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**PROPOSED FINANCING PRODUCTS, TERMS AND CONDITIONS  
FOR PUBLIC SECTOR OPERATIONS OF THE  
CLEAN TECHNOLOGY FUND<sup>1 2</sup>**

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<sup>1</sup> Working title

<sup>2</sup> This paper focuses on public sector operations financed by the Fund. A separate paper on an approach to engage the private sector (CIF/DM.1/Inf.10) addresses terms and conditions for investments related to private entities.

## Introduction

1. The Clean Technology Fund (the Fund) will support the rapid deployment of low-carbon technologies on a significant scale, with the objective of cost-effective reductions in the growth of greenhouse gas emissions. The Fund will do so by supporting policies, measures and programs that reduce the costs and risks imposed on developing countries by the adoption of low GHG-emitting technologies.

2. The Fund would fill a specific financing gap in the international aid architecture by primarily providing finance to Middle Income Countries (and “Blend” countries) at more concessional rates than standard multilateral development bank terms and at the scale necessary to help provide incentives to integrate low-carbon strategies into their development plans and investment decisions. The Fund responds to the Development Committee’s call, in September 2006, “for deeper cooperation between the Bank, regional development banks, and other development partners in their engagement with MICs, and encouraged the Bank to develop a menu of options to respond to country demand-driven initiatives for targeted blending of concessional donor support with multilateral development bank loans in cases of market failure or where there are affordability issues”.

3. A key feature of the Fund would be its ability to blend financing to tailor terms to a target level of concessionality, which would vary depending on project-specific factors. As noted in the Development Committee paper “Strengthening the World Bank’s Engagement with IBRD Countries” (2006), in many MICs, while multilateral development banks would be ready to provide additional lending for projects and programs related to the MDGs 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 could help unlock demand for the financing of such projects and programs. Blending Fund resources and multilateral development bank loans could augment the volume of financing available, better tailor concessionality to needs, with the degree of concessionality calibrated to achieve transformative investments which would otherwise not proceed.

### Modalities for blending with MDB loans

4. It is proposed that the Fund provide the multilateral development banks (MDBs) with a menu of blending options to accommodate different needs of client countries and program interventions:

- (i) Co-finance MDB non-concessional loans or provide additional financing of new components within ongoing investment lending operations, on concessional terms. Resources from the Fund would thereby increase the concessionality of the overall financing for the project. The development of such co-financing arrangements can be done in a relatively low-cost manner when fully embedded in the project preparation and supervision process.<sup>3</sup>

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<sup>3</sup> Fund resources could also be used to “top up” concessional finance allocations of “blend countries”.

- (ii) Buy-downs of interest and repayments of MDB loans. A project with an MDB buy-down would be developed as a normal MDB loan with standard financing terms, measurable performance indicators and targets and a commitment from the Fund to reduce the project's interest rate on the MDB loan by a specified amount. There are a number of options for such arrangements. For example, at project completion, an independent performance audit could be commissioned to verify that the targets are achieved. If successful, the Fund would release a grant to the MDB to reduce some of the project debt. If the performance targets are not achieved, then the borrower would be obligated to re-pay the loan on standard terms. Alternatively, funds could be disbursed as the proceeds of the MDB loan are disbursed and used at the time to prepay a portion of the loan, thus reducing accrual of interest charges on the loan.

5. A set of principles and/or eligibility criteria would be established for selecting blending options in order to provide the greatest incentives to invest in low carbon technologies.

## **Products**

6. There are a number of financing products for which MDBs could use the Fund's resources. These include loans or credits, guarantees, grants, and a combination of these.<sup>4</sup> A set of criteria for selecting the range of products offered by the Fund will help ensure that the Fund meets its intended objectives. The criteria may include (amongst others) nature of target investments, simplicity of operation, speed of processing transactions, ease in disbursement, borrower demand, extent to which donor funds need to be leveraged, and the extent to which the Fund needs to have a rate of return. Below is a preliminary list of possible financing products. The Trust Fund Committee will review and approve financing modalities, including appropriate terms.

