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Policy instruments for the Green Climate Fund

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Preface

This study is part of the research of the Belgian Policy Research Group on Financing for Development (BeFinD)[1]. It provides technical support for the Belgian participation to international climate governance bodies, such as the GCF, where Belgium is a Board member since the end of 2014. The specific objectives of the study are to provide a comprehensive overview of the financial instruments that a donor can use to make contributions to the GCF taking into account the aim of the GCF and the institutional context ("upstream financial instruments"), the financial instruments that the Board of the GCF and national and regional intermediaries can use to mobilize private finance ("instream financial instruments") and the financial instruments that the Board of the GCF can use to finance projects ("downstream financial instruments").

[1] www.Befind.be

Content

List of abbreviations

CTF	Clean Technology Fund
GCF	Green Climate Fund
GEF	Global Environmental Facility
LCD	Least Developed Country
NDA	National Designated Authority
OECD	Organization for Economic Co-operation and Development
SCF	Strategic Climate Fund
SIDS	Small Islands Developing States
UNFCCC	United Nations Framework Convention on Climate Change

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Executive summary

This study is part of the research of the Belgian Policy Research Group on Financing for Development (BeFinD). In particular, it fits within the WP-PG3 that aims at providing technical support for the Belgian participation to international climate governance bodies, such as the Green Climate Fund, where Belgium is in the Board since from the end of 2014.

The specific objectives are

- to provide a comprehensive overview of the financial instruments that a donor can use to make contributions to the GCF taking into account the aim of the GCF and the institutional context ("upstream financial instruments");
- to provide a comprehensive overview of the financial instruments that the Board of the GCF and national and regional intermediaries can use to mobilize private finance ("instream financial instruments");
- to provide a comprehensive overview of the channels and financial instruments that the Board of the GCF can use to finance projects ("downstream financial instruments").

Take away insights on contributions to the GCF ("Upstream instruments")

1. There are three channels through which contributions to the GCF can be made:
    - Grants from private or public sources;
    - Capital contributions from public sources and;
    - Concessional loans from public sources.

2. In addition, grants and capital contributions can take two forms:
    - By promissory note (=financial instrument, in which one party (issuer) promises to pay a sum of money to the other (payee). The promissory note defines the specific modalities, such as the encashment schedule and interest rate);
    - In cash.

    This is in contrast with loan contributions that are made in cash.

3. There are benefits and drawbacks attached to each of these instruments:

    - **Grant contributions**: A grant refers to a contribution, which can be paid in cash or by promissory note. A grant contribution has the following characteristics:
        i. Use of contributions in the GCF: Grant contributions can be used to finance all downstream financial instruments, including grants; and to finance all administrative costs related to the functioning of the GCF.
        ii. Implications on government budget and repayment obligations: The impact on the government is negative in the year that the grant is

attributed. In principle, a grant does not entail a repayment obligation. Only in case the GCF is liquidated the pro-rata share of the remaining funds reduced by the amount of outgoing grants made by the GCF (including administrative budgets and fees) will flow back to the grant contributors.

iii. Risks and implications for the functioning of the GCF: No specific risks attached to this type of contribution. Moreover, since there are little constraints attached to this type of contribution (e.g. no restrictions in terms of use), grant contributions seem to fit the ideology of the GCF best, in particular to support projects in LCDs and SIDS. Therefore, the Board of the GCF has already indicated that it will seek to maximize, in aggregate, grant contributions and that grant contributions must significantly exceed loan amounts.

- **Capital contributions**: A capital contribution refers to a contribution, which can be paid in cash or by promissory note. The difference with grant contribution relates to the difference in the repayment obligation (and the type of project finance for which it can be used). A capital contribution has the following characteristics:
  i. Use of contributions in the GCF: Capital contributions can be used for the types of project financing that generate reflows, independent on the level of concessionality (but hence not to finance grants). Capital contributions cannot be used to finance administrative costs related to the functioning of the GCF (unless differently specified by the donor country). Therefore, donors that make a capital contribution are also required to make a grant contribution to cover the administrative costs.
  ii. Implications on government budget and repayment obligations: The impact on the government is negative in the year that the capital contribution is attributed. There is repayment obligation and in case the GCF is liquidated, the capital contribution will be returned to the donor, in whole or in part (depending on the modalities associated with the capital contribution). However, unlike grant contributions, capital contributions are not reduced by the amount of outgoing grants (including administrative budgets and fees).
  iii. Risks and implications for the functioning of the GCF: No specific risks attached to this type of contribution, but more constraints attached to capital contributions than to grant contributions.

- **Loan contributions:** Concessional loans or "soft loans" are loans extended on terms that are substantially more generous than market loans. The concessionality is achieved either through an interest rate below the market interest rate and/or through a longer grace period. A loan contribution has the following characteristics:
  i. Use of contributions in the GCF: Loan contributions can only be used to finance specific instruments, namely loans with a higher interest rate and/ or shorter duration than the loan of the donor country to the GCF. Loan contributions cannot be used to finance administrative costs related to the functioning of the GCF (unless differently specified by the donor country). Therefore, donors that make a loan contribution are also required to make a grant contribution to cover the administrative costs.

ii. Implications on government budget and repayment obligations: In general, the impact of loan contributions on the government budget in the first year is the same as for grant and capital contributions. However, after the grace period (part of) the loan will flow back to the government budget, which means that there is a positive effect in the years afterwards. The overall, long-term impact of a loan contribution on government expenditures will be dependent on the level of concessionality of the loan.

iii. Risks and implications for the functioning of the GCF: The use of loan contributions will affect the financial stability of the GCF as constraints the use of the financial instruments "downstream". Therefore, the Board of the GCF has foreseen a number of risk management actions. First, it is emphasized that loan contributions should only be used for a small share of the total contributions to the GCF. Second, the Board will take a conservative approach with respect to the attribution of outgoing loans. Third, donors making a loan contribution are also requested to make an additional grant contribution that serves as a loan-cushion for non-performing loans downstream (currently set at 20%).

4. There are benefits and drawbacks attached to the form of the grant and capital contributions (promissory note vs. cash).
   - By promissory note: For the GCF, the Board defined that the promissory notes should be non-negotiable, non-interest bearing and should be deposited in a designated custody account. A promissory note has the following characteristics:
     i. Provides a potential for considerable interest savings for the donor country depending on the encashment period and the return of the funds.
     ii. Entails more risk than payments in cash as payments by promissory note are spread over time. There is a currency risk (for the GCF), which depends on exchange rate and encashment period. As a result, there is more uncertainty (for the GCF) regarding the funds that will be available for the GCF in the future.

   - In cash: Payments in cash have the following characteristics:
     i. No currency risk and uncertainty on the funds that are available for the GCF.
     ii. No interest savings.

Take-away insights on mobilizing private flows ("Instream instruments")

1. There are two channels through which the GCF can mobilize private flows:
   - Through the national and regional intermediaries
   - Through the GCF itself

   However, there are important concerns related to both channels.

2. In case private flows are mobilized through national and regional intermediaries the following considerations have to be made:
    - **Supply side:** The use of complex financial instruments to mobilize private flows imposes important requirements on the national and regional intermediaries. First, they are required to have a high-level of institutional and fiduciary capacity to be able to design and issue these instruments. Second, they are required to have some experience (and a well-established reputation) to be able to issue these instruments and attract investors at a reasonable cost. Third, they should be able to deal with the large issue sizes that are required to justify the issuance cost of some instruments. Finally, there are significant project-country risks attached to these instruments and it is unclear how national and regional intermediaries will be able to deal with those risks (especially important in the context of LCDs or SIDS). As a result, it is unclear to what extent intermediaries will have the right capacities to deal with these complex instruments. This holds especially for the LCDs and SIDS, but also more general. Exceptions are the multilateral development banks, such as the World Bank and the European Investment Bank, which already have experience with some of the proposed instruments.

    - **Demand side:** The main investors in this type of instruments would be local commercial banks, local pension funds, local insurance companies and wealthy individuals. As a result, the success of these instruments will depend on the local potential and appetite to invest in climate-related investments. While in the emerging countries there could be an interest in this type of financial instruments, it is unclear whether local investors in the LCDs and SIDS are willing and able to invest in these products.

    Overall, there are important constraints for national and regional intermediaries to mobilize private flows and in particular for the LCDs and SIDS these instruments do not seem appropriate to attract finance at a large scale. Nevertheless, it could be a useful approach to attract finance for projects in some emerging countries. However, it is recommended to limit the use of these instruments to mobilize private flows to the intermediaries that have a proven capacity to deal with these instruments, such as the multilateral development banks.

3. In case private flows are mobilized through the GCF, the following considerations have to be made:
    - **Supply side:** In order to be able to mobilize private flows at a large scale and attract investors, the GCF first needs to establish a reputation regarding risk management, liquidity and solvency. In addition, the GCF would need to acquire a credit rating. Finally, the issuance of these types of instruments requires an institutional and organizational capacity, which is currently not in place (e.g. hiring specialized financial profiles). This process will require time.

