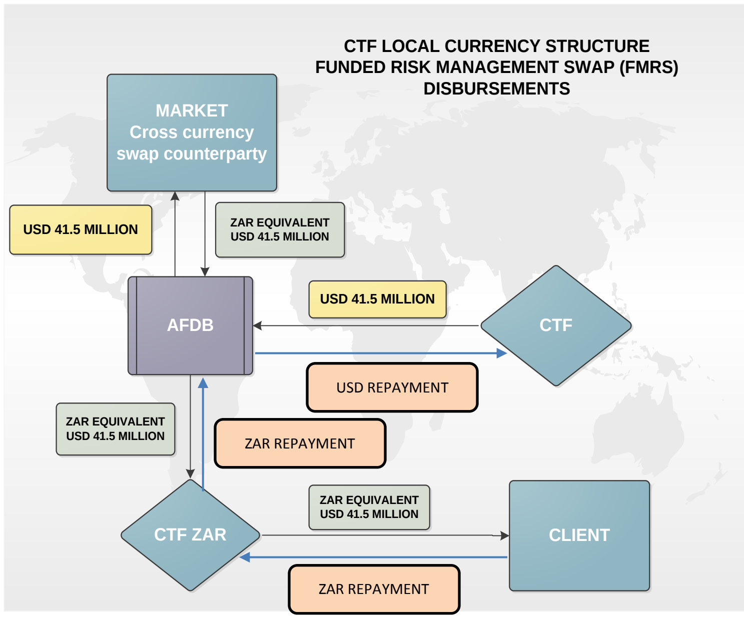
13. *Residual Foreign Exchange losses:* Any residual foreign exchange losses not covered by the hedge would be borne by the CTF Trust Fund.

14. **Tool 2: Hedge executed by the MDB.** Under this risk mitigation tool, the MDB executes the hedge using its ISDA[1] master agreements with commercial banks and standard procedures. The costs of executing the hedge are borne by the CTF Trust Fund up to 2% per annum of the hedged amount. Due to existing MDB policies (for which amendments would require board approvals), not all MDBs can execute transactions using this tool. For this Tool there is a first request to implement this hedging instrument that is proposed by AfDB. Details are provided in Figure 2 below.

15. Figure 2 depicts a project in South Africa where the AfDB would provide to the borrower CTF funding in South African Rand (ZAR). The project and its tentative loan amount is used to showcase (a) how the proposed hedging structure can mitigate foreign exchange and interest rate risk, and (b) the costs, fees and expenses associated with this hedging tool.

[1] International Swaps and Derivatives Association (ISDA)

Figure 2. Proposed Structure of Flow of Funds with Cross Currency Swap Executed by the MDB: South Africa Concentrated Solar Project (AfDB)



16. Under this structure, the CTF Trust Fund would provide USD 41.5 million to AfDB as CTF's portion of the project financing. AfDB would then enter into a cross currency swap with a market counterparty, whereby it would exchange the USD 41.5 million received from the CTF Trust Fund to a ZAR equivalent amount (approximately ZAR 373 million). The ZAR received from the market counterparty would then be deposited into a separate account established by AfDB to hold CTF proceeds received from the Trustee. Disbursements to the project recipient on the CTF loan would be made from this dedicated account.

17. Under the cross currency swap, AfDB will pay ZAR and receive USD interest and principal from the market counterparty. The CTF loan to the Project Recipient and the cross currency swap will have the same amortization schedule. This facilitates the AfDB's ability to honor its obligations under the swap agreement as the interest and principal received from the ZAR loan repayments by the project recipient are passed through to pay the ZAR interest and principal repayments of the cross currency swap.

18. The USD principal repayments and interest payments received from the market counterparty will be passed through to the CTF Trust Fund. In structuring the cross currency swap the AfDB will try to ensure that the interest and the credit margin of the ZAR loan to the project recipient is completely hedged with the market counterparty leaving no residual foreign exchange and interest rate risk to the CTF Trust Fund.

19. *Estimated Costs*: AfDB will charge an estimated 0.5% of the total hedged amount per year for the initiation, administration and management of the cross currency swap which requires the use of the AfDB's internal resources on behalf of the CTF. Depending on the complexity of the transactions, this fee may be revisited. The total estimated costs for entering into a cross-

currency swap vis-a-vis the US$41.5 million project in South Africa are estimated at US$2 million.

