

## **IDFC – The International Development Finance Club**

### **Work Plan 2: Leverage Private and Public Funds**

#### **Position Paper on Leverage of Public and Private Funds**

The International Development Finance Club is a group of national and sub-regional development banks that established climate financing as the central focus of their 2012 development agenda. It is expected that the development banks, based on their historic performance in meeting the challenges society faces, take an important position in financing the transition to a low-carbon economy, coordinating efforts with governments and private investors in order to eliminate the barriers that hinder the progress of low-carbon technologies, and carefully allocating their resources so as to leverage climate investments.

#### **1. The strategic role of development banks**

Development banks are financial institutions with mandates associated with the performance strategies in countries to which they are linked or where they operate. Such mandates vary from institution to institution and can be focused on specific niches – such as infrastructure, small and medium-sized companies, foreign trade and innovation – or on widespread performances in financing sustainable development in countries and regions. The origin of resources is also substantially diversified, including bonds issued on capital markets, deposits from the public (similar to private institutions), other development banks and public resources, which guarantees that funding is aligned with its strategic objectives. Such funding diversification allows for the execution of a comprehensive range of public policies.

Although they are diversified, development banks have similar characteristics that establish a common identity for all of them. Among them, one highlight is the performance in areas where services have not been provided, totally or partially, by private capital, such as long-term financing, as well as projects associated with large amounts of resources and/or in sectors and companies at embryonic technological stages, where risks are too high. Another common characteristic is their corporate nature, since, as a rule, they are owned by national states. Thus, as national state governments represent the interests of society, the latter ultimately determine the guidelines for allocating resources managed by development banks.

Society's needs and desires evolve over time, and along with them, so does the performance of these banks. As an example of this adaptability, one highlight is the recent anti-cyclical performance fostered by development banks during the financial crisis, when access to credit in the global financial system became scarce. Within the economic historical context, development banks have specialized not only in perceiving society's needs to transform, but also in taking up the challenge to solve them.

## **2. Environmental Urgency**

The world is on the threshold of massive climate change, which would impact developed and developing countries at different levels of intensity. According to the scientific community, if drastic measures are not adopted to restrict the 2°C increase in the global temperature, the risk that man's actions will affect the climate balance will increase considerably. The consequences of such imbalances threaten the existence of the human species' itself as we know it. Therefore, it is no overstatement that the transition to a low-carbon economy is one of the most significant challenges humanity has ever had to face.

Although the principle of the Climate Convention is one of common, yet differentiated responsibilities, which suggests a greater responsibility on developed countries, the fact that developing countries already account for over 50% of global emissions, associated with growth projections in these economies, means that mitigation efforts need to occur on a global level.

The challenge not only entails global mobilization, but also several sectors in society. Consumers, which have become more aware of their influence, manifest their expectations in their purchasing decisions, boycotting products and companies that are not engaged socially and environmentally. The non-profit sector supervises public and private agents, and acts as think tanks, helping make public policies compatible with the climate's urgent needs. The academic community has a fundamental role in impartially verifying not only the consequences of man's actions upon climate change, but also the challenges that must be faced to avoid it.

This challenge can be quantified through estimates of financing needed for mitigation and adaptation actions. The World Bank<sup>1</sup> estimates that the incremental cost of adaptation efforts in developing countries is between US\$ 30 billion and US\$ 100

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<sup>1</sup> World Bank. Generating the Funding Needed for Mitigation and Adaptation in World Development Report: 2010.

billion per year up to 2030, while mitigation costs would be US\$ 140 billion to US\$ 175 billion per annum. In order to universalize access to sustainable energy services, which is indispensable in fostering human and economic development in regions that do not dispose of such services, one trillion dollars in financial flow will be necessary up to 2030, or US\$ 48 billion per year<sup>2</sup>.

On the supply side, the Climate Policy Initiative estimates that US\$ 97 billion were allocated to climate financing in 2009/2010, mostly originating from the private sector, followed by public sources – which, in their majority, were channeled through financial intermediaries such as development banks – and other sources, such as carbon markets and philanthropy. Although in Copenhagen developed countries committed to mobilizing US\$ 100 billion annually for climate financing up to 2020, which would reduce the gap between the needed and existing resources, the international financial crisis increased uncertainty regarding the availability of governmental resources.

This scenario indicates the fundamental need for available resources to be carefully allocated so as to make it feasible to leverage investments to a level that is compatible with what is needed for mitigation and adaptation actions. Considering that private agents follow an investment logic in which the maximization of profits and the minimization of risk are not only pursued, but also to some extent have to determine their decision making process, leveraging the necessary amount of resources will only occur if the leveraging mechanisms are used so as to create a business environment that is favorable to private investments.

This is, therefore, an immense challenge facing development banks, which have historically been the main financiers at different transitional moments in society by making their expertise and financial instruments available to society, operating in coordination with governments and the private sector. Thus, it is fundamental that, at this moment, these institutions earmark their resources to leverage climate financing. These tools include not only financial instruments that can be offered, but also mechanisms that allow coordinated efforts between government, companies and society and that provide the dynamism required to meet the urgency of the climate issue.

