CLIMATE
POLICY
INITIATIVE

Operationalizing the Private Sector Facility of the Green Climate Fund: Addressing Investor Risk

April 2014

Barbara Buchner
Martin Stadelmann
Jane Wilkinson

A CPI Brief

Ministerie van Infrastructuur en Milieu

Descriptors

Sector	Climate Finance	
Region	Global	
Keywords	Climate Finance, Green Climate Fund, Public Finance	
Related CPI Reports	The Global Landscape of Climate Finance 2013	
	Risk Gaps: A Map of Risk Mitigation Instruments for Clean Investments	
Contact	Barbara Buchner	barbara.buchner@cpivenice.org

Acknowledgements

This study would not have been possible without the generous technical and financial support of the Netherlands' Ministry of Infrastructure and Environment. The findings, interpretations, and conclusions expressed in this report are those of the authors, and do not necessarily reflect the views of the Netherlands' Ministry of Infrastructure and Environment.

The authors also wish to thank participants at the Danish-Dutch Dinner on the Private Sector Facility (PSF) at the Green Climate Fund (GCF) meeting in Songdo, South Korea on 26 June 2013, and the participants of the workshop on Operationalizing the PSF of the GCF, held in Venice, Italy on 4 October 2013 for their excellent input. A special thanks to Herman Sips, who advised us throughout the project and the development of this report, and to Malaya Zumel. Our work has benefitted substantially from their expert inputs and suggestions.

We also thank the following CPI staff for their support and review inputs: Tom Heller, Angela Falconer, Gianleo Frisari, Chiara Trabacchi, Dan Storey, and Tim Varga.

About CPI

Climate Policy Initiative is a team of analysts and advisors that works to improve the most important energy and land use policies around the world, with a particular focus on finance. An independent organization supported in part by a grant from the Open Society Foundations, CPI works in places that provide the most potential for policy impact including Brazil, China, Europe, India, Indonesia, and the United States.

Our work helps nations grow while addressing increasingly scarce resources and climate risk. This is a complex challenge in which policy plays a crucial role.

Copyright © 2014 Climate Policy Initiative www.climatepolicyinitiative.org
All rights reserved. CPI welcomes the use of its material for noncommercial purposes, such as policy discussions or educational activities, under a Creative Commons Attribution-NonCommercial-ShareAlike 3.0 Unported License. For commercial use, please contact admin@cpisf.org.

BY NC SA

Table of Contents

1. Focal Work Areas of the Private Sector Facility

Global investment in climate mitigation and adaptation reached $359 billion in 2012 **far short of the investment required to support action capable of limiting global temperature rise to below two degrees Celsius.** To achieve this goal, the International Energy Agency projects that the incremental investment necessary in the energy sector alone will have to reach approximately USD 1 trillion each year from 2012 to 2050. **The world is facing a major green financing gap.**

The private sector invested 62% of climate finance in 2012, and there is more private money out there, but to-date, holders of some of the largest pools of capital, such as institutional investors which together manage assets of over $70 trillion, have yet to invest at scale. **Unlocking this capital and encouraging private investment in low-carbon, climate-resilient development should be a central objective of the future operation of the Private Sector Facility (PSF) of the Green Climate Fund (GCF).**

This study is the outcome of a project that aims to support the design and operationalization of an innovative and effective PSF. CPI carried out the project on behalf of and in close partnership with the Netherlands' Ministry of Infrastructure and Environment. Its objective was to understand how different design options for the PSF could facilitate the most effective use of public money to mobilize private finance, by examining and drawing lessons from a wide range of existing funding practices. Through a series of events and interactions with key financial intermediaries and institutions actively engaged in green, low-emissions finance, the project aimed to learn from cases across geographies and technologies about how private sector involvement has helped to successfully finance projects and programs.[1]

Gaps in coverage for policy and financing risks continue to impede green investment

One solution to the challenge of scaling up finance is to address risk. Whether real or perceived, risk is the single most important factor keeping promising projects from finding investors. Generally, when risk falls on parties unsuited to bear it, it is covered through insurance products or other mechanisms.