20. *Process for Tool 2:*

a) The MDB submits project/program proposal to the CTF Trust Fund Committee for approval, outlining the estimated costs and/or cost ceiling associated with hedging to be executed by the MDB;

b) CTF Trust Fund Committee approves funding the proposed project/program and for the grant to cover costs of hedging;

c) The Trustee commits and transfers USDs to the MDB for the project amount and the grant for the costs incurred by the MDB for executing the hedge (and bearing any swap counterparty credit risk) by the way of a grant using CTF grant contribution resources;

d) The MDB would convert the funds into local currency and sign a loan agreement with the borrower for the local currency amount;

e) At the time of disbursement, the MDB will enter into a local currency swap for the amount to be disbursed with a swap counterparty;

f) The borrower repays the loan to the MDB in the same local currency; and

g) The MDB repays the funds to the CTF Trust Fund in USD.

21. *Bearing the Expected Costs, Fees and Expenses for Tool 2*:

a) <u>The CTF Trust Fund</u> would cover the costs of executing the hedge up to 2% per annum of the hedged amount. by providing a grant to the borrower, administered by the MDB (the lender). The CTF Trust Fund would also bear any costs associated with unwinding/breakage due to borrower default, if requested; and

b) <u>The borrower</u> would bear any costs associated with redeployment, or unwinding/breakage caused by a potential prepayment.

22. *Advantages*: Tool 2, like Tool 1, also enables project recipients to match local currency revenues with liabilities and mitigates CTF Trust Fund's exposure to currency and interest rate risk related to CTF local currency operations. In addition, Tool 2 could be relatively less expensive than Tool 1 because the MDBs have AAA rating which results in lower costs and no posting of collateral with the counterparty.

23. *Disadvantages*: As the currency swap locks-in the USD value of local currency loans and the corresponding reflows, the CTF Trust Fund would forego potential gains from foreign exchange rate fluctuations, if any, that could incur if the currency swap were not done.

24. *Residual Foreign Exchange losses:* Any residual foreign exchange losses not covered by the hedge would be borne by the CTF Trust Fund.

B. Guarantee Tools for Domestic Markets

25. The following two tools are currently available under the existing procedures and guidelines for private sector operations (but any foreign exchange risk had to be borne by the MDBs, which risks cannot typically be assumed by the Implementing Entity). The purpose of being presented here is to clarify the conditions under which they could be used, address the cost/risk issue, and outlines the advantages and disadvantages

26. **Tool 3: Guarantee in USD**. Under this risk mitigation tool, the MDB would use CTF funds to provide a credit guarantee in USD to support a local currency operation. This credit guarantee could be extended either to a local bank to support its lending operations in local currency for one or more projects or directly to a single project.

Figure 3a: Structure of a Guarantee (to a local bank) in USD for on lending to a client

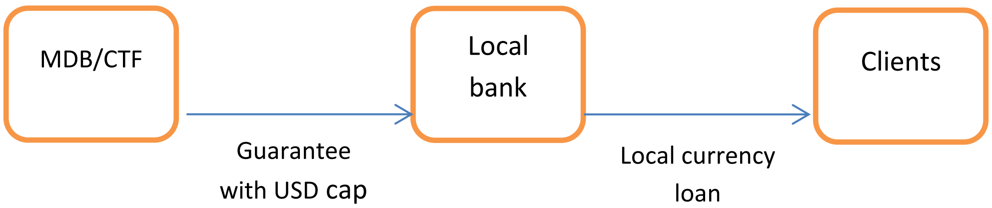
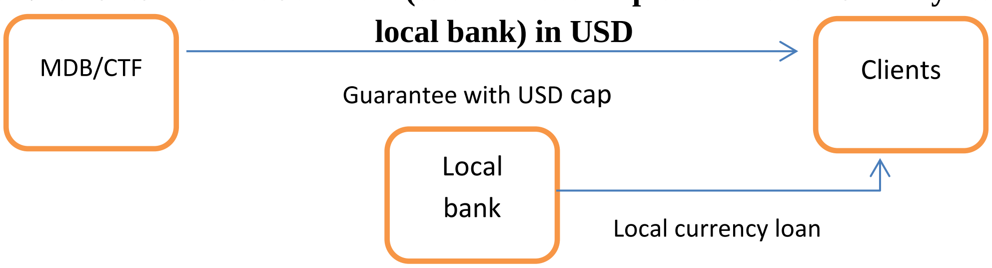


Figure 3b: Structure of a Guarantee (to a client to help obtain local currency loan from a local bank) in USD



27. Such a credit guarantee could be partial or full and guarantee fees would be charged in accordance with the CTF Financing Products, Terms and Review Procedures for Private Sector Operations. The guarantee represents a promise of full and timely debt service payment up to a predetermined amount USD. Thus client gets local currency financing and MDBs' exposure is always capped in US dollars.