    - **Demand side:** There could be a wide range of potential investors: international commercial banks, pension funds, wealth funds. However, the actual interest will strongly depend on the reputation and credit rating of the GCF.

Overall, it is unlikely that in the short-term, the GCF will be able to attract private flows on its balance sheet. In order to issue the appropriate instruments to mobilize private flows, the GCF needs to establish a reputation regarding risk management, liquidity and solvency and acquire a risk-rating. This process will take time.

4. There are several instruments through which local and regional intermediaries can mobilize private flows. The instruments that are mostly likely to be used are bonds, commercial paper, syndicated loans and private placement programs. These instruments, except for (green) bonds, are not commonly used in climate finance, which makes it complicated to judge on their potential to mobilize private flows. Green bonds, however, have been used intensively in the past years by several multilateral development banks (and private investors) to attract private flows for climate-related investments. In fact, in 2014, the market for green bonds reached a record when 35 billion USD of new green bonds were issued. This indicates that this type of instrument has some potential to mobilize private flows at a large scale. In addition, more than the other instruments its relatively long lifetime seems to correspond best to the long-term perspective of the projects financed by the GCF. Nevertheless, as indicated above there are also drawbacks (e.g. usefulness in LCDs and SIDS) and mobilizing private flows has implications on the functioning of the GCF (e.g. return on investment required which restricts the use of the instruments downstream).

Take-away insights on instruments used by the GCF ("Downstream instruments")

1. There are two modes of access for recipient countries: direct (through accredited subnational, national or regional implementing entities and intermediaries) and/or international (through accredited international entities). With respect to direct access, there is also the possibility of "enhanced direct access". The difference between "direct access" and "enhanced direct access" lies in the fact that in the case of the "direct access" the funding decision to finance particular projects lies with the Board of the GCF, while for "enhanced direct access" it is the responsibility of the implementing agency.

2. For direct access (both simple as well as enhanced direct access), a key role is played by the national designated authority (NDA) or focal point. It main responsibilities are

   - disseminating information on the operations of the GCF;
   - nominating the competent subnational, national and regional implementing agencies for accreditation;
   - ensuring country coordination and multi-stakeholder consultation ("no-objection" procedure);
   - communication with the Board of the GCF.

   In addition, for enhanced direct access the NDA also plays an important role in the institutional arrangements (specific funding decisions, oversight activities and stakeholder consultation procedures).

3. Experiences from other climate funds show that there is a large variety in the level of engagement of the NDAs. In order to ensure a transparent and uniform approach across

countries, it is recommended that the Board of the GCF ensures that NDAs meet a number of minimum standards. These standards could relate to the authority's capacity to assess the environmental and social impact of projects, to provide transparent information about the operations of the GCF and to ensure a transparent and inclusive stakeholder consultation process. However, in order to reduce the administrative burden associated with the implementation of these standards for the NDAs and the focal points, it is recommended to explore potential spill-overs of standards imposed by other climate funds (e.g. Global Environmental Facility). This will also reduce administrative burden for the GCF that will be responsible to control the implementation of these standards. Finally, specific guidance of NDAs and focal points in LCDs and SIDS may be required as in these countries NDAs or focal points may not have the institutional capacity to implement these standards themselves. However, with respect to "enhanced direct access", NDAs and SIDS in LCDs and SIDS most likely do not have the required institutional capacities.

4. In a first stage, the GCF will only use grants and deep and moderate concessional loans. The deep concessional loans do not entail an interest rate (0%), have a long maturity (15 to 40 years) and a long grace period (5 to 10 years). The moderate concessional loans entail an interest rate which equals a benchmark rate (e.g. European Central Bank rate, US Treasury bond rate), have a short maturity (8 to 15 years) and a short grace period (2 to 4 years).

   It will be important to adjust the loan conditions to the mix of private and public contributions to the GCF. This mix and the corresponding repayment obligations upstream will impose important constraints on the instruments and their level of concessionality used downstream.

5. There is a variety of financial instruments available which the GCF (and/or its intermediaries) could use to finance project. The instruments discussed are de-risk instruments, such as guarantees, and non-debt risk-bearing instruments, such as equity investments. However, note that mainly multilateral development banks have some experience with these instruments, while climate funds such the Global Environmental Facility and the Adaption Fund have only limited experience with these products.

In addition, it is important to note that these instruments require a substantial level of private investment, which makes them not necessarily suited for all types of projects and countries. For example, high risk projects in vulnerable countries are likely to attract less private finance (at a reasonable cost).

Introduction

The Green Climate Fund (GCF) is a global fund formally established in 2010 at the 16th session of the Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC) in Cancun, Mexico.[2] A year later, at the 17th session of the Conference of Parties to the UNFCCC in Durban, the governing instrument of the GCF was adopted. The main aim of the GCF is to redistribute money from developed to developing countries "*to promote the paradigm shift towards low-emission and climate-resilient development pathways by providing support to developing countries to limit or reduce their greenhouse gas emissions and to adapt to the impacts of climate change, taking into account the needs of those developing countries particularly vulnerable to the adverse effects of climate change*" (UNFCCC, 2010). The resources of the GCF will be used to finance climate change mitigation and adaptation projects in developing countries.[3]
In order to achieve its aims, the GCF will support several projects, programs, policies and other activities in developing countries. It is intended to be the centerpiece of the UNFCCC commitment to raise 100 billion USD per year climate finance by 2020. However, this is not the official figure for the size of the GCF. The GCF is capitalized by contributions from donor countries and may potentially also attract funding from private actors (Lattanzio, 2014).
While up to now, most of the attention is focused on the role of private funds in the GCF (Bird et al., 2011), less attention is paid to the type of instruments that public institutions can use to finance the GCF and the instruments that the GCF can use to finance projects. A simplified overview of the design of the GCF and the financial instruments at the different levels can be found in Figure 1-1. We distinguish between financial flows with respect to the capitalization of the GCF ("upstream financial instruments") and the financial flows with respect to the financing of actual projects in developing countries ("downstream financial instruments").

Capitalization of the GCF ("upstream financial instruments"): There is some flexibility foreseen in how the GCF can be capitalized. Initially, contributions from the public and private sector[4] will be made in the form of grants, capital contributions and loans (see section 2). Over time, the GCF may also attract other forms of financing and may to mobilize private finance (see section 3, instream). However, the Board has already indicated that the GCF should, in aggregate, seek to maximize grant contributions. In case the GCF would receive most of its contributions in the form of capital contributions or loans this could constrain the viability and well-functioning of the GCF (see section 2.2.2).

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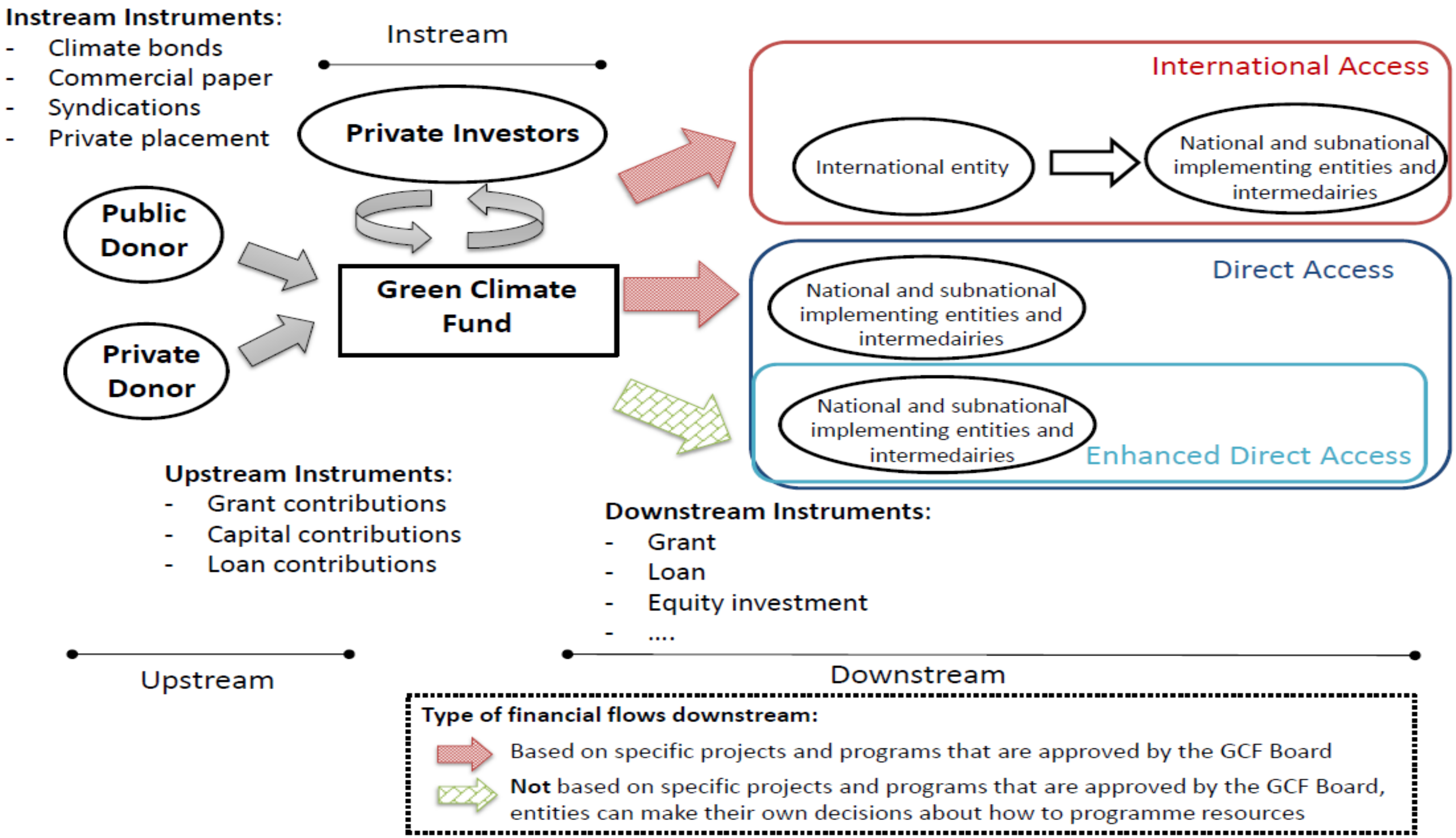
[2] In 2009, the establishment of a new multilateral fund for climate change finance was mentioned for the first time in the Copenhagen Accord, which was established during the 15th Conference of the Parties in Copenhagen.