Low-carbon and climate-resilient projects present new and unfamiliar risks as they involve investments in new technologies and geographies, and higher costs associated with new financial vehicles. These are often unacceptable to private actors and typically lead to higher perceptions of risk due to specific factors such as dependence on public policy and, often, the relative immaturity of technologies, markets, and industries. As a result, investors demand higher financial returns, and higher-risk/low-carbon projects typically have higher financing costs than the lower-risk/polluting alternatives, often pricing them out of the market.

Climate Policy Initiative (CPI) has categorized the risks often associated with low-carbon infrastructure projects, matched them with available risk coverage instruments, and identified where gaps between the supply and demand for risk mitigation continue to impede investment. **A variety of instruments have been developed by private and public institutions to cover risks for investors in both developed and developing countries.** These include credit enhancement tools, such as loan guarantees and letters of credit, indemnity-based and parametric insurances, and contract instruments like derivatives and power purchase agreements. In developing countries, the supply of risk mitigation instruments is usually higher, in line with the higher level of perceived risk affecting these countries.

However, despite the high availability of instruments and financial institutions' experience in using them, to date risk coverage instruments have been used only infrequently to support low-carbon and climate-resilient projects. In particular, there are notable gaps in risk coverage in two main areas:

- **Policy risks** related to rapid and unexpected policy change around the world. For instance, retroactive changes to state support for the deployment of climate-friendly technologies.
- **Financing risks** related to the immaturity of financial markets in emerging countries and the relative newness of clean technologies that result in difficulties in accessing capital and investment exit/liquidity risks.

1 More information on the project and the events is available at: www.climatepolicyinitiative.org/europe/event/operationalizing-the-private-sector-facility/

The PSF can remove barriers to low-carbon, climate-resilient investment by providing instruments that bridge gaps in risk coverage

As identified in the Governing Instrument, the PSF will enable the GCF to directly and indirectly finance private sector mitigation and adaptation activities at the national, regional, and international levels to address barriers to private sector investment in adaptation and mitigation activities and mobilize private capital at scale.[2] Addressing the risk dimension of climate investments is key to successful mobilization. A new facility such as the PSF could focus a significant share of resources to deliver new instruments capable of bridging the risk gap and thus attract new investors and drive transformational change.

This study identifies two types of instruments that can address policy and financing risks but for which demand still outweighs supply, a gap that the PSF should be well placed to help bridge. They are:

- **First-loss dedicated insurance instruments to address policy risks.** The risk that policy changes may harm the financial stability of existing projects ('retroactive policy risk') may be addressed through expropriation coverage offered by political risk insurances (PRIs), or, when clearly identified in a contract as a material cause of detriment, by partial risk guarantees (PRGs). However, the effectiveness of these insurance tools could be improved by streamlining procedures, providing direct coverage for policy changes, and increasing certainty and timeliness of remedies. There are examples of progress, such as the Overseas Private Investment Corporation's (OPIC) feed-in-tariff insurance. However, while a step in the right direction, this instrument has not yet been fully implemented, and its effectiveness remains to be seen.
- **First-loss protection instruments to address financing risks:** these instruments shield investors from a pre-defined amount of financial loss, enhancing projects' credit worthiness and improving the financial profile of an investment. In addition, they could reduce the perception of liquidity risks by attracting, at scale, institutional investors, thus increasing the number of participants in these markets.

In order to provide these instruments effectively, the PSF will need a clear internal risk management framework to ensure both that the GCF's own balance sheet is not made vulnerable due to taking on inappropriate risk, and a governance approach that avoids subsidizing normal commercial risk, creating moral hazard, or crowding out (B 04/08, g) the private sector.

PSF interactions and synergies with other GCF windows

Within the GCF, interaction with the private sector is not the exclusive domain of the PSF. Making reducing investment risk an overarching objective of the GCF could encourage necessary interfaces between the PSF and the adaptation and mitigation windows, and facilitate a comprehensive risk management approach. For example, there is general agreement that the private sector needs to be a integral part of the programs and portfolios that countries put forward to the adaptation or mitigation windows. Countries' National Designated Authorities (NDAs) have an important role to play in fostering this private sector engagement, but the adaptation and mitigation windows could explicitly support private sector mobilization by focusing 'readiness' or capacity building activities on measures such as the creation of stable policy environments, in order to enhance developing countries' ability to effectively engage with the private sector.