### *(a) Loans*

7. The loan product will provide financing to fill the investment gap in transforming sectors or sub-sectors to low-carbon technologies, or in scaling up the adoption of such technologies, with concessionality related to the additional costs and risks of deployment. MDBs may provide financing support through (a) lending to national governments, (b) lending to national governments for on-lending to sub-national entities; or, (c) lending to sub-national entities. Security for the debt will be project revenue and assets.<sup>5</sup> For sub-national lending to entities that are not considered creditworthy by the MDB, additional credit enhancement would need to be provided, such as a guarantee from the government (or a creditworthy government entity).

8. MDBs' lending criteria will address credit risk through their assessments of borrower creditworthiness, financial viability, corporate governance, and safeguards against irresponsible borrowing. MDBs will need to demonstrate to the Trust Fund Committee that due diligence,

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<sup>4</sup> An issue for further examination is the final disposition of reflows to the Fund.

<sup>5</sup> In such situations, negative pledge clause issues will need to be consulted. In the event that it is not practicable to obtain security from the borrower, alternative arrangements adequate to cover the relevant loan exposure may be considered.

transaction structuring and portfolio management will be key elements of credit management procedures. The credit risk of a borrower's default will be borne by the Fund, unless such default was due to gross negligence or willful misconduct of the MDB.

9. There is potentially substantial headroom between the commercial rates of interest available in the country and highly concessional terms that the Fund may consider offering. The choice of interest rate adopted will depend on how important it is for the fund to have a rate of return, levels of cash flows likely to flow from the project being developed, and alternative credit terms available to the implementing institution. It will be important to ensure that highly concessional or grant terms do not displace investments that might have taken place anyway using commercial or standard MDB borrowing. Concessional forms of finance need to be designed to minimize market distortions and potential disincentives to long-run private investment.

10. In view of the fact that many of the potential priority countries borrow in the commercial markets for their infrastructure financing needs without having exhausted their credit lines with IBRD and other multilateral financiers, and given the objectives of the Fund to address the costs and risks of scaled-up deployment of low carbon technologies by these countries, it is proposed that the Fund adopt lending terms similar to IDA (see Box 1). Given the potential development impacts and environmental co-benefits of the Fund's investments, IDA-like harder terms might offer the appropriate balance in the concessionality of funding. Based on further consultations, including with potential borrower countries, a more detailed proposal on concessional terms will be presented to donors.<sup>6</sup> Program/project submissions to the Trust Fund Committee for approval of allocation of Fund financing will provide an explanation of how proposed concessional terms relate to the needs of investments to be supported.

Box 1: Current IDA Terms (as of July 1, 2007)

|                               | Maturity<br>a/ | Grace<br>Period | Principal<br>Repayments<br>Year 11-20 | Principal<br>Repayments<br>Years 20-40 | With<br>Acceleration<br>Clause b/ | FY08<br>Commitment<br>Charge for<br>Credits c/ | FY08<br>Commitment<br>Charge for<br>Grants c/ | Service<br>Charge<br>for<br>Credits<br>d/ | Interest<br>Rate |
|-------------------------------|----------------|-----------------|---------------------------------------|--|-----------------------------------|--|---|---|------------------|
| IDA-only                      | 40             | 10              | 2.0%                                  | 4.0%                                   | Yes                               | 0.10%  | 0.00%   | 0.75%                                     | NA               |
| Blend                         | 35             | 10              | 2.5%                                  | 5% e/                                  | Yes                               | 0.10%  | 0.00%   | 0.75%                                     | NA               |
| Hardened<br>Term f/           | 20             | 10              | 10.0%                                 | NA                                     | No                                | 0.10%  | 0.00%   | 0.75%                                     | NA               |
| Hard<br>Term<br>Lending<br>h/ | 35             | 10              | 2.5%                                  | 5% e/                                  | Yes                               | 0.10%  | 0.00%   | 0.75%                                     | 4.2%             |
| Guarantee                     | NA             | NA              | NA                                    | NA                                     | NA                                | 0.10% i/                                       | 0.00%   | 0.75%<br>g/                               | NA               |

<sup>6</sup> Including presentation of background information on concessional financing terms of the regional development banks.