[3] Mitigation and adaption projects will represent each 50% of the total fund portfolio. In terms of geographic balance, at least 50% of the adaptation portfolio is targeted to Small Island Developing State, Least Developed Countries and Africa (Green Climate Fund, 2014a).

[4] Up to now the majority of the contributions and pledges are made by developed countries' public authorities, although the private sector can also contribute to the GCF.

Figure 1.1 Upstream and downstream financial flows in the Green Climate Fund



- Financing of projects in developing countries (“downstream financial instruments”): The GCF will work through a variety of partners. Subnational, national, regional and international implementing entities and intermediaries can be accredited by the Board of the GCF and hence can get access to the GCF.

In this paper, we will analyze both the instruments that public and private institutions can use to finance the GCF (“upstream financial instruments”) and the instruments that the GCF can use to finance projects in developing countries (“downstream financial instruments”).

1 | Objectives of the study

1.1 General and specific objectives

This study fits within the activities of the Belgian Policy Research Group on Financing for Development (BeFinD). In particular, it fits within the overall objective of WP-PG3 that consists of providing technical support for Belgian participation to international climate governance bodies, such as the GCF, where Belgium will be in the Board starting from the end of 2014.
The specific objectives are

- to provide a comprehensive overview of the financial instruments that a donor can use to make contributions to the GCF taking into account the aim of the GCF and the institutional context ("upstream financial instruments");
- to provide a comprehensive overview of the financial instruments that the Board of the GCF and national and regional intermediaries can use to mobilize private finance ("instream financial instruments");
- to provide a comprehensive overview of the channels and financial instruments that the Board of the GCF can use to finance projects ("downstream financial instruments") .

1.2 Outline of the study

The study consists of the following chapters:

- Chapter 2 discusses the three types of financial instruments that donors can use to make contributions to the GCF ("upstream financial instruments") and their advantages and disadvantages. In particular, the chapter discusses grants, capital contributions and concessional loans.

- Chapter 3 presents an overview of the financial instruments that could be used in the future to mobilize private flows ("instream financial instruments"). In particular, this chapter discusses green bonds, commercial paper, syndicated loans and private placement programs. In addition, it discusses the potential of these instruments when used by (A) national and regional intermediaries; and (B) the GCF itself.

- Chapter 4 presents an overview of the channels through which the GCF can fund projects. A distinction is made between international access, direct access and enhanced direct access. Further, this chapter discusses the financial instruments that the Board of the GCF can use to finance projects ("downstream financial instruments"). In particular, this chapter will discuss grants and loans, the two instruments that the GCF will use to finance projects. In addition, this chapter will also discuss two potential instruments that could be used by the GCF in the future, namely de-risk instruments such as guarantees and non-debt risk bearing instruments such as equity investments.

2 | Contributions to the Green Climate Fund ("upstream instruments")

The GCF aims to receive funding from different sources. As its main source of finance, the GCF will receive contributions from the developed country Parties to the Convention. However, in addition the GCF may also receive financial inputs from a variety of other public or private sources (Lattanzio, 2014). However, the process of resource mobilization has been controversial from the beginning. The initial capitalization of the GCF is based on voluntary contributions and there is no agreement on how a long-term capitalization of the GCF can be ensured. In addition, there is no agreement on burden-sharing between developed countries nor is there an agreement on the balance between public and private contributions (Lattanzio, 2014; Schalatek and Nakhooda, 2014). At the fifth meeting of the Board in October 2013 in Paris it was agreed that for the initial resource mobilization there are three types of contributions to the GCF (Green Climate Fund, 2013):

- Grants from private or public sources;
- Capital contributions from public sources and;
- Concessional loans from public sources.

Up to December 2014, the majority of the contributions and pledges are made in the form of grants (95,5% of all pledges on 31 December 2014 are grants). In fact, only France has confirmed that part of it committed contribution of 774 million EUR will be provided as a loan (342 million EUR or 44% of the French contribution) (Table 2-1).
On December 9, 2014, the Belgian minister of development cooperation, Alexander De Croo announced that Belgium pledges 51,6 million euro to the GCF. This pledge has immediately been translated for 80% in a grant contribution. No specific modalities have been attached yet to the remaining 10 million euro.

Table 2.1 Initial Resource Mobilization Pledges (31 December 2014; in millions)

Contributor	Currency	Type of instrument			Total pledge (loc. curr.)	Total pledge (USD equi.)
		Grant	Capital	Loan		
Australia	AUD	200	-	-	200	186,94
Austria	USD	25	-	-	25	25
Belgium	EUR	51,6	-	-	51,6	69,03
Canada	CAD	300	-	-	300	277,02
Chile	USD	0,3	-	-	0,3	0,3
Colombia	USD	6	-	-	6	6
Czech Republic	CZK	110	-	-	110	5,32
Denmark	DKK	400	-	-	400	71,78
Finland	EUR	80	-	-	80	107,02
France	EUR	432	-	342	774	1035,4
Germany	EUR	750	-	-	750	1003,29
Indonesia	USD	0,25	-	-	0,25	0,25
Italy	EUR	250	-	-	250	334,43
Japan	JPY	154028,7	-	-	154028,7	1500
Latvia	EUR	0,35	-	-	0,35	0,47
Liechtenstein	CHF	0,05	-	-	0,05	0,06
Luxembourg	EUR	5	-	-	5	6,69
Mexico	USD	10	-	-	10	10
Monaco	EUR	0,25	-	-	0,25	0,33
Mongolia	MNT	90	-	-	90	0,05
Netherlands	EUR	100	-	-	100	133,77
New Zealand	NZD	3	-	-	3	2,56
Norway	NOK	1600	-	-	1600	257,86
Panama	USD	1	-	-	1	1
Peru	USD	6	-	-	6	6
South Korea	USD	100	-	-	100	100
Spain	EUR	120	-	-	120	160,53
Sweden	SEK	4000	-	-	4000	581,19
Switzerland	USD	100	-	-	100	100
UK	GBP	720	-	-	720	1210,98
US	USD	3000	-	-	3000	3000
Total						10193,26

Source Green Climate Fund website - http://news.gcfund.org/wp-content/uploads/2015/02/pledges_GCF_dec14.pdf

2.1 Characteristics of different types of contributions to the GCF

The instruments a donor can use to make a contribution to the GCF have different modalities (e.g. repayment obligation when the fund is liquidated), but also different purposes and uses by the GCF (e.g. some contributions can only be used to finance instruments that generate reflows) (GCF, 2013). In this section, we discuss the different types of contributions to the GCF. Table 2-2 presents an overview.

2.1.1 Grants from public and private sources

A grant refers to a contribution for which in principle no repayment is required. It can be paid in cash or by promissory note. A promissory note is a financial instrument, in which one party (issuer) promises to pay a sum of money to the other (payee). The promissory note defines the specific modalities, such as the encashment schedule and interest rate.
In principle, a grant does not entail a repayment obligation. Only in case the GCF is liquidated, the pro-rata share of the remaining funds reduced by the amount of outgoing grants made by the GCF (including administrative budgets and fees) will flow back to the grant contributors.

A grant contribution can be used to finance all downstream financial instruments (e.g. grants, loans – independent of their concessionality level[5], guarantees, equity investments, …). In addition, it can be used to finance the administrative costs associated with the functioning of the GCF.

2.1.2 Capital contributions from public sources

A capital contribution refers to a contribution for which in principle repayment is required as the donor receives equity in the GCF. In case the GCF is liquidated, the capital contribution will be returned to the donor. However, unlike grant contributions, capital contributions are not reduced by the amount of outgoing grants (including administrative budgets and fees). Moreover, capital contributors may even receive a potential return of their contribution, depending on the availability of such funds at the time of the liquidation of the Fund. A capital contribution can be paid in cash or by promissory note.