To maximize synergies and minimize policy risks between the PSF and the mitigation and adaptation windows, all of them should engage actively with the country programming and readiness divisions. In addition, the particular role of the PSF suggests that it is well-positioned to explore ways of reducing transaction costs that are typically associated with making climate-relevant investments in developing countries. Amongst others, the PSF could function as a broker between different parties by appraising and 'packaging' small-scale investment opportunities into attractive portfolios at scale.

2 The Governing Instrument (G.I.) describes the PSF as follows: "The Fund will have a private sector facility that enables it to directly and indirectly finance private sector mitigation and adaptation activities at the national, regional and international levels" (G.I., para 41), meant to address barriers to private sector investment in adaptation and mitigation activities and mobilize private capital at scale (B 04/08, b).

2. Possible business models for the PSF

Two very different options for the PSF business model exist:

- **Facilitated Model - indirect PSF engagement as a fund-of-funds.** In conformity with earlier GCF Board decisions, the PSF could operate by working through established intermediaries, using GCF funding to match the specific needs of particular capital markets. The PSF would indirectly engage with the private sector through (financial/private) intermediaries (B 04/08, h and l, i), operating as a fund-of-funds by providing grants and loans and specific credit lines to a range of financial intermediaries. These intermediaries could then use these funds to derisk program and project portfolios put forward by the private sector. This would allow it to start up almost immediately. It would also allow the PSF to leverage the existing know-how and networks of multilateral, regional, and national Development Finance Institutions (DFIs), either by funding specialized instruments (grants and concessional loans) targeting particular geographies, technologies, or asset classes as part of blended public financing tranches, or by transferring PSF resources to partner intermediaries as grants and concessional debt. The PSF could rely on intermediaries for identification, due diligence, and bundling of projects, as well as obtaining a no-objection. It would allow the PSF to focus on a speedy assessment of proposals and deployment of funds vis-à-vis GCF objectives. In order to maximize the impact of the PSF, ways of tendering or competitive bidding for proposals that intermediaries put forward could be tested (B 04/08, g). The array of intermediaries could include, among others, selected funds and regional/national banks, and equity funds with solid track records in climate finance.

  The disadvantage of this model might be that insufficient scale (at least to start with) would mean there is very little shift away from business as usual.

- **Full-service Model – direct PSF interaction as a full service provider.** The PSF could have its biggest and most transformational impact by piloting new approaches and instruments and marketing these directly to the private sector - including new types of investors such as institutional investors. This second model would enable the PSF to directly engage with various private sector parties, such as micro, small and medium sized enterprises (MSMEs), impact investors, and institutional investors such as pension funds and sovereign wealth funds (B 04/08, c and f). The PSF could be developed to specialize in filling financing gaps, either for geographies not well served by DFIs, riskier technologies, or specific market segments. The PSF could develop instruments and modalities to effectively address specific barriers to climate-relevant investments. Examples could include specific credit lines for MSMEs, catalytic capital for impact investors and the bundling of projects of the adaptation and mitigation window into aggregated portfolios large enough to be of interest to institutional investors.

  The main disadvantage of this model is that it could complicate global architecture (if it were poorly designed) and could take years to develop, pilot and nuance, and ultimately, get right. Further, it would only be transformational if it operated at sufficient scale to tap new classes of investors, such as institutional investors for example. In addition, it would require extensive new human resources to run the business, which could be a drain on the GCF's initial and long-term resources.

These two models are not mutually exclusive. As it evolves, the PSF could incorporate elements from both. As the PSF scales up activity through intermediary partners, it could eventually supplement the international climate finance architecture either by becoming a fully self-sufficient financial intermediary, or a facility with some growing capacity to offer its own new risk coverage mechanism able to address policy risk, possibly alongside a full suite of improved traditional and new risk instruments. In the PSF's initial phase, the main emphasis is likely on the first model, which allows for indirect engagement with the private sector. Through a phased-in approach (B 04/08, l, ii and B 04/09, a), in-house capacity for the second model could be developed, allowing for direct interaction.