- a/ The maturity of IDA credits approved by the Board through June 30, 1987, is 50 years. The maturity of IDA credits approved by the Board after June 30, 1987 are 20, 35 or 40 years.
- b/ IDA credits include an acceleration clause, providing for doubling of principal payments from creditworthy borrowers where per capita income remains above eligibility thresholds.
- c/ IDA's commitment charge is a variable charge set (annually) within a range of 0%-0.5% of the un-disbursed balance of IDA credits and grants.
- d/ The service charge is 0.75% of disbursed and outstanding credit balance.
- e/ Year 20-35.
- f/ The hardened term lending was approved in IDA 13 and is effective from July 1, 2002. All IDA countries with GNI per capita above the operational cutoff for more than two consecutive years will be subject to IDA lending on hardened terms. Lending on hardened terms supersedes the accelerated repayment provision.
- g/ This fee is applied on the disbursed and outstanding amounts of a guaranteed financing, in the same way service charges on IDA credits are applied. The guarantee fee is currently fixed at 75 basis points (bps) per annum, equal to the fixed level of service charge on IDA credits.
- h/ Countries eligible for hard-term IDA credits under a defined lending window in IDA 14. These are blend countries with both (a) per-capita income below the operational cut off for IDA eligibility and (b) an active IBRD lending program. Standard IDA service and commitment charges apply plus a fixed interest charge for the life of each credit.
- i/ This fee is applied on the un-disbursed balance of the guaranteed financing and is analogous to the commitment charge on IDA credits. The standby fee is currently 10 bps per annum.

11. Furthermore, consistent with the objective of simplified loan administration procedures and streamlined project processing, it is proposed that the Fund have uniform financing terms, rather than terms varying by country and/or projects, or each MDB applying different terms. For example, loan financing could be on the terms similar to IDA "hardened terms":

- (i) Maturity: 20 years
- (ii) Grace Period: 10 years
- (iii) Principal Repayments: 10% (years 11-20), to be returned to the Fund, along with any investment income earned by the MDB
- (iv) Lending Fee: 0.1% of un-disbursed loan balance accrues to MDB to recover its costs related to project preparation and appraisal, as well as loan negotiations
- (v) Service Charge: 0.75% of disbursed and outstanding loan balance (per annum) accrues as cost recovery to MDB for project supervision and implementation status and completion reporting<sup>7</sup>

*(b) Guarantees*

12. The objective of the guarantee instrument, in the context of this paper, is to improve conditions for private sector investment in or lending to public sector projects. Guarantees take the form of partial credit guarantees or partial risk guarantees. Partial credit guarantees cover debt service defaults from borrowers on a specified portion of a loan. Partial risk guarantees cover defaults due to a government's failure to meet its obligations under project contracts to which it is a party. Guarantees could also cover technology risk.

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<sup>7</sup> Also applicable to grants.

13. For each guarantee operation, MDBs will appraise whether risk mitigation instruments could be an efficient and effective means to facilitate the mobilization of private capital to finance the public sector project, instead of or in combination with loan support from the Fund. In the event that there is sufficient debt and/or equity capital to finance the project, risk mitigation instruments should be considered if the government or sub-national entity is not sufficiently creditworthy or does not have a proven track record in the eyes of private financiers to be able to borrow debt or attract private investment without support.

14. Proceeds from the Fund may be used for such guarantees by the MDBs, in accordance with their policies for determining eligible beneficiaries, eligible forms of investment, maximum tenor and maximum amounts.

15. As in the case of loans, it is proposed that guarantee products generally follow IDA-like terms. For example:

- (i) The initiation fee of 0.10% would be applied on the committed but undisbursed balance of the guaranteed financing and will be analogous to the lending fee on loans. These would accrue to the MDB for preparation, appraisal and negotiation costs. As in the case of loans and grants, all investment income earned by the MDBs on undisbursed balances would accrue to the Fund..
- (ii) Guarantee fee: 75 basis points (bps) per annum, applied on the disbursed and outstanding amounts of a guaranteed financing, in the same way service charges on loans will be applied. Accrues to MDB for guarantee supervision and reporting.