The use of a capital contribution to finance the activities of the GCF is restricted and depends on the modalities imposed by the donor on the capital contribution. In general, it can be used by the Board of the GCF to finance activities of implementing agencies that generate reflows, independent on the concessionality level (e.g. concessional loans, guarantees generating fee income). Capital contributions cannot be used to finance grants or administrative costs, unless the modalities imposed by the donor allow this.

2.1.3 Concessional loans from public sources

Concessional loans or "soft loans" are loans extended on terms that are substantially more generous than market loans. The concessionality is achieved either through an interest rate below the market interest rate and/or through a longer grace period. A concessional loan is paid in cash.

[5] The concessionality level of the loan refers to the level of "softness", which reflects the benefit to the borrower compared to a loan at market rate. For loans the level of concessionality is determined by the difference in the interest rate and/or grace period of the loan as compared to a loan at market terms.

Since it is a loan, there is an obligation of the GCF to repay the donor, with or without interest, depending on the modalities of the loan.

The use of a concessional loan to finance the activities of the GCF is restricted as it can only be used by the Board of the Fund to finance activities of implementing agencies using loans on terms that are less concessional than the loan contributions by the donor. Loans cannot be used to finance grants or administrative costs. In addition, there are more financial risks related to loan contributions (see section 2.2)

Table 2.2 **Implications for the government budget and the functioning of the GCF**

<table>
<tr><th></th><th>Implications for the government budget</th><th>Implications for the functioning of the GCF</th></tr>
<tr><td>Grants</td><td>Repayment obligation:
In principle, no repayment obligation. However, note that in case the GCF is liquidated, the pro-rata share of the remaining funds reduced by the amount of outgoing grants made by the GCF (including administrative budgets and fees) will be attributable to the grant contributors.
Impact on government budget:
Impact is negative in the year that the grant contribution is attributed.</td><td>Use of downstream financial instruments:
Project financing: All instruments allowed – no constraints attached to the type of finance instrument used.
Administration costs: Can be covered with grant contributions.
Risks:
Financial stability: No specific risks associated with the use of grant contributions. In fact, these flows ensure sufficient liquidity of the GCF.
Currency risk: Depending on whether grant contributions are made in cash or by promissory notes (in case of a promissory note the payment is spread over a longer period and therefore the GCF may be subject to a currency risk).</td></tr>
<tr><td>Capital contributions</td><td>Repayment obligation:
Repayment obligation (in whole or partly). In case the GCF is liquidated, the capital contributions will be attributable to the capital contributors.
Impact on government budget:
Impact is negative in the year that the capital contribution is attributed.</td><td>Use of downstream financial instruments:
Project financing: Can be used for the types of project financing that generate reflows, independent on the level of concessionality (e.g. concessional loans, guarantees); in principle, capital contributions cannot be used for grants unless the design of the capital contribution allows this.
Administration costs: Cannot be covered with capital contributions, unless the specific design of the capital contribution allows this.</td></tr>
</table>

Table 2-2: Implications for the government budget and the functioning of the GCF (continued)

<table>
<tr><th></th><th>Implications for the government budget</th><th>Implications for the functioning of the GCF</th></tr>
<tr><td>Capital contributions</td><td></td><td>Risks:
Financial stability: No specific risks associated with the use of capital contributions.
Currency risk; Depending on whether capital contributions are made in cash or by promissory notes (in case of a promissory note: the payment is spread over a longer period and therefore the GCF may be subjected to a currency risk).</td></tr>
<tr><td>Loans</td><td>Repayment obligation:
Repayment obligation with or without interest – depends on the modalities
Impact on government budget:
Impact is negative in the year that the loan is attributed. However, since it is a loan there is a repayment obligation and after the grace period, (part of) the loan will flow back to the government budget. The long-term impact on government expenditures will be dependent on the level of concessionality of the loan. In the case the loan is highly concessional, the long-term impact is likely to be negative, but in principle the long-term impact can also be neutral or even positive, depending on the modalities of the loan (interest rate, grace period and repayment period).</td><td>Use of downstream financial instruments:
Project financing: To finance specific instruments, namely loans with a higher interest rate and/ or shorter duration than the loan of the donor country to the GCF
Administration costs: Cannot be covered with loan contributions.
Risks:
Financial stability: Risk of non-payment by the recipient which jeopardizes the repayment obligation to the donor country. In order to deal with this risk, the contribution of a loan should be accompanied with an additional grant contribution that will serve as a cushion for non-performing loans. In addition, it is foreseen that the GCF should seek to maximize grant contributions as compared to capital and loan contributions.
Currency risk: Due to the time lag between the contribution to the GCF and the repayment, the GCF is confronted with a currency risk</td></tr>
</table>

2.2 Implications for the government budget and the functioning of the GCF

The type of contributions to the GCF (grant, capital or loan contributions) will affect the government budget of the donor countries and the general functioning of the GCF. In this section we will discuss those implications in detail. In Table 2-2, we present a summary.

2.2.1 Implications for the government budget

In the discussion on the implications, we distinguish between the different types of contributions (grant, capital or loan contributions).

In general, the overall impact of grant and capital contributions on the government budget of the donor country is similar. However, the impact differs depending on whether the contributions are made in cash or promissory notes.

For the GCF, the Board defined that the promissory notes should be non-negotiable, non-interest bearing and should be deposited in a designated custody account. The encashment period should be negotiated, but cannot exceed nine years.[6] For those that accelerate their payment, the GCF foresees a credit, which equals the difference between the present value of the standard encashment schedule and the contributor's encashment schedule. The discount rate that will be used equals the estimated return on the Fund's liquidity over the standard encashment schedule. For the initial pledges, the discount rate has been fixed at 1,5% (GCF, 2014).

The issuance of a promissory note is usually debited within the donor country from the donor agency's budget at the time of delivery of the promissory note. The promissory note then becomes a liability and a call on the national treasury for encashment (Markie, 2013). The benefit of a non-interest bearing promissory note for a donor is that it provides a potential for considerable interest savings for the donor country depending on the encashment period and the return of the funds (Dernbach, 2002).

In general, the impact of loan contributions on the government budget in the first year is the same as for grants and capital contributions. However, after the grace period the loan will flow back to the government budget, which means there is a positive effect in the years afterwards. The overall, long-term impact of a loan contribution on government expenditures depends on the level of concessionality of the loan. In the case the loan is highly concessional, the overall, long-term impact is likely to be negative, but in principle the overall, long-term impact can also be neutral or even positive, depending on the modalities of the loan (interest rate, grace period and repayment period).

6 The standard encashment scheme for the "intitial resource mobilization period" is as follows: 6,7% of the contribution in 2015; 11,7% in 2016; 15,6% in 2017; 12,3% in 2018; 11,9% in 2019; 11,9% in 2020; 11,3% in 2021; 10,4% in 2022 and 8,2% in 2023.

2.2.2 Implications for the functioning of the GCF

In the discussion on the implications of the different types of contributions for the functioning of the GCF, we distinguish between (A) the impact of the type of contribution for the activities and projects financed by the GCF and (B) the impact of the type of contribution on the financial risks for the GCF:

- **Activities and projects financed by the GCF:**
  Capital contributions and in particular contributions in the form of concessional loans to the GCF constrain the risks and the concessionality of the financial instruments that the GCF can offer to its recipients. For example, capital contributions can only be used for the types of project financing that generate reflows, independent of the level of concessionality (e.g. concessional loans, guarantees) and in principle, they cannot be used for grants unless the design of the capital contribution allows this. There are even more constraints related to the use of loans as they can only be used to finance loans with a higher interest rate and/or shorter duration than the loan of the donor country to the GCF.

  In addition, the type of contribution will also determine whether it can be used to finance the administrative costs associated with the functioning of the GCF. In principle, only grant contributions can be used to finance administrative costs (depending on the design, capital contributions could also be used to finance administrative costs). Therefore, donors that make capital or loan contributions are requested to also make grant contributions to cover administrative costs. Note that for capital contributions this will depend upon the design – in some cases the design is defined in such a way that the capital contribution does allow to cover administrative costs (in whole or partly).

- **Financial risks:**
  The possibility of using loan contributions will affect the financial stability of the GCF and therefore a number of financial risk management actions are foreseen.

  First, the Board has specified that the majority of the contributions should come from grant contributions: *"The Fund will, in aggregate, seek to maximize grant contributions, taking into account its theme-based allocation. It is foreseen that grant contributions must significantly exceed loan amounts"* (Decision B.07/05 - Annex XI, paragraph 2(a).

  Second, in order to minimize financial losses as a result of non-performing loans the Board decided that the GCF should take a conservative approach with respect to the attribution of outgoing ("downstream") loans. This will help to ensure that reflows from outgoing loans always exceed repayments to loan contributors.