3. Exploring PSF design options: insights from an expert dialogue

The Songdo GCF Board meeting provided clarity on a number of pieces of the PSF puzzle that would enable the PSF to add value, both to the Green Climate Fund and to the existing international climate finance architecture. However, we do not yet provide a full operational picture of the PSF, or a clear illustration of its tangible deliverables and services. A number of key issues need further specification and iteration, including the PSF's interaction with the two GCF windows and external intermediaries, relationships between the various instruments and the three committees/groups within the GCF, and implications for risk appetite.

On October 4th, 2013, in partnership with the Dutch Ministry of Infrastructure and the Environment, Climate Policy Initiative held a workshop to consider these issues and concretely think through PSF design options, benefitting from hands-on experience of the private sector and International Finance Institutions. The main discussion focused around three questions:

- Who are intermediaries, and what are their functions? What is the interaction between national level institutions and existing intermediaries?
- What is the Investment Committee, and what is its practical role? How can it help ensure expeditious project approval and efficient use of PSF money while minimizing risk for the GCF at large?
- Who will be doing the due diligence for funding activities and how can we ensure it is conducted independently? How should private sector expertise be brought in?

The next sections will explore these issues in more depth, and then propose a specific design option for the PSF that builds upon the discussions.

The role and functions of PSF intermediaries

The questions 'who will be intermediaries and what will they be doing' are doing is central to the functioning of the PSF business model.

Options for who could be an intermediary include a wide range of entities:

- Development Finance Institutions (DFIs) are an obvious option for this role, given their existing know-how and networks. Multilateral, bilateral, and regional finance institutions are frequently cited options. However, their current dominance in this area might be perceived as possibly crowding out national finance institutions.
- Private financial institutions or banks could theoretically become intermediaries. Even beyond that, funds themselves could also be intermediaries. This could constitute one of the innovative elements that distinguish the PSF from the intermediaries active in other GCF focal areas. There are questions about whether these institutions have appetite for the role particularly given the operational costs it would require.

Questions about the roles of intermediaries (corresponding to 'intermediaries' and 'implementing entity' in GCF language), mostly concern their independence and flexibility:

- The degree of independence and flexibility seems to be influenced by the expertise of the specific intermediary and the specific governance structure chosen for the PSF.
- Open issues are whether they can approve and evaluate projects and programs on their own after a multi-year strategy is approved on a higher level, or whether they will only be able to implement the decisions of other PSF components.
- It is unclear which safeguards should be used. An overview of best practices across DFIs would help to narrow the range of effective options.

While further work is needed to agree on the role of intermediaries or funding entities in light of the chosen governance structure, all participants agreed that increasing the number of intermediaries on the ground is important and that these intermediaries should include multilateral, bilateral and national financial institutions and possibly private ones. In fact, competition could encourage a more effective process. At the same time, a competitive process to select eligible intermediaries would favor fast and efficient actors.

The role and functions of the PSF Investment Committee

According to GCF decisions, the Investment Committee comprises GCF Board members only. This precludes the possibility of including others that might have additional expertise. Drawing on experiences of other funds, the role of this committee seems thus to be strategic development and the review of clear and streamlined investment strategies. This leaves the question unresolved if authority to approve individual PSF funding proposals could be delegated, how, and to whom.

The importance of due diligence

To help ensure prompt project approval and efficient use of PSF money while minimizing risk for the GCF as a whole it is critical to carry out independent due diligence and bring in private sector expertise. The information gathered during this process is essential to successfully assess deals and make investment decisions.

Options for the conduct of due diligence and bringing in private sector expertise include:

- **The Investment and / or Risk Committees.** However, due to their composition these committees are unlikely to have the needed expertise.
- **The Private Sector Advisory Group.** However, due diligence isn't considered as part of its role.
- **Intermediaries.** These entities could conduct due diligence for projects or even programs, and bring in private sector expertise provided they were obliged to have their investment plan reviewed by someone else. In addition to DFIs, private intermediaries and, if part of the eligible intermediaries, fund-of-fund managers would be well placed to do due diligence.
- **A panel of experts.** Broad expertise and dynamic investment decisions could also be facilitated through technical review by a panel of experts. Some proposals for the design of the PSF include a PSF Investment Panel, consisting only of private sector experts.