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<sup>2</sup> AIE. Energy for All. Oct. 2011.

### 3. Financial Instruments and IDFC Members

#### Debt

Among the financial collaboration mechanisms available in the development bank portfolios, the most common is long-term debt financing, generally with interest rates at the lower end or below market conditions. Such conditions can be obtained for several reasons. Many development banks rely on sovereign guarantees to raise resources, which allows them access conditions that are more competitive than those of private institutions. Additionally, it is possible that governments will transfer resources from their national treasuries or public funds to them, associated with lower interest rates than those practiced by the market. Others have policies that provide resources from well-developed sectors to make financing conditions more attractive to the sectors at an embryonic stage, which require differentiated access to credit<sup>3</sup>.

Aimed at enhancing the environmental benefit of financed projects, development banks can also:

- Condition the availability of resources to meet environmental safeguards and policies with climate components that expand the climate results and increase the resilience of the economic sectors receiving support;
- Incorporate the climate component in credit risk analysis, traditionally performed by the banks, brought up by changes in company/sector competitiveness stemming from the transition to a low-carbon economy and from climate vulnerabilities in the different sectors and regions;
- Develop solutions that involve joint financing with other development institutions or private banks, who's benefits are not limited to leveraging resources, but also to knowledge sharing on analysis methods, safeguards and better practices; and
- Promote the development of climate change projects for mitigation or adaptation by establishing more attractive financing conditions. The aim would be not only to increase competitiveness of such projects but also the proportion of climate financing to the total portfolio.

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<sup>3</sup> LUNA-MARTINEZ, José de; VICENTE, Carlos Leonardo. *Global Survey of Development Banks*. World Bank: Feb. 2012.

### **CAF: Syndicated loan: "Financing Plan for Investment in the Energy Sector (Colombia)"**

In an effort to promote development, leverage funds and help clients meet their financial needs, CAF makes Co-financing available for projects and looks for appropriate partners in order to complete the financing required. Financial conditions of a loan can be the same if the co-financing group agree on common terms, or can simply be structured independently according to the necessities of each one. The financing package can include Common Terms Agreement and can use (i) a single loan agreement, or (ii) by separate agreements, with an agreement between creditors.

In 2009, CAF structured a financing to a project in Colombia to prepare the design, development, procurement, construction and insurance of the conversion of two Thermo-electric plants from open cycle natural gas-fired into integrated combined cycle power plants with an aggregate installed capacity after such conversion of 610 MW (up from 441 MW, prior to conversion), a good example of energy efficiency with great benefits in terms of climate change mitigation. The total estimated cost of the project was USD 282 Million, CAF financed USD 62.5 Million and the other 2 agencies financed USD 87.5 Million, the remaining amounts came from equity contributions and cash flow from operation. In this co-financing agreement three international agencies (DEG from Germany and part of KfW Bankengruppe, IFC and CAF) participated. The three agencies subscribed a "Common Term Agreement (CTA)" including the common covenants among the parties and a separate loan agreement per each institution for the particular legal, financial and administrative matters.

### **BNDES: Financing Renewable Energy**

The BNDES' support to the electric power generation sector has differentiated financing conditions according to the source of energy being used, which has generated expressive results in leveraging private resources for investments in renewable energy, since it increases competitiveness of these sources in comparison to fossil sources in energy auctions.

Currently, projects based on renewable sources have interest rates that are 1.4% below those practiced for coal or oil thermal plants. Besides this, the maximum financing participation for renewable sources varies between 70% and 90%, while for coal or oil thermoelectric plants, it is 50%. The expiry date of financing conditions also varies according to the generation source; it can be limited to 16-20 years for renewable sources and to 14 years for fossil fuel thermoelectric plants. Associated with this, the BNDES has provided support to install production capacity in the Wind Farm Sector in Brazil, which has contributed to reducing the sector's project costs. These conditions will allow for Brazil, the twentieth largest wind energy producer in 2011, to become the tenth largest producer in 2013.

Adding all electric power generation projects from renewable sources, disbursements by the BNDES, between 2007 and 2011, reached over 185 projects, in a total amount superior to USD 20 billion. These projects, as a whole, are equal to an installed capacity of at least 17,300 MW.

Recently the BNDES launched a credit line with resources from the Brazilian Climate Fund to stimulate the dissemination of mitigation technologies that are still not used in the country.

## **Equity Instruments**

Equity instruments may also contribute to the development banks' strategic objectives; especially the aim to offer resources in situations where private capital is not present, however.

Development banks can establish equity instruments that earmark resources for companies and sectors where the expectations for return prevail in the long run and where there are governance gaps or other factors that inhibit the company's entrance in the stock market.

In these cases, development banks can help structure companies' governance, preparing it for a new virtuous growth cycle, which are in line to market expectations. This strategy also allows the resources initially invested by development banks to be recycled when companies engage a virtuous growth cycle.