  Third, in case of loan contributions, the donor is requested to make an additional grant contribution (on top of the grant contribution to cover administrative costs as described higher) (GCF, 2013). This additional grant contribution provided by loan contributors serves as a cushion for non-performing loans and may be used to make repayments to loan contributors in case reflows from outgoing loans are insufficient to cover repayments to loan contributors. The minimum grant contribution will depend on the assessment of the risks taken by the GCF and the expected cash flow. However, for initial pledges and commitments this grant contribution was determined at 20% of the value of the loan contribution.

Finally, it is foreseen that any financial losses will be borne on a pro-rata basis by contributors whose loan, capital or grant contributions were used by the GCF to extend loans. However, it is unclear how this will be managed in practice. First, given the complexity of the channels through which intermediaries and implementing agencies can access the funds of the GCF (direct access and enhanced direct access), the monitoring and attribution of funds to specific donor countries will be difficult. Second, it is unclear whether the donor countries will have a say on whether their funds will be used to finance loans.

These mechanisms aim to ensure that grant contribution would not need to be drawn on to pay for non-performing loan outputs and there is no cross-subsidization of grant and loan contributors.

In addition to the risks related financial stability, there are currency risks:

- In case of loan contributions, there is a repayment obligation. However, usually there is a significant time lag between the loan contribution and the repayment. As a result, the GCF will be confronted with currency risks. In order to limit this risk, the GCF could use some of the instruments available at international markets (e.g. interest swaps). However, it should be noted that there are costs attached to those types of instruments.

- In case of grant or capital contributions using promissory notes, there are also currency risks. These risks will depend on volatility of the exchange rates and the encashment period. In order to reduce this volatility, encashment rates could be shortened. For example, in the fifth overall performance study of the Global Environmental Facility (GEF)[7], it was advised to work with shorter encashment schedules for promissory notes. This would allow to reduce the currency risk and allow the Board to get an earlier view on the funds that are available for the GEF (Markie, 2013). In addition, the GCF can also use financial instruments to reduce the currency risk (see higher).

[7] The GEF was established in October 1991 as a 1 billion USD pilot program of the World Bank to promote sustainable development and currently, it is a partnership for international cooperation where 183 countries work together with international institutions, civil society organizations and the private sector, to address global environmental issues. The GEF provides grants (and to some extent concessional loans) to finance the "incremental" or additional costs associated with environmental sustainable projects.

3 | Alternative financial instruments to mobilize private flows ("instream instruments")

In addition to public finance from the developed country Parties of the Convention, the GCF aims to attract financial resources from private sources. In principle, there are various pathways through which the GCF can play a role in mobilizing private flows for climate finance. First, it can aim to attract funding from private investors by making the GCF and its projects an attractive financial investment. Therefore, the GCF (or its intermediaries) can issue specific financial instruments, such as for example green bonds. Second, the GCF can mobilize private flows by enabling projects that would not be attractive for private investors without the concessional support from the GCF for a part of project. In this paper, we will limit the discussion on mobilized private flows to the first type. In particular, we will discuss the instruments that were proposed during the eighth meeting of the Board in October 2014, namely bonds, commercial paper, syndications and club deals, and private placement programs.

3.1 Characteristics of the financial instruments to mobilize private flows

3.1.1 Climate bonds

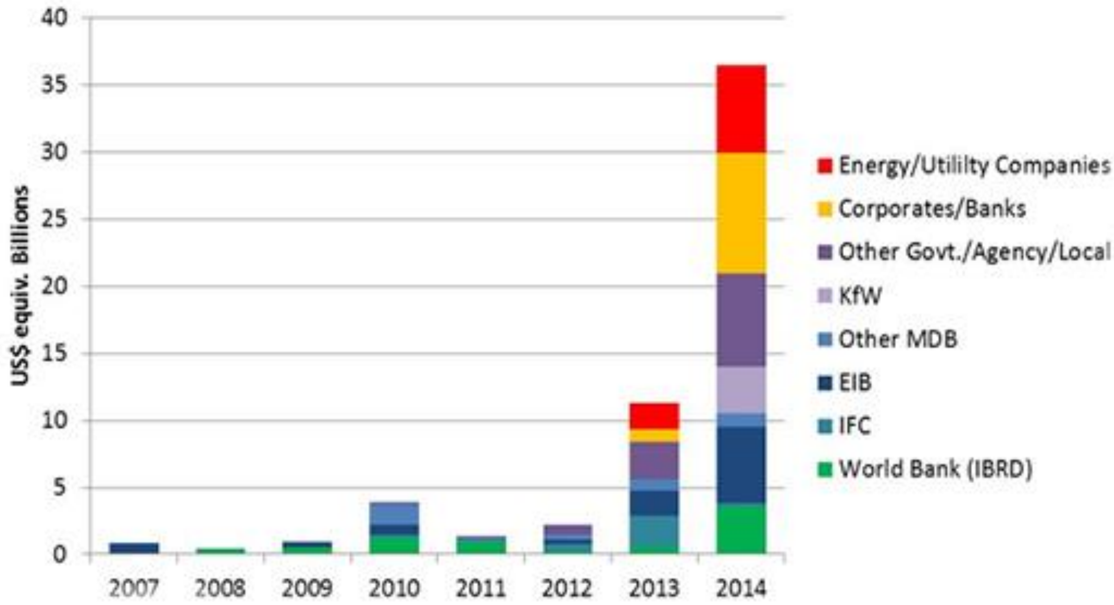
Climate bonds are fixed-income financial instruments that are issued by governments, multilateral banks or corporations to raise finance for investments in emission reduction or climate change adaptation (MaxKenzie and Ascui, 2009). Climate bonds can be seen as a special type of green bonds, which aim to raise finance for environmental projects in general. However, because these terms are closely related, they are often used interchangeably (Climate Bonds Initiative, 2014).

A green bond, or more general a bond, is a simple debt instrument (so-called debt security) that can be traded during its lifetime. When an investor buys a bond he provides the issuing entity with money to invest (in the case green bonds in environmental projects). In exchange, the issuing entity pays the investor an interest "coupon" (fixed or variable rate of return) at predetermined intervals and guarantees to repay the bond on the maturity date. Bonds can be issued by governments or (big) private corporations.

Bonds require, in general, a long term commitment (although they can be traded during their life time). As a result, they expose the investor to a significant credit and interest rate risk. In general, the risk associated with a specific bond is assessed by a rating agency, who rates the issuer's ability to repay its obligations (interest + principal). Ratings range from "Triple A" (very secure – likely to be repaid) to "D" (very insecure – unlikely to be repaid). The most famous three rating agencies are Standard & Poor's, Moody's and Fitch Group.

Overall, green bonds are relatively new on the market, but their success is rapidly growing. In 2008, the World Bank issued its first green bond. Since then the World Bank has raised more than 7 billion USD through green bonds. Other multilateral and public institutions have also issued green bonds, such as the European Investment Bank, International Finance Corporation, the state of Massachusetts and Ile de France. Recently, corporations such as Toyota, Unilever and GDF Suez, have issued green bonds. Green bonds allow private corporations to raise capital for their corporate social responsibility activities and the greening of their operations. In 2014, the market for green bonds reached a record when 35 billion USD of new green bonds were issued (Figure 3-1). The purchasers (investors) of the green bonds are mainly institutional investors, such as commercial banks, pension funds, insurance companies and wealth funds.

Figure 3.1 Annual Green Bond issuance by type of issuer



Source http://www.worldbank.org/en/news/feature/2015/01/22/green-bonds-changing-investor-expectations-three-trends

Up to now, there is no standardized approach for the issuance of a green bond. Among the bonds issued in 2013 and 2014, 39% were issued without independent review, while 61% were reviewed either by CICERO (research center from the University of Oslo), Vigeo or DNV GL. However, there are some efforts to provide guidance on which projects can be associated with green bonds. Therefore, the Climate Bonds Initiative, a wide coalition of academics and industry experts, has developed the Climate Bonds Standard. These are open access environmental standards and guidelines for which climate-related investments can be associated with green bonds (Climate Bonds Initiative, 2014). Such an initiative will be particularly important to provide trust to investors in the event that low-rated issuers enter the market.

In order to attract private finance through green bonds, there are two options for the GCF. First, in the short term, the GCF can work through national and regional intermediaries to issue project-specific bonds. The role of the GCF could then consist of providing a loss mechanism in which it would insure (part of) the capital exposed in case there is a financial loss. However, the feasibility of this option will depend on the institutional capacities of the national and regional intermediaries and their ability to issue these instruments. In addition, when targeted to specific projects and/or countries these bonds bear high project-country risks. Second, in the long term, the GCF can issue its own bonds (which could either be general or project-specific). However, in order to be able to attract funds itself, the GCF first needs to establish a strong reputation regarding risk management, liquidity and solvency. In addition, note that the issuance of green bonds is very costly and an issue volume of at least 300 to 500 million USD is required

3.1.2 Commercial paper

Commercial paper is a debt instrument issued by a bank or corporation. It is a promissory note with a fixed maturity (in general less than one year), where both principal and interest are paid at the maturity date. Given its short lifetime, it is mainly used by the issuer to finance short-term obligations. Only issuers with a good rating will be able to successfully issue commercial paper at a reasonable cost. The purchasers of the commercial paper are mainly local banks and individuals.