28. *Process for Tool 3:*

a) The MDB submits a guarantee proposal to the CTF Trust Fund Committee for approval;

b) CTF Trust Fund Committee approves funding and the USD amount for the guarantee operation;

c) The Trustee commits and transfers USDs to the MDB for the full guarantee amount approved by the CTF;[2]

d) The MDB would use the CTF funds to provide a credit guarantee to a local bank for a portion of the exposure of a local currency operations; or

e) The MDB would issue a credit guarantee using CTF Trust Fund resources to help a potential borrower obtain a local currency loan from a domestic bank.

29. *Bearing the Expected Costs, Fees and Expenses for Tool 3:* There will be no costs, fees[3], or expenses associated with this tool that could be charged to the CTF Trust Fund. The CTF will receive revenues in the form of guarantee fees from these operations somewhat like interest on a loan.

30. *Advantages:* Tool 3 enables project recipients to receive local currency funding from other sources other than the CTF Trust Fund. The MDB's role in credit enhancing debt instruments may allow creditors to benefit from the MDB's relationship with, and ongoing monitoring of, the underlying borrower. This oversight role may allow viable first-time borrowers to tap markets that they otherwise would not normally be able to access. The guarantee can also help borrowers to secure long-term funding from local financial institutions that may have been previously unavailable.

31. *Disadvantages*: (i) This tool supports local currency operations but is not specifically targeted to facilitate direct lending of local currency from the CTF Trust Fund. (ii) There is a risk of insufficient due diligence by local financial intermediaries with regards to critical assessment of projects resulting from significantly reduced local financial intermediaries-side credit risk. This could be reduced by offering partial guarantees to ensure that the local financial intermediaries continue to bear some of the project risk, thereby fully aligning the local financial intermediary with the same risk as CTF. This approach is considered best practice.

32. *No Residual Foreign Exchange Risk under this tool except if guarantee is called, in which case recovery of defaulted local currency payments is in local currency.*

33. **Tool 4: Risk sharing facility in Local Currency.** For local currency financing of a portfolio of climate related assets, a risk sharing facility allows a local financial intermediary to sell a portion of the risk associated with a pool of assets. Several options exist for structuring risk sharing facilities transactions. Depending upon the needs of the originator and possible third-party participants, the availability of historical performance data, and the nature of the assets to be covered by the facility, one or more of the structural options illustrated in the diagrams below

[2] MDBs require guarantees to be fully backed by cash. Thus, for CTF funded guarantees, the Trustee transfers the full guarantee amount to the MDB after CTF Committee approves the funding.
[3] Other than typical project administration fees allowed for MDB implementation services and approved with the proposal.

may be appropriate for a client originator to consider. In the case where a third party guarantee would be available this would potentially decrease the exposure of the CTF.

34. In general, the guarantee is available for new assets to be originated by the LFI using an agreed upon underwriting criteria, but in certain situations may also be used for assets that have been already originated. The risk transfer happens through a partial credit guarantee provided by an MDB so it is priced similarly as explained under Tool 3, but in the context of a portfolio as opposed to a single loan or project. The MDB's exposure is capped in USD terms.

Figure 4: Structure of a Risk Sharing Facility in USD

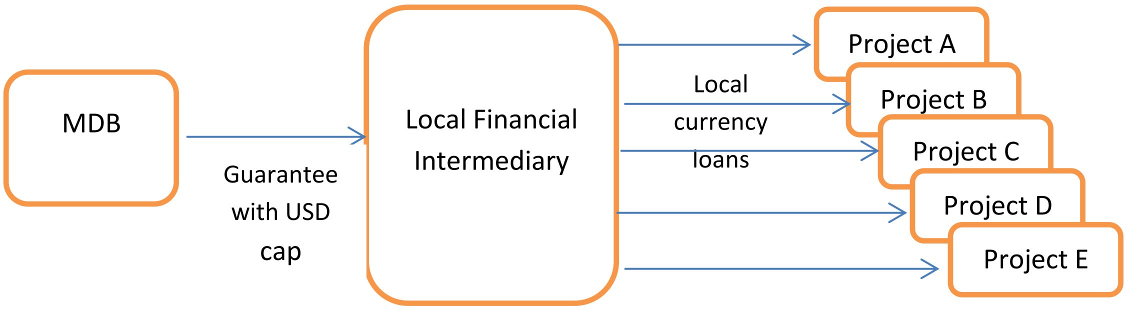
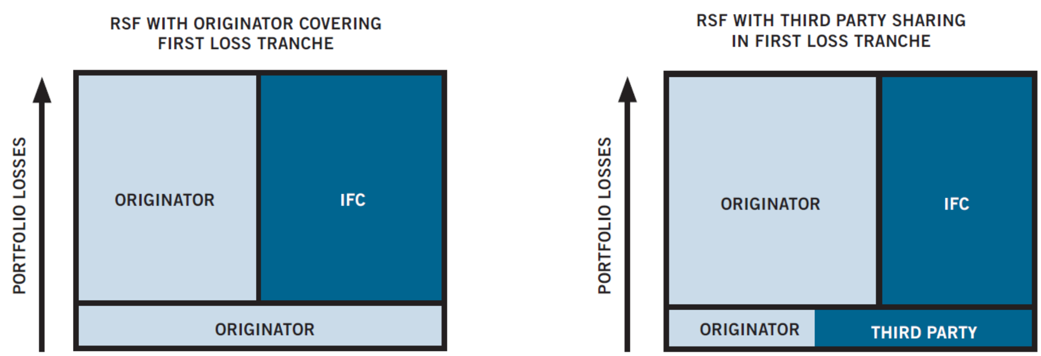