In summary, early considerations suggest that intermediaries or a panel of experts would be well placed to provide the needed due diligence and incorporate the critical private sector experience. Alternatively the PSF could rely on the due diligence carried out by the intermediaries and might only need to add a second order light touch due diligence to ensure compatibility with the GCF's safeguards and investment and risk framework.

Options for interaction of the PSF with its Investment and Risk Committees and intermediaries

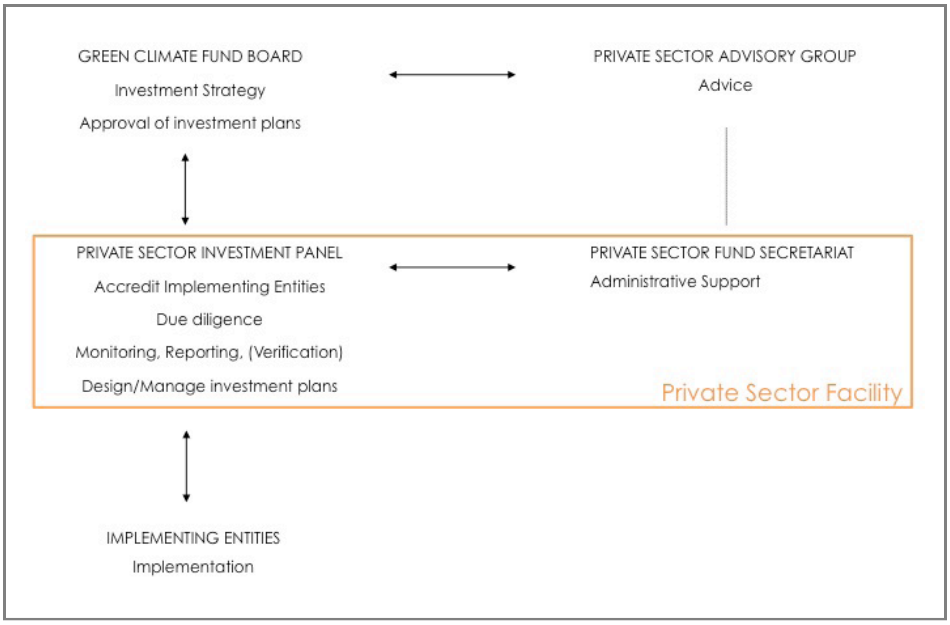
Governance of the PSF ought to be separate from its management. The relationships between the various elements of the PSF – the GCF Board, the Investment Committee, the Risk Committee, the Private Sector Advisory Group, the intermediaries and possible panel of experts – need to reflect this division. The previous sections highlight the pre-requisites for the effective organization and operation of the respective bodies. This section aims to put the various pieces of the puzzle together, to ensure the efficient and timely operation of the PSF.

Option 1: A fund-of-funds with private sector investment panel

A survey of pension fund and hedge fund governance models (for the example of the hedge fund, see Annex I) suggests that several layers of decision-making are needed to facilitate sufficient organizational structure and encourage an appropriate division of labor.

According to this model, the primary role of the GCF board (which only meets four times a year) would be to provide strategic direction and perform a limited and specific range of functions, such as approving investment strategies and multiyear programmatic plans. This would complement the strategic functions of the Investment and Risk Committees, composed of board members, thus helping to develop streamlined investment strategies. Private sector experts would participate in the PSF's operations via a special PSF Investment Panel, composed of private sector representatives. This panel would manage the Private Sector Facility as a fund of funds and, therefore, perform a number of core functions, such as designing multi-year investment plans; monitoring, reporting, and verification (MRV) of projects/programs; due diligence of projects/programs; and accreditation of implementing entities assisted by the PSF Secretariat Unit. Accredited implementing entities would be able to access PSF funding once their projects / programs are approved.