Overall, this instrument is currently used less frequently in the context of climate finance than bonds. In fact, according to our knowledge none of the existing climate funds uses this instrument to attract finance. The GCF could use commercial paper through its national and regional intermediaries to attract project specific finance. The instrument is less suited to be used by the GCF itself to attract general funding as the short term nature does not correspond to the long term perspective of the projects financed by the GCF.

3.1.3 Syndications and club deals

A syndicated loan is a loan provided by a group of lenders to one single borrower. This mechanism allows lenders to finance large projects for which one single lender would not be able to take on the risk.

Syndicated loans are usually restricted to five to seven years. However, unlike bonds syndicated loans are illiquid in nature, meaning that they do not provide an easy way out for investors. As a result, syndicated loans generally provide higher returns as compared to bonds. However, since they are considered as loans and not securities, syndicated loans are subject to significantly less regulatory/licensing hurdles than bonds or commercial paper. As a result, the issuance of this type of instrument can be carried out with lower transaction costs and hence it can be done for lower volumes and be used to finance smaller projects.

3.1.4 Private placement programs

Private placement programs are an intermediate step between bonds/commercial paper (securities) and syndicated loans (loan instrument). Private placements are often used to attract funding for a non–rated entity or project that does not meet the volume requirement to seek a rating and issue a bond. Unlike bonds, they are not sold through a public offering, but rather through a private offering, mostly to a selected group of private investors. Private placements generally have a duration of three to seven years. The transaction costs and regulatory hurdles faced by issuers of private placement programs are lower than in case of bonds or commercial paper, but higher than in the case syndicated loans.

3.2 Implications for the functioning of the GCF

In Table 3-1, we present the drawbacks and risks associated with the use of the different financial instruments that could be used by national and regional intermediaries or the GCF itself to mobilize private flows. We distinguish between four categories:

- **Cost of issuance:** The issuance of bonds and commercial paper is associated with substantial transaction costs. For example, in order to justify the issuance cost of green bonds, an issue volume of at least 300 to 500 million USD is required (Green Climate Fund, 2015). For private placements and especially syndications these costs are lower. As a result, these instruments can be used to finance more small scale projects.

- **Ability to attract funding:** The only financial instrument that has been used at a large scale to attract private climate finance is green bonds. Especially in the last five years, green bonds issued by multilateral organizations and private organizations have gained importance. The other products are not used at a large scale to attract finance.

    - **Use by national and regional intermediaries:** The use of each of these instruments by national and regional intermediaries requires a certain institutional and financial capacity. In addition, ideally these institutions should have some experience with the use of these instruments in the past. As a result, it is unlikely that the national intermediaries in LCDs and SIDS will be able to use these instruments. In addition, these instruments also depend on the local interest in investing in climate finance. With respect to commercial paper and syndicated loans, local banks are the main investors. For private placements, the interest from banks is generally lower and especially (wealthy) individuals and wealth funds are interested in this type of instruments.

    - **Use by the GCF itself:** The instrument that is best suited to be used by the GCF to attract funding directly to the GCF's balance sheet is the green bonds. Green bonds have a relatively long lifetime (as compared to the other instruments) and therefore they seem to correspond the best to the long-term perspective of the projects financed by the GCF. A large number of investors are interested in green bonds (commercial banks, pension funds, insurance companies and wealth funds). However, in order to be able to issue its own bonds and successfully attract private funding, the GCF first needs to establish a strong reputation regarding risk management, liquidity and solvency. This will require time and it may take more than a more than a decade to establish a strong reputation..

- **Restrictions on the downstream instruments:** The use of all four financial instruments to attract private finance restricts the use of the financial instruments downstream as after some time the buyer of the instrument needs to be repaid (capital + interest costs). This requires that the money mobilized by these instruments can only be invested in non-concessional instruments, which yield a return on investment (loans, equity investments, ...).

- **Conductive to mobilize funds for LCDs and SIDS:** None of these instruments is conductive to mobilizing climate finance for LCDs and SIDS. First, national intermediaries in LCDs and SIDS are not likely to have the institutional and financial capacity to issue these instruments on a large scale. Second, there are substantial project-country risks related to investments in LCDs and SIDS, which will increase the cost (interests that need to be paid). Finally, it is important to take into account that due to the fact that the use of financial instruments downstream is restricted to non-concessional instruments. As result, the access for some LCDs and SIDS could be restricted or these countries may take up inappropriate levels of debt.

Table 3.1 The use of alternative financial instruments to mobilize private flows

	Bonds	Commercial paper
Cost of issuance	Substantial transaction costs and regulatory hurdles such that a substantial issue volume is required to justify the issuance cost	Substantial transaction costs and regulatory hurdles such that a substantial issue volume is required to justify the issuance costs
Ability to attract funding	In recent years, green bonds are extensively used by multilateral institutions and private investors to attract climate finance at a large scale.	Not been used extensively for climate finance in the past by other climate funds; Due to the short lifetime, commercial paper is less suited to be used to finance large scale, long term projects.
Use by national and regional intermediaries	Yes, but this depends on the institutional and financial capacity of the intermediaries and their capacity to deal with country and project risks.	Yes, but depends on the institutional and financial capacity of the intermediaries and their capacity to deal with country and project risks. In addition, it depends on the local interest to invest in climate finance as the main buyers of commercial paper are local banks and investors.
Use by GCF itself	Yes, but in order to get a rating and successfully issue bonds the GCF first needs to establish a strong reputation regarding risk management, liquidity and solvency	No, as the short term lifetime does not correspond to the long-term projects financed by the GCF
Restrictions on downstream instruments	Can only be used for non-concessional finance. Corresponds to long term perspective of GCF projects	Can only be used for non-concessional finance Short-term finance
Conductive to mobilize private climate finance for LCDs and SIDS	No	No

Table 3-1: Implications of the use of alternative financial instruments to mobilize private flows (continued)

	Syndicated loans	Private placement programs
Cost of issuance	Less transaction costs and regulatory hurdles as syndicated loans are considered to be loan instruments (and not securities such as bonds or commercial paper). As a result, this instrument can be used to finance smaller projects.	Intermediate transaction costs and regulatory hurdles as private placements are an intermediary instrument between bonds/ commercial paper (securities) and syndicated loans (loan instruments). As a result, this instrument can be used to finance smaller projects.
Ability to attract funding	Not been used extensively for climate finance in the past Due to its intermediate life time, this instrument is less suited to attract large scale, long-term finance.	Not been used extensively for climate finance in the past Due to its intermediate life time, this instrument is less suited to attract large scale, long-term finance.
Use by national and regional intermediaries	Yes, but depends on the institutional and financial capacity of the intermediaries and their capacity to deal with country and project risks. In addition, it depends on the local interest to invest in climate finance as the main buyer syndicated loans are local banks.	Yes, but depends on the institutional and financial capacity of the intermediaries and their capacity to deal with country and project risks. In addition, it depends on the interest in this type of product as the main investors are wealthy individuals and wealth funds (banks are not interested in this instrument.
Use by GCF itself	No, as the intermediate lifetime does not correspond to the long-term projects financed by the GCF	No, as the intermediate lifetime does not correspond to the long-term projects financed by the GCF
Implications on the functioning of the GCF	Can only be used for non-concessional finance Short-term finance	Can only be used for non-concessional finance Short-term finance
Conductive to mobilize private climate finance for LCDs and SIDS	No	No

Source UNFCCC (2014)

4 | Instruments used in the Green Climate Fund ("downstream instruments")

Up to now, the GCF only provides financial support through grants and concessional loans. In the future, the GCF may consider additional instruments under the condition that these instruments are effective in reaching the objectives of the GCF. In this section, we will discuss the different channels through which actors can access the GCF, the characteristics of the instruments that are currently in place to finance GCF funded projects. In addition, we will discuss alternative downstream financial instruments which may be used by the GCF in the future.

4.1 Channels to access the GCF

There are two modes of access for recipient countries: direct (through accredited subnational, national or regional implementing entities and intermediaries) and international (through accredited international entities) (Figure 1-1). With respect to direct access, there is also the possibility of "enhanced direct access". Overall, we can distinguish between three channels through which a recipient country can access the GCF (Berliner et al., 2013; Shalatek et al., 2014):

- **International access through accredited international entities:** The accredited international entities may include United Nations agencies, multilateral developments banks, international financial institutions and regional institutions. Examples of such international entities are the World Bank, the European Bank for Reconstruction and Development and the European Investment Bank. In case of international access, the international entity serves as an intermediary between the GCF and the national (or sub-national) implementing agency. The management decision takes place a at the national level, but the funding decision will still be with the Board of the GCF. This implies that the Board of the GCF approves the specific projects and programs that will be financed.

- **Direct access through accredited national (or sub-national) implementing entities and intermediaries ("direct access"):** The accredited national and sub-national implementing agencies and intermediaries may include public and private entities such as government ministries, national development banks and NGOs.[8] Similar as in the case of international access, the management decision takes place at the national level, but the funding decision will still be with the Board of the GCF.