Figure 5: Structuring of a Risk Sharing Facility (example taken from IFC)



In the example above the Third Party in diagram on right would be the CTF.

35. *Process for Tool 4*:

a) The MDB submits a guarantee/risk sharing facility proposal to the CTF Trust Fund Committee for approval;

b) CTF Trust Fund Committee approves funding for the guarantee/risk sharing facility operation;

c) The Trustee commits and transfers USDs to the MDB for the full guarantee amount funded by the CTF;[4] and

d) The MDB then enters into a risk sharing agreement with an LFI. The MDB would use the CTF funds to provide a partial credit guarantee to the LFI. The guarantee can either be pari-pasu with the LFI or could be used as a first loss tranche (please see figure 5, above). The assets typically remain on the LFI's balance sheet and the risk transfer comes from a partial guarantee provided by the MDB.

36. *Bearing the Expected Costs, Fees and Expenses for Tool 6:* No costs, fees or expenses would be charged to the CTF Trust Fund.

37. *Advantages:* Tool 4 enables project recipients to receive local currency funding from other sources different from the CTF Trust Fund. In addition, by shifting a portion of the risk associated with an asset portfolio to an MDB, a risk sharing facility allows an originator to introduce or expand a new or existing product (e.g. clean technology projects). This may allow the originator—typically a local financial institution—to attract new clients, generate additional fee income, and spread the fixed costs of the covered product line over a large portfolio of assets. This aspect will lessen the risk for the CTF as a pool of assets will be guaranteed and not an individual project as under Tool 3.

38. *Disadvantages*: (i) This tool supports local currency operations but is not specifically targeted to facilitate direct lending of local currency from the CTF Trust Fund; (ii) depending on the process and degree to which individual assets/projects are pooled under the proposed facility, the resulting consolidation might reduce transparency and hamper ability of the CTF Trust Fund Committee to make informed decisions regarding individual projects and final beneficiaries of the facility. This could be mitigated through a mechanism whereby only projects with certain characteristics are considered for the risk sharing facility.

39. *No Residual Foreign Exchange Risk under this tool except if guarantee is called, in which case recovery of defaulted local currency payments is in local currency.*

C. Tools to Promote Local Currency Lending: Other Tools

40. +The implementation of tools described in category C depends on specific financial resources being made available and limits being set for this purpose. It is understood that it would be premature to reach a decision on the exact limits for these tools in the absence of the ERM system currently being developed for the CIFs. It is anticipated that the ERM will eventually provide more detailed information for the TFC to understand how much risk is being borne across the portfolio. This would in turn allow a more informed decision by the TFC on additional risks from supporting local currency operations. Therefore, they are included here only to illustrate the full range of possibilities for local currency financing. A full discussion and decision on category C will come at a later date.

[4] MDBs require guarantees to be fully backed by cash. Thus, for CTF funded guarantees, the Trustee transfers the full guarantee amount to the MDB after CTF Committee approves the funding.

41. **Tool 5: Establish an envelope for the MDBs to use for local currency lending where the CTF Trust Fund absorbs losses.** Under this option, the CTF Trust Fund Committee agrees to a maximum amount for the MDBs to collectively use for local currency lending and agrees that the CTF Trust Fund to absorb aggregate losses and gains due to exchange rate fluctuations, if any. This envelope amount will be set to the point where the balance of the projected CTF Net Income[5] less projected potential loan losses due to defaults[6] would be sufficient to cover projected potential losses due to exchange rate fluctuations from local currency lending[7] as shown below.

Projected CTF Net Income minus projected potential loan losses due to defaults	>=	Potential losses due to exchange rate fluctuations from local currency lending

42. Based on the most current quantitative analysis conducted by the Trustee, the envelope amount that could be used for unhedged local currency lending (i.e. without any foreign exchange risk mitigation measures) is USD 50 million.