Option 1



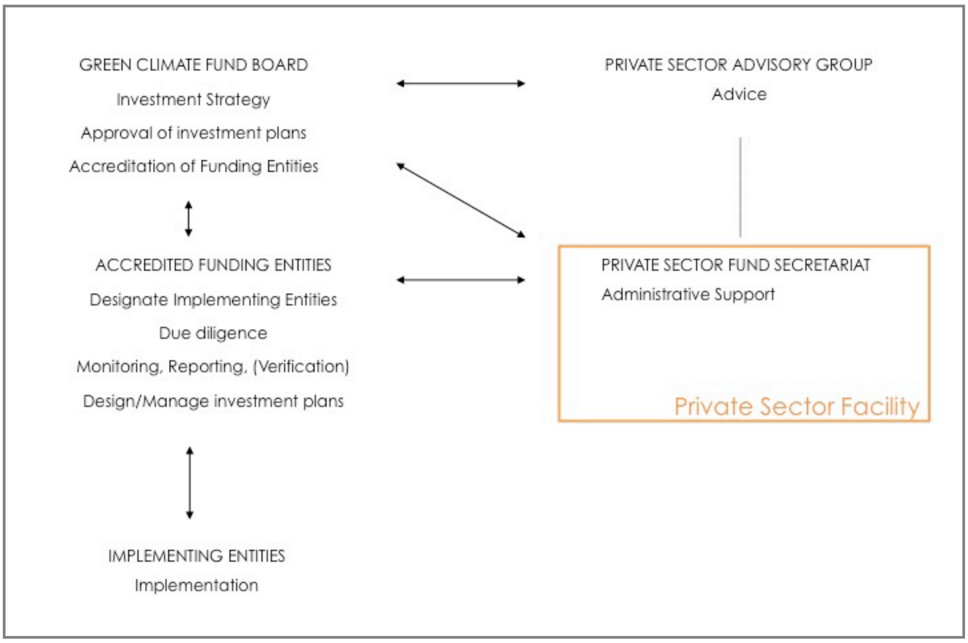
Option 2: A fund-of funds model with devolution to funding entities

As in option 1, option 2 distinguishes between governance and management. Further similarities include that the GCF Board's responsibility for high-level governing questions including approving PSF strategy and multi-year plans (that incorporate advice from the Private Sector Advisory Group) recommended by its Investment Committee; and the Secretariat of the PSF Unit's provision of administrative support including by finally disbursing funding to implementing entities.

The main difference between the two options is that the design of multi-year investment plans and the approval of individual programs/projects would be undertaken by accredited funding entities instead of a PSF Investment Panel. These funding entities (e.g. development banks, private companies) would submit multi-year investment plans with budgets to the GCF Board for approval. The GCF board would use the Secretariat, the Advisory Group and possibly a panel of experts when reviewing these proposals, and conducting MRV of funding entities. Once multi-year investment plans were approved by the board, funding entities would be responsible for implementing investment plans, disbursing funding to implementing entities, and MRV of the projects. At the end of each multi-year program, an evaluation based on continuous monitoring would be conducted. Another difference is that the GCF Board itself would have to accredit funding entities, potentially adding to its workload.

Option 1 and 2 could be combined, if the Investment Panel from Option 1 were to take over some functions of the GCF board in Option 2, such as accreditation and MRV of funding entities, and due diligence on submitted investment plans.

Option 2



4. Early conclusions and reflections on what's next for the PSF design

As an integral element of the GCF design, the PSF has potential to distinguish the fund as an innovative addition to international climate financing architecture and to contribute significantly to its ability to deliver and unlock investment at transformational levels. To achieve these outcomes, it will be essential to **ensure that the overarching strategy, governance, and management, are separate from each other and operate independently**. At the same time, the PSF needs to incorporate arrangements with **clear guidelines and rules that make good business sense and operate in a streamlined fashion**. To ensure the private sector can work at the speed to which it is used to, efficient decision making timeframes and processes need to be developed while bureaucracy should be kept to a minimum. Independent due diligence and private sector expertise are also essential for the PSF's investment decisions and, therefore, its success. Competitive processes could help to encourage these qualities.