[8] Accreditation is based on fiduciary standards (administration and financial capacity, transparency and accountability and activity-related standards) and environmental and social safeguards (capacity to assess and manage environmental and social risks). Note that the regional, national and sub-national entities that apply through direct access need to accompany their application for accreditation with evidence of their nomination from the National Designated Authority or focal point. Some entities can apply for the "fast-track accreditation" process in case they are already accredited by the Global Environment Facility (GEF), the Adaptation Fund or the Directorate-General for Development and Cooperation – EuropeAid of the European Commission.

- **Direct access through accredited national (or sub-national) implementing agencies and intermediaries ("enhanced direct access"):** In this case, there is a stronger devolution of decision-making and both the management and funding decision take place at the national level. This means that the final decision on the specific activities to be funded is taken by the national implanting agency or intermediary. As a result of these broader responsibilities, only accredited implementing agencies and intermediaries with a well-developed institutional capability will in theory be able to provide funding through this channel (Bird et al., 2011b).

For direct access (both simple as well as enhanced direct access), a key role is played by the national designated authority (NDA) or focal point. This authority is responsible for disseminating information on the operations of the GCF and for nominating the competent subnational, national and regional implementing agencies for accreditation. Further, the NDA ensures country coordination, multi-stakeholder involvement and the communication with the Board of the GCF. The NDA can object to some proposed (private) projects in case they are not in line with national objectives. As result, the NDA facilitates genuine country ownership.

Other climate funds also rely on the cooperation with a designated authority or focal point (e.g. Global Environmental Facility (GEF), Adaptation Fund and Clean Development Mechanism). Finally, also most multilateral development banks use a designated authority or focal points (often ministry of finance). Table 4-1 presents an overview of the different funds that have a designated authority/focal point.

Table 4.1 Funds that have a designated authority or focal point

Fund	Experiences
Global Environmental Facility (GEF)	Focal points that coordinate, liaise and communicate between the country and the GEF Board and Secretariat. No specific guidelines which authorities classify for this role (mostly officials in the ministry of Environment or Finance). There exist political focal points (concerned with governance and political decisions) and operational focal points (concerned with project proposals, coordination and consultation).
Clean Development Mechanism	National designated authority. No specific guidelines.
Adaptation Fund	Designated authority (individual) appointed by a minister or ambassador. No specific guidelines which individuals classify for this role. Main task is to verify that proposals are consistent with national adaptation priorities.
Multilateral Development Banks	Designated authority appointed by the country. No specific guidelines (mostly officials in the ministry of Finance).

*
Source Green Climate Fund (2014c) and Orestein et al. (2012)

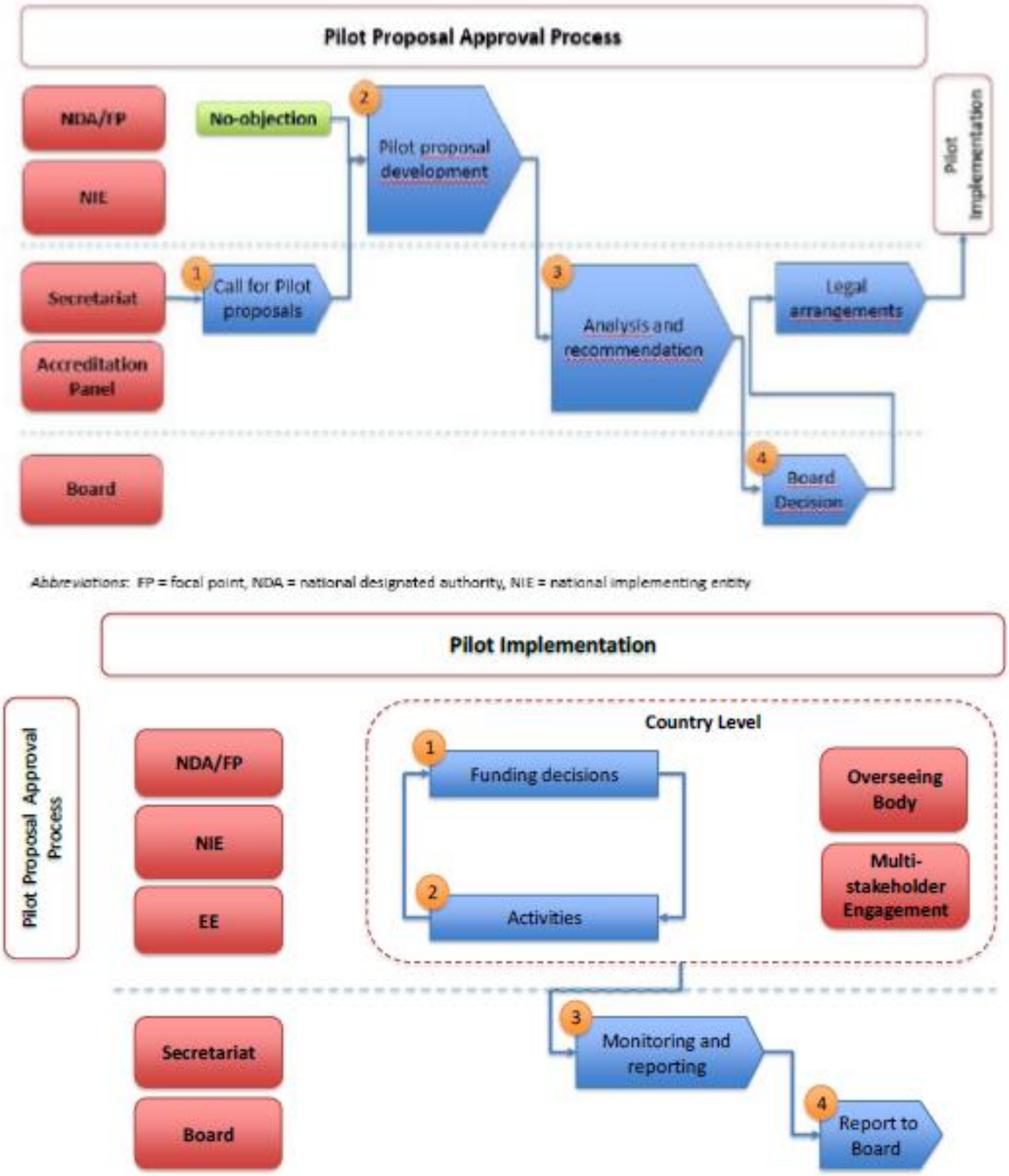
Experiences from the Global Environmental Facility (GEF) and the Adaptation Fund show that the officials from the ministries of Environment may have a good overview of the countries' climate change agenda. However, they have not always an overview of the countries' broader development agenda (Green Climate Fund, 2014c). In fact, in some cases, ministries of finance seem to have more authority with respect to climate change actions (Orestein et al., 2012). Until the beginning of March 2015, the GCF has received 101 NDAs or focal point designations, which include mainly officials from ministries of agriculture and environment and ministries of finance and economic development.

In addition, experiences from other climate funds show that there is a large variety in the level of engagement of the NDAs. Some have developed transparent standards and procedures for assessing projects, while others use ad hoc methods. Some have tried to actively engage specific stakeholders, such as NGOs or indigenous people, in the process, while others have largely ignored these groups. In order to ensure a transparent and uniform approach across countries, it is recommended that the Board of the GCF ensures that NDAs meet a number of minimum standards. These standards could relate to the authority's capacity to assess the environmental and social impact of projects, to provide transparent information on the operations of the GCF and to ensure a transparent and inclusive stakeholder consultation process. However, in order to reduce the administrative burden associated with the implementation of these standards for the NDAs and focal points, it is recommended to explore potential spill-overs of standards imposed by other climate funds (e.g. Global Environmental Facility). This will also reduce the administrative burden for the GCF that will be responsible to control the implementation of these standards. Finally, specific guidance of NDAs and focal points in LCDs and SIDS may be required as in these countries NDAs or focal points may not have the institutional capacity to implement these standards themselves.

Strengthening the role of the NDAs or focal points will also be important with respect to "enhanced direct access". Similar as in case of "direct access", the NDAs or focal points are responsible for nominating prospective accredited entities and the "no-objection" procedure. However, unlike for "direct access", they are more involved in the actual decision-making on projects in case of "enhanced direct access". In particular, the NDAs or focal points will play an important role in the institutional arrangements regarding "enhanced direct access". These are, for example, the specific funding decisions, oversight activities and stakeholder consultation procedures. Figure 4-1 presents a graphical overview of the proposal, approval and implementation process for "enhanced direct access" pilot projects.

The advantage of "enhanced direct access" is that it allows countries to strengthen their capacity and gain country ownership over the projects financed by the GCF. However, experiences with enhancing direct access to climate finance and development show that this procedure is not suited for low-capacity countries (LCDs and SIDS) as it requires a well-developed institutional framework, in particular with respect to budget management and fiduciary standards (Green Climate Fund, 2015b).