43. *Process for Tool 5*:

a) The MDB submits project/program proposal to the CTF Trust Fund Committee for approval, outlining the reason why hedging or other risk mitigation tools are not available for the country/project;

b) CTF Trust Fund Committee approves funding the proposed project/program within the established envelope amount, approves local currency lending without the use of hedging or other risk mitigation tools;

c) The Trustee commits and transfers approved project funds to the MDBs in USDs;

d) The MDBs either: (i) convert the USDs received from the CTF into local currency and subsequently enter into a local currency loan with borrowers in the amount of the proceeds of the conversion; or (ii) the MDBs enter into a USD loan agreement with borrowers and borrowers convert the USDs received from the MDBs into local currency;

e) Following b) above, borrowers repay the loan and interest in: (i) local currency or; (ii) USDs; and

[5] CTF Net Income constitutes cumulative investment income on the CTF less cumulative administrative budget, plus interest received on outgoing CTF loans in excess of 0.75%, guarantee fees in excess of 0.75% and reflows from other financial products in excess of 0.75% after deducting the original principal amount.

[6] The assumptions for the loan loss rates on public sector loans (5%) and private sector loans (11%) are based on the data obtained from the Global Emerging Markets (GEMs) risk database.

[7] The assumption on the foreign exchange loss rate is based on historical average worst case losses on local currencies in the reference portfolio (66%).

f) If borrower repays in local currency, the MDBs convert such local currency back into USD using spot rates and subsequently transfer the proceeds in USDs back to the Trustee.

44. *Bearing the Expected Costs, Fees and Expenses for Tool 5:* Tool 5 does not increase the administrative or project costs of the CTF Trust Fund.

45. *Advantages*: This arrangement will enable local currency operations in countries where there is limited hedge market or limited appetite for guarantees and risk-sharing mechanisms available. The CTF Trust Fund may in some cases receive gains from foreign exchange rate fluctuations.

46. *Disadvantages*: The demand for local currency operations in the CTF will likely exceed the amount of available resources. If this option is approved, the CIF Administrative Unit and the MDB Committee would need to determine which private sector projects and programs would avail itself of Tool 5. In addition, if the assumptions used to determine the maximum amount to be used under Tool 5 significantly deviates from actuals, there could be a risk of potential losses that would have to be shared among contributors.

47. *Residual Foreign Exchange Risk:* If the assumptions used to determine the envelope amount under Tool 3 significantly deviate from actuals, there could be potential foreign exchange losses that would have to be shared among contributors.

48. **Tool 6. Use available grant contribution funding to provide unhedged local currency financing as reimbursable grants[8].** Under this tool, the CTF Trust Fund Committee would agree to introduce a reimbursable grant as a new financing product that can be used for unhedged local currency financing using CTF resources. Consistent with the matching principles governing the use of the CTF contributions, funding available from grant contributions will be used to provide unhedged local currency financing as reimbursable grants.

49. *Process for Tool 6:*

a) The MDB submits project/program proposal to the CTF Trust Fund Committee for approval, outlining the reason why hedging or other risk mitigation tools are not available for the country/project and rationale for using a reimbursable grant;

b) CTF Trust Fund Committee approves funding the proposed project/program using reimbursable grants and without the use of hedging or other risk mitigation tools;

c) The Trustee commits and transfers USDs to the MDB for the approved project amount. The funding will be recorded in Trustee system as grants and will be counted against grant contribution funding;

[8] Tool 6 is based on a suggestion from Canada in their remarks of September 20.

d) The MDBs either: (i) convert the USDs received from the CTF into local currency and subsequently enter into a local currency loan with borrowers in the amount of the proceeds of the conversion; or (ii) the MDBs enter into a USD loan agreement with borrowers and borrowers convert the USDs received from the MDBs into local currency;

e) Following b) above, borrowers repay the loan and interest in: (i) local currency or (ii) USDs;

f) If borrower repays in local currency, the MDBs convert such local currency back into USD using spot rates and subsequently transfer the proceeds in USDs back to the Trustee; and

g) The Trustee and the Contributors need to discuss amendments to the Standard Provisions in the case the Committee approves this tool to cover the possibility of borrower defaults.

50. *Bearing the Expected Costs, Fees and Expenses for Tool 6:* Tool 6 does not increase the administrative or project costs of the CTF Trust Fund.

51. *Advantages*: This arrangement will enable local currency operations in countries where there is limited hedge market or limited appetite for guarantees and risk-sharing mechanisms available. Any reflow received from reimbursable grants will be counted as additional reflows (gain) to the CTF trust fund.

52. *Disadvantages*: Funding available for grant financing will be used for this tool, therefore, reducing funds available for other grant financing planned for projects in the pipeline.