After considering the governance models of similar funds, including those of pension fund and hedge funds, participants in the expert dialogue agreed that what is needed are **several layers of decision-making to allow for a structured organization and an appropriate division of labor between governance and decision-making/management**. A fund-of-funds model which delegates authority appropriately and is able to blend public/ multilateral development bank funding with private capital has the potential to scale. Fund-of-fund managers have vast experience in defining the terms of funds, in doing due diligence, and in accrediting experts. However, this model may pose difficulties around governance (i.e., leaving too much leeway). More information is needed to make an informed decision on the benefits of this option.

To keep progressing to the implementation phase of the PSF, the following are the next key decisions need to be made:

- **Integrated risk management:** Investment risk has multiple dimensions. In addressing risk, the PSF design must take into account its own internal risk profile, how it might be complemented by the activities of the other windows to create better enabling environments, and which instruments and approaches are best suited to reducing investment risks, real and perceived.
- **Accreditation process.** Accreditation criteria are critical to the functioning of the PSF; they strongly influence the level of due diligence needed (strong accreditation principles lower the need for additional layers of assessment).
- **Accountability.** A sunset clause for intermediaries or funding entities could speed up the process by reallocating money that has not been spent within a certain time frame.
- **Allocation.** To ensure competitive outcomes between the specific windows and within the PSF, options including tendering approaches need to be explored.

Annex I: A typical hedge fund governance and management structure

Experiences from various types of funds show the types of different decisions that those managing the fund need to make and more importantly, how often they need to make them. These types of funds are typically organized as follows:

1. Board, CEO, Chief Investment Officer (CIO), and Chief Operating Officer (COO)
2. Investment Committee (CIO, analysts, and Chief of Risk)
3. Investment team
4. Operations team
5. Risk Team

In this decision cycle, it is crucial to note that the investment decisions (at the hedge fund level) and the portfolio allocations (at fund of fund level) are taken by investment professionals working full time on the markets/deals. The investment committee works on the basis of the research done by the teams (meeting on a monthly basis it can only approve/reject suggestions and proposals) while the board (given the distance from the markets and the little time committed to investments) works only on the long-term direction and more importantly, on establishing the "rules of the game" (i.e. the boundaries the analysts need to know to determine what they can do and how they can do it).

In the case of the PSF's governance and management structure, it is useful to start from the resources that each committee/function will have available. In order to make decisions on particular investments, the PSF needs full time investment professionals. A solution with an investment panel (with professionals working on a personal/fiduciary basis) could work but could only approve or reject investments proposed by others. Given the time and resources available for board members, it is common sense that their role should be to focus on setting the high level strategy and goals of the facility (e.g. allocation by geography, mitigation / adaptation) and in setting the rules for the approval of the investment managers (criteria for eligibility, performance evaluation, and accountability), leaving the day-to-day investments to people working in the markets every day.

Table 1: Decision cycle of a typical hedge fund

DECISIONS	FREQUENCY	DECISION MAKER
Funds' overall strategy and risk profile Fund's eligible markets (equity, debt, structured finance), maximum leverage, risk-return goals and benchmark for performance, eligible instruments and areas of "no investment" (ex. Private placements, physical commodities...)	yearly (sometimes even longer)	Board
Investment strategy	quarterly / biannually	Investment Committee
Approval of hedge funds Detailed due diligence of investment analysts, operations' quality and infrastructure, key personnel's biographies and disciplinary history, organizational structure and ICT resources, controls and risk management. Once approved, the fund enters in the portfolio of potential investments. Barring exceptional events, the fund would be re-evaluated on a yearly basis with the three teams updating their due-diligence.	variable frequency but usually following several months of due diligence	Investment committee, risk team, operations team
Portfolio allocations Monthly allocation of capital (purchase or sale of the hedge funds' shares) between the funds in the approved list. Decisions suggested by the investment team and approved by the investment committee.	monthly	Investment Committee
Single investments The fund of fund manager/analyst has no saying in the daily investment decision of the hedge fund manager but monitors his activity on a monthly basis (calls or site visits and portfolio report). Given the sensitivity of the investment decisions, often only limited information on the hedge fund portfolio is offered.	daily	Hedge fund manager