Figure 4.1 Enhanced direct access to the GCF



Source Green Climate Fund (2015b)

4.2 Characteristics of grants and concessional loans provided by the GCF

The Board decided that in its initial stage of operations the GCF will only use grants and two types of concessional loans, deep concessional loans and moderate concessional loans (Green Climate Fund, 2014b). The implementing agencies and intermediaries that receive enhanced direct access will be granted the opportunity to use a wider range of instruments, including guarantees and equity instruments. In the future, the GCF may offer these instruments (and others) also directly.

The grants and loans offered by the GCF are very similar to those offered by other climate funds (Table 4-2). All funds offer grants. In addition to grants, the Clean Technology Funds and the Strategic Investments Funds offer also highly-concessional loans, de-risk instruments (guarantees) and equity investments.

Table 4.2 **Instruments used by other climate funds**

	Grants	Lending (debt)	De-risk instruments	Equity investments
Global Environmental Facility (GEF)	Offered (for technical assistance, enabling activities and knowledge transfer)	None (only in pilot program)	None (only in pilot program)	None (only in pilot program)
Climate Investment Funds – Clean Technology Funds (CTF)	Offered	Highly concessional loans	Risk mitigation instruments (e.g. guarantees)	Offered
Climate Investment Funds – Strategic Climate Funds (SCF)	Offered	Highly concessional loans	Risk mitigation instruments	Offered
Adaptation Fund	Offered	None	None	None

Source Venugopal et al. (2012)

Table 4-3 provides an overview of the modalities attached to these downstream financial instruments. All instruments are available in international and local currencies, depending on the requirements of the project or program that is financed and other concerns, such as financial situation of the recipient country.[9] The deep concessional loans do not entail an interest rate (0%), have a long maturity (15 to 40 years) and a long grace period (5 to 10 years). The moderate concessional loans entail an interest rate which equals a benchmark rate (e.g. European Central Bank rate, US treasury bond rate), have a short maturity (8 to 15 years) and a short grace period (2 to 4 years).

Table 4.3 **Modalities of the existing downstream financial instruments**

	Currency	Interest rate	Service fee	Maturity	Grace period
Grants	International; Local	N.A.			
Highly concessional loans	International; Local	0%	0.75%	15 to 40 years	5 to 10 years
Less concessional loans	International; Local	Benchmark rate: e.g. European Central Bank rate, US treasury bond rate	0.75%	8 to 15 years	2 to 4 years

Source Green Climate Fund (2014b)

[9] Note that in case loans are attributed in the local currency, the GCF will ensure that appropriate risk hedging instruments (such as currency swaps) are in place to limit the currency risk.

The modalities for loans offered by other climate and development funds are presented in Table 4-4. For the highly concessional loans, the proposed conditions are similar to loans offered by other funds, such as the Global Environmental Facility (GEF), the Strategic Climate Funds or the International Development Association. These loans have – if any - a very low interest rate, a maturity of 40 years and a grace period of 10 years. For the less concessional loans, the proposed conditions are less concessional as for loans offered by other funds. For example, for the Global Environmental Facility (GEF) the less concessional loans have also a low interest rate, a maturity of 20 years and a grace period of 10 years. For the International Development Association, the less concessional loans have an interest rate of 1.5%, a maturity of 25 years and a grace period of 5 years.

It will be important to adjust the loan conditions to the mix of private and public contributions to the GCF. This mix and the corresponding repayment obligations upstream will impose important constraints on the instruments and their level of concessionality used downstream.

Table 4.4 Instruments used by other climate and development funds

	Grants	Loans				
		Type	Interest rate	Service fee	Maturity	Grace period
Global Environmental Facility (GEF)	Offered	Pilot project: Highly concessional loans for vulnerable countries	0.25%	-	40 years	10 years – Annual repayment: years 11-20: 2% years 21-40: 4%
		Pilot project: Less concessional loans for other recipients	0.75%	-	20 years	10 years – Annual repayment: years 11-20: 10%
Climate Investment Funds – Clean Technology Fund (CTF)	Offered (max 1 million USD per project)	Highly concessional loans for projects with negative or below market threshold return	0%	0.25%	20 years	10 years
		Less concessional loans for projects with rates of return near or above market threshold	0%	0.75%	20 years	10 years
Climate Investment Funds – Strategic Climate Fund (SCF)	Offered	Highly concessional loans	0%	0.1%	40 years	10 years – Annual repayment: years 11-20: 2% years 21-40: 4%
Adaptation Fund	Offered	-	-	-	-	-
International Development Association	Offered	Highly concessional	0%	0.75%	40 years	10 years
		Blended	1.25%	0.75%	25 years	5 years
		Less concessional	1.5%	0.75%	25 years	5 years

The different instruments (grants and loans) can be used separately, but they can also be "blended" in order to allow the full range of concessionality levels (from pure grants to loans at market terms) and create the appropriate incentives. In addition, also intermediaries and implementing agencies are allowed to "blend" GCF financing with their own financial instruments. This may allow them to finance projects for which the internal rate of return without the concessional financing by the GCF is too low to be financed by the private sector, but which are viable due the concessional financing of the GCF.

4.3 Alternative downstream financial instruments

In last decade, the number of financial instruments that is used for financing development projects has increased exponentially. In order to present a comprehensive overview of the alternative downstream instruments, we focus our discussion on two broad categories that are currently not used by the GCF: (1) De-risk instruments, such as guarantees; and (2) Non-debt risk-bearing instruments, such as equity investments.

4.3.1 De-risk instruments

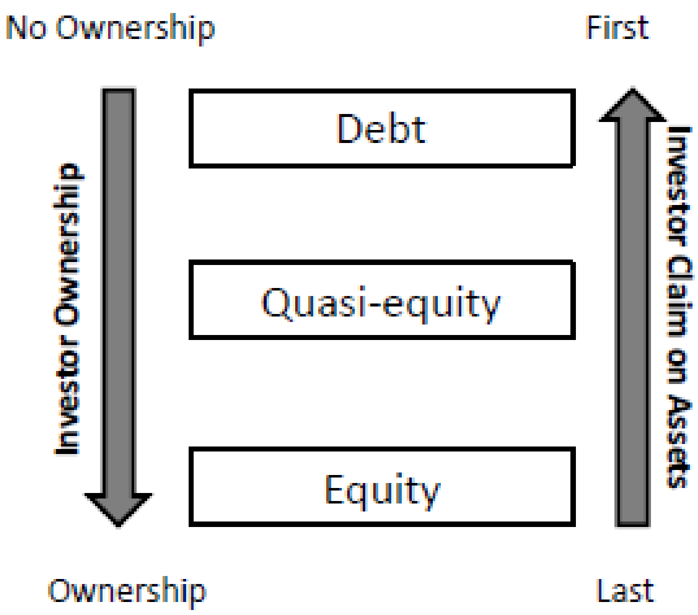
The most common used de-risk instruments that would be used in the context of the GCF are guarantees. Guarantees help investors to reduce or manage investment risk such that also projects with inadequate risk-adjusted returns are able to attract funding. Guarantees are financial instruments where a guarantor commits to fulfill the obligations of the borrower in the event of a non-performance or default by the borrower. The guarantee can be linked to a pre-specified event (e.g. political or weather risk) and can cover the entire investment or only a proportion of it.
De-risk instruments, such as guarantees, are not commonly used by other climate funds as only the Clean Technology Fund uses guarantees. In contrast, the multilateral development banks are more familiar with the use of guarantees. Partial credit guarantees are, for example, used by, among others, the International Bank for Reconstruction and Development, the International Finance Corporation and the African Development Bank. In addition, other forms of guarantees and de-risk instruments have been used by multilateral development banks: political risk guarantees (Asian Development Bank), disaster payments (International Bank for Reconstruction and Development), currency and risk management swaps[10] (International Finance Corporation, Asian Development Bank and African Development Bank).

4.3.2 Non-debt risk-bearing instruments

The most common used non-debt risk-bearing instruments are equity investments. Equity investments are direct capital contributions to a project in which ownership is acquired, but without any guarantee of return or even repayment. The return to investment entirely depends on the performance of the project during the investment period. Moreover, in case of a project falls into bankruptcy, equity investments will only be repaid after the more "senior" farms of debt (e.g. quasi-equity or loans) are repaid. In addition, intermediate forms of equity-debt instruments exist. These quasi-equity investments combine debt and equity characteristics in terms of ownership and in terms of returns in case of bankruptcy. Figure 4-2 gives an overview of the differences between the instruments in terms of ownership and in terms of returns in case of bankruptcy.

[10] Swaps are financial instruments that supplement other financial instruments and aim to manage different types of risk (e.g. weather risks and currency risks).

Figure 4.2 **Equity instruments**



Source Venugopal and Srivastava (2012)

In general, equity investments are not widely used by other climate funds as only the Clean Technology Fund offers this instrument. However, similar to the de-risk instruments, several multilateral development banks offer this instrument (Asian Development Bank, African Development Bank and European Development Bank) (Venugopal et al., 2012).

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