53. *No Residual Foreign Exchange Risk under this tool.*

III. PROJECTED COSTS, FEES, AND EXPENSES THAT MAY BE INCURRED FROM THE PROPOSED TOOLS AND INSTRUMENTS AND HOW SUCH COSTS, FEES, AND EXPENSES WOULD BE BORNE AMONG THE CTF CONTRIBUTORS

Projected costs, fees, and expenses of projects financed using local currency operations

54. The exact projected costs, fees, and expenses will have to be determined on a project/ project basis. MDBs that submit projects for any one of the Tools described above (except for Tools 5 and 6 which will need further discussion) would provide the following information in the project document:

a) Financial Instrument to be used

b) CTF Funding amount in USD

c) Expected costs per annum for the CTF in USD [or range of costs]

d) Expected maturity

e) Total estimated costs associated with the use of risk management tool

55. If the cost of the tool cannot be specified at the time that CTF funding for the proposal is approved, the proposal should include an estimate of the cost. For Tools 1 and 2, this cost will be within the 2% per annum cap. When an estimate of the cost is specified at the time of the Committee's approval of CTF funding, the MDB will inform the Committee as soon as the actual cost is known. If immediately prior to the execution of the hedge the expected hedge costs exceeds the estimate provided to the Committee, the MDBs should inform the CIF Administrative Unit and the Trustee of the revised hedging cost before executing the hedge. Approval from the CTF Trust Fund committee will be provided on a no objection basis with 48 hours of receipt of the information from the MDB as long as the revised hedging costs are still within the 2% per annum cap.

Sharing of projected costs, fees, and expenses among the CTF Contributors

56. Table 3 below presents the sharing of projected costs, fees and expenses among the CTF Contributors.

Table 3: Sharing of Projected Costs, Fees and Expenses among the CTF Contributors

Tool	Expected Costs, Fees and Expenses to be Borne by the CTF Trust Fund	Classification	Types of contributions to cover the Cost
A. Hedging Tools			
Tool 1 *The borrower executes the hedge on the CTF resources lent by the MDBs*	CTF to bear costs of executing the hedge up to 2% per annum of the hedged amount.	Grant funding to borrower	Grant Contributions
Tool 2 *MDB executes the hedge on CTF resources lent by the MDB*	Costs of executing the hedge up to 2% per annum of the hedged amount; Costs associated with unwinding/breakage resulting from default by the borrower if requested.	MDB costs for project implementation support	Grant Contributions

B. Tools to* Promote *Local Currency Lending: Guarantee Tools for corporate beneficiaries and local financial intermediaries			
Tool 3 *MDBs use CTF funds to provide a credit guarantee in USD supporting a local currency loan*	None	No costs, fees and expenses	N/A
Tool 4 *Risk sharing facility in local currency to allow a local financial intermediary to share a portion of the risk associated with a portfolio of climate related assets*	None	No costs, fees and expenses	N/A
C. Tools to Promote Local Currency Lending: Other tools			
Tool 5 *Establish an envelope for the MDBs to use for local currency lending and allow the CTF Trust Fund to absorb losses*	None	No costs, fees and expenses	N/A
Tool 6 *Use available grant contribution funding to provide unhedged local currency financing as reimbursable grants*	None	No costs, fees and expenses	N/A (Grant Contributions funding to be used for this tool)

IV. PROPOSED AMENDMENTS TO LEGAL AGREEMENTS

57. Net gains from foreign exchange rate fluctuation will form part of the reflows returned from the MDBs to the Trust Fund and constitute part of the CTF net income. On the other hand, net losses from foreign exchange rate fluctuation exceeding the amount covered by the CTF net income will be shared by all contributors to the CTF, on a pro-rata basis proportional to their overall contributions to the CTF (excluding any portion used for grant funding), in the same manner in which losses on defaults on outgoing loans from the CTF are shared by all contributors pursuant to the Standard Provisions Applicable to the Clean Technology Fund (the "CTF Standard Provisions") and the Principles regarding Contributions to the Clean Technology

Fund (the "Principles"), attached to the Contribution and Loan Agreements/Arrangements between the Trustee and the CTF contributors.

58. Net losses from foreign exchange rate fluctuation will be taken into account at the Recalculation Date for any adjustment on loan contribution repayments. When the CTF Trust Fund is liquidated, the balance of funds remaining in the Trust Fund will be returned to the Grant and Capital Contributors as provided in the CTF Standard Provisions.