16. Guarantees for conventional energy projects have proved to be highly successful in catalyzing private sector investments – with successful deployment leading to leverage ratios of the order of 1 to 4 or 1 to 5. A fund with a strong priority on leveraging private sector funds is likely to make significant use of guarantee products. Leverage and other financial requirements will need to be developed for the use of guarantee instruments.

*(c) Grants*

17. Grants create limited leveraging of donor funds and should therefore only be used where concessional loans or guarantees would have little take-up for otherwise important activities. Grants are likely to be used for project investments that have no associated returns or that contribute to technological developments with returns at some time in the future or with returns dispersed over several projects. The primary purpose would be to demonstrate technical viability and to promote buy down of costs.

18. The Fund could also provide grants to recipient countries to enhance their capacity to understand new technologies and manage the operations and maintenance risk associated with such technologies, as well as for limited and focused economic and sector work and pre-investment and feasibility studies, related to low-carbon investment programs.

19. Grant financing offered by the Fund could also be used to buy down the cost of commercial or MDB loans that might form part of the wider financing package for a project.

20. The positive trade off of grant financing is that there is greater ease in disbursement as counterparty credit checks and repayment funds flows do not have to be set up and monitored.

### **Financing Conditions**

21. Consistent with the objectives of the Paris Declaration, each MDB will apply its own appropriate procedures in appraising, approving, supervising, monitoring and evaluating operations to be financed from the Fund. Each MDB will provide to the Trust Fund Committee a summary of its ground rules/procedures for administrating the activity including project/program appraisal and approval, procurement and anti-corruption plans, flow of funds, financial reporting, accounting and audit arrangements (including technical audits), quality assurance arrangements and a results-based monitoring and evaluation framework.

22. The following will apply to all financing products<sup>8</sup> financed by the Fund:

- (i) Each operation will be approved and administered in accordance with the applicable guidelines of the concerned MDB;
- (ii) Allocations by the Trust Fund Committee will be denominated in United States Dollars. However, MDBs may denominate individual financing provided by them to the beneficiaries<sup>9</sup> according to their own policies and procedures, subject to the MDB assuming any exchange rate risk;
- (iii) The MDB will, for purposes of each financing, conclude an agreement with the beneficiary, indicating in particular that the resources have been provided from the Clean Technology Fund. The agreement will, among other clauses, include the various items bulleted in this paragraph;
- (iv) The procurement of goods, works and services financed under the loans/grants will adhere to the principles of economy, efficiency, and transparency in the implementation of the approved activity while giving all eligible bidders a fair and equal opportunity to bid on a competitive basis;
- (v) Eligible expenditures under individual financing will be determined in accordance with the policies and procedures of the respective MDBs;
- (vi) The design and implementation of activities financed with Fund resources will ensure that appropriate governance, environmental, and social safeguards arrangements are established and carried out in accordance with principles that

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<sup>8</sup> Includes loans or credits, guarantees, and grants.

<sup>9</sup> The beneficiaries include the borrowers of loans or credits, the recipients of grants and the beneficiaries of guarantees.

build ownership, prevent and mitigate undue harm to people and their environment, through the participation of recipients and other stakeholders;

- (vii) Financial accountability arrangements in loan/grant agreements should be adequate to ensure that proceeds from the Fund are used only for the intended purposes, and take into consideration economy and efficiency.
- (viii) In each eligible country, the principle of sovereign programmatic prior no-objection will be a foundation of the investment program. The MDB will agree with the government on the overall program framework and will consult with the central government and request its endorsement on the engagement in each country. The MDBs will not seek their Boards' approval for any financial transaction which is not acceptable to the national government. They will follow their own operational procedures regarding notification of the national government of a proposed financing before Board consideration.