59. If the CTF Trust Fund Committee approves the use of tools 1, 2 and 5 proposed in this paper, and thereby agrees that the CTF Trust Fund will absorb potential losses and gains, if any, associated with foreign exchange rate fluctuations related to local currency operations, the following documents will need to be amended:

a) *Contribution and Loan Agreements/Arrangements*. Provisions regarding the sharing of net gains and losses from foreign exchange rate fluctuation will need to be reflected in the Principles. Proposed texts for the amendments to the Principles are attached in Annex I to this paper[9]; and

b) *CTF Financing Products, Terms and Review Procedures for Private Sector Operations*. Proposed texts for the amendments are attached in Annex II to this paper.

V. NEXT STEPS

60. If the CTF Trust Fund Committee agrees that the tools in Categories A and B described in this document may be employed in CTF-funded programs and projects with the private sector, the Trustee will work with the contributors to prepare the necessary amendments to the Contribution/Loan Agreements/Arrangements.

61. In addition, the CIF Administrative Unit will revise the *CTF Financing Products, Terms and Review Procedures for Private Sector Operations* in accordance with revisions proposed in Annex II to this paper.

62. The CIF Administrative Unit will work with the MDBs to include in the second semi-annual operational report of a calendar year a table which could include the list of projects/sub-programs, type of tool, funding amounts, and associated costs to CTF. It is further recommended that the CTF Trust Fund Committee review the use of the tools and their effectiveness in facilitating the engagement of the private sector in CTF operations by the end of 2015. The CIF Administrative Unit will work with the MDB Committee to prepare an assessment of the use of the tools to serve as a basis for the Committee's review.

[9] Note that with respect to Loan Contributors, the Schedule to the Loan Agreement/Arrangement on "Principal Repayment Adjustment" will also have to be amended accordingly. The Trustee will coordinate with the Loan Contributors to process such amendments.

ANNEX I

Proposed amendments to the Principles regarding Contributions to the Clean Technology Fund, attached to the Contribution and Loan Agreements/Arrangements between the Trustee and the CTF contributors:

Appendix A to Annex 1

Principles regarding Contributions to the Clean Technology Fund

1. General Principles

1.1. Contributors can provide funding to the Trust Fund as grants, capital contribution and concessional loans with IDA-like terms.

1.2. There will be no cross subsidies among the contributors.

1.3. Outgoing financing from the CTF can be no more concessional than incoming financing.

(a) Grant contributions may be used to finance grants, concessional loans and other financial products, such as guarantees.

(b) Capital contributions may be used to finance concessional loans and other financial products, such as guarantees;

(c) Loan contributions may be used to finance loans and other financial products, such as guarantees, on terms no more concessional than the terms of the contributions.

1.4. The CTF cannot blend financing from grant and capital contributions with financing from loan contributions unless it is on terms no more concessional than the terms of the loan contributions or supports separate parts of a project (for example, grants for technical assistance and concessional loans for investment financing).

1.5. The CTF Trust Fund Committee is responsible for determining the terms of outgoing financing (bearing in mind principle 1.3 above and other financial management issues as determined by the Trustee), including financing and terms for the private sector.

1.6. All sources of funds will be co-mingled for administrative and investment purposes. Sources of funds comprise:

(a) Funding from contributors, as described in principle 1.1 above,

(b) Investment income earned on the undisbursed balance of the CTF,

(c) Investment income returned from MDBs,

(d) Interest (service charge) payments on outgoing loans and guarantee fees,

(e) Principal repayments on outgoing loans, and

(f) Reflows from MDBs related to ~~unused~~ guarantee funds, grant and loan funds and administrative budget.

The Trustee will keep records and report on the amount received for each source of funds on an aggregate basis.

1.7. Loan contributors will provide loans to the CTF at 0.75% interest, 20 years maturity and 10 years grace on principal repayments. The CTF will make interest and principal payments to loan contributors in accordance with the terms of the loan agreement. Such loan agreements will provide for a reduction in the principal payments in case of ~~defaults~~losses on outgoing CTF loans[1], as described in section 2 below.

1.8. Losses~~ on defaults~~ on outgoing loans from the CTF will be shared by all contributors on the same basis, in proportion to their overall contributions to the CTF (excluding the portion, if any, used for outgoing grants) and covered from the CTF net income as described in section 2 below.

1.9. Following repayment of the loan contributors loans, the remaining contributors will then bear the~~ default~~ risk on losses on all outstanding CTF loans (and guarantees and other financial products which may result in ~~defaults~~losses) and upon termination of the Trust Fund will share on a pro-rata basis the outstanding unallocated balance, including any reflow of funds received; provided, however, to the extent contributors provide funds to the CTF that are used to fund grants rather than CTF loans, such donors will not share in CTF reflows, ~~defaults~~losses, CTF net income or any unused balance of funding to the extent of such grant funding.

2. Agreement on ~~Defaults~~Losses on Outgoing Loans from the Clean Technology Fund

2.1. ~~Defaults~~Losses on outgoing loans from the CTF will be shared by all contributors on a pro-rata basis proportional to their overall contributions to the CTF (excluding the portion, if any, used for grants). Such ~~defaults~~losses will be covered, to the extent available, by (i) net investment income on the CTF, (ii) interest received on outgoing CTF loans in excess of 0.75 per cent, ~~and~~ (iii) guarantee fees in excess of 0.75 percent , and (iv) net gains from foreign exchange rate fluctuation[2] on outgoing CTF loans, guarantees and other financial products (collectively "CTF net income")~~[2]~~[3]. Based on the models prepared by the Trustee, it is projected that the CTF net income would be adequate to cover defaults on

[1] ~~Defaults~~Losses on outgoing CTF loans would include defaults and losses ~~resulting~~ from foreign exchange rate fluctuation on outgoing CTF loans, guarantees and other financial products. Losses from foreign exchange rate fluctuation would be borne by the Trust Fund if the CTF Trust Fund Committee agrees for the Trust Fund to bear foreign exchange rate risks.

[2] Net gains from foreign exchange rate fluctuation would constitute reflows to the Trust Fund if the CTF Trust Fund Committee agrees for the Trust Fund to bear foreign exchange rate risks.

~~[2]~~[3] In case any other financial products than loans and guarantees, which generate reflows other than net gains from foreign exchange rate fluctuation, are provided from the CTF, ~~any~~such reflows received in excess of 0.75 percent, after deducting the original principal amount, will be included in the CTF net income.

CTF loans up to 5 percent, which is the projected loan loss rate used for IDA credits based on historical performance.

2.2. The CTF will make interest and principal payments to loan contributors in accordance with the terms of the loan agreements.

2.3. Twenty five months prior to the maturity date of the loans, the Trustee will calculate (i) each loan contributor's pro rata share of the cumulative amount of ~~default interest/principal payments~~losses on outgoing loans up to such calculation date (i.e., the difference between the scheduled interest and principal payments due to the CTF on all CTF loans up to that date and the actual payments received by the CTF up to that date) and (ii) each loan contributor's pro rata share of cumulative CTF net income up to such calculation date. In the event (i) exceeds (ii), the Trustee will adjust either the last or the last two years repayments by deducting the difference between (i) and (ii).

2.4. To ensure that the last two years of principal repayments to loan contributors will fully cover the cumulative ~~default~~loss amount attributed to their contribution, the Trustee will periodically review accumulated ~~default~~loss amounts. If the Trustee determines at any time that loan contributor's pro-rata share of the ~~default~~loss amount is likely to exceed loan contributor's pro rata share of CTF net income at the point that is two years prior to the maturity date of the loan contributors loans, it shall convene a meeting of the Trust Fund Committee to review the situation and to agree on steps to be taken. The Trustee will propose to the Trust Fund Committee all possible actions that may be taken so that there will be sufficient funds available to repay the loan contributors loans in accordance with their terms.

2.5. In the event that the loan contributor's pro rata share of cumulative CTF net income as of the calculation date exceeds their pro rata share of the cumulative ~~default~~loss amount as of such date, loan contributors will not receive the excess amount of CTF net income. Instead, loan contributors will have received 100% of the scheduled interest and principal payments on their loans to the CTF.

Annex II

Proposed amendments to the document entitled "CTF Financing Products, Terms and Review Procedures for Private Sector Operations" (CTF/TFC.5/9):

Current Paragraph 22: Unless otherwise approved by the Trust Fund Committee in the CTF proposal, CTF funds will be allocated by the Trustee to the MDB, and be repayable to the Trustee, in United States Dollars or Euros. However, MDBs may denominate individual financing provided by them to the beneficiaries according to their own policies and procedures, subject to the MDB assuming any exchange rate risk.

Proposed Amended Paragraph 22: Unless otherwise approved by the Trust Fund Committee in the CTF proposal, CTF funds will be allocated by the Trustee to the MDB, and be repayable to the Trustee, in United States Dollars or Euros. However, MDBs may denominate individual financing provided by them to the beneficiaries in local currency according to their own policies and procedures for projects that require such funding. If such a need for local currency financing is anticipated within a program or a project, the MDB will indicate the need for local currency financing at the time it presents the CTF project or program proposal for review and approval by the CTF Trust Fund Committee.

Footnote 7 should be deleted. The footnote currently reads: It should be noted that not allowing CTF funds to be on-lent in local currencies reduces the flexibility of the funds and increases the costs and complexity of the project, as currency risk must be hedged. It should further be noted that most of the MDBs are prevented by their guidelines to incur such exchange rate risk.