By combining equity investments with social and environmental policies, several improvements in business practices can be encouraged by establishing specific conditions for stakes owned by development banks or funds managed by them, which contributes to increased long-term sustainability. Some of these conditions include:

- Company governance improvements, focused on process efficiency;
- Environmental balances as well as carbon and water inventories;
- Policies for the social and environmental improvement of the supply chain which may include climate financing for suppliers;
- Establishing performance goals such as the reduction of water consumption, the treatment of effluents and occupational safety and health; and
- Adopting integrated management systems.

Thus, using a variety of equity instruments, development banks can play a key role on fostering strategic sectors for their countries' and hence political clients' sustainable development, by focusing their investments on the long term, dissociated from short term volatility, assuming risks that may be considered too high by the private investors, and assuming a proactive approach in the choice of investments that they see as crucial for their development agenda.

### **DBSA: Support For The Renewable Energy Independent Power Producer (REIPP) Programme**

The REIPP programme launched by the South African Department of Energy (DoE) will see the Government, through the DoE, procure 3725 MW of renewable energy from independent power producers at an estimated cost of US\$ 15 billion over the next 3 years. Technologies earmarked for this programme are Solar; Wind, Small Hydro, Biomass, Biogas and Landfill gas (Methane).

Realizing the size and importance of this programme the DBSA put together a Financing Facility to ensure participation of broad based Black owned enterprises at all levels of the value chain. This was to ensure that the requirement by the South African Government for a 40% SA Entity participation at Project Company level was realized. In addition since most of these projects are located in remote rural areas the DBSA also sought to support Government's objective of ensuring that the benefits from this programme accrue to the immediate communities surrounding the projects by sponsoring the participation of eligible local communities at equity level. In terms of this financing arrangement, DBSA provides up to 100% equity finance to these communities to participate at levels of between 2.5-7.5% in these projects with the repayments to be made from their dividend shares but structured in such a way to ensure revenue starts accruing to the shareholders from early on in the financing cycle.

In addition the DBSA's role is seen as catalytic in lowering the perceived risks in the IPP Projects, and thus lowering the costs of financing of BEE equity in these IPP projects and also attracting other financiers both at equity level as well senior debt. The DBSA is therefore seen as a major contributor to the development of the IPP market and ensuring active and effective broad based Black Enterprises' participation as well as the high Economic development objectives set by the Government.

### **Grants for Technical Assistance**

Grants, or financial resources that are not associated with reimbursement, are typically used in the climate context to overcome barriers that prevent investments in low-carbon enterprises or technologies. Considering that they are not necessarily associated with financial returns, their funding sources are generally governments, which use them in efforts to generate collective benefits for society. Such resources can be invested via direct governmental transfers, but usually occur via development banks or funds managed by them. Within the context of a low-carbon economy, grants are used especially in technical support to train public and private agents in matters related to climate change.

Training public agents is important to support local-level public policies on climate change. Regarding technical training for private agents, it is important in order to overcome barriers such as cultural resistance and limited information on climate investments.

**JICA: Comprehensive Support for Climate Response Measures: From Institutional Reform for Better Business Environment to Finance Renewable Energy Infrastructure Development**

In Indonesia, JICA supported comprehensive assistance for climate change response measures focusing on a renewable energy development.

With its series of financial and technical assistance, JICA supported the Indonesian Government to elaborate a package of policy actions to mainstream the climate change response measures in the public expenditure and improve business environment to mobilize private resources as the IPP projects for the area.

In designing the comprehensive assistance program, JICA enhanced discussions between the private sector and the Indonesian government, the result of which contributed as inputs for the government's initiative to improve the regulatory environment that is more conducive to the IPP projects.

JICA supported some of the key policy actions in the form of master planning such as that for renewable energy development and financing of infrastructure development projects that could trigger scaling up with private resources to achieve the expected result. For geothermal power development, with JICA's financial support, the government constructs total 480 MW geothermal projects, and for the scaling up, established the risk mitigation fund that supports costly drilling tests in order to catalyze IPP investment and introduced regulation on power tariff to improve profitability of power producers.

**De-risking**

The risks associated with climate investments, whether they are technological, regulatory, political, or performance-related, may, according to the scenario in each country and economic sector, reduce the ability to attract private investors. There are different instruments capable of mitigating them, such as insurance and guarantee instruments. In addition, development banks can aid public policy-makers in the establishment of regulatory frameworks that enable a friendly business environment.

In short, several de-risking and technical support mechanisms demonstrate a high potential to overcome barriers and create a favorable business environment for private investments. This, as a consequence, presents a high capacity to leverage resources in the medium or long term.

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### KfW: Global Climate Partnership Fund (GCPF)

A Public-Private Partnership Fund for the enhancement of energy efficiency (EE) and renewable energies (RE), predominantly through the provision of dedicated financing to businesses and households via partnering with financial institutions and direct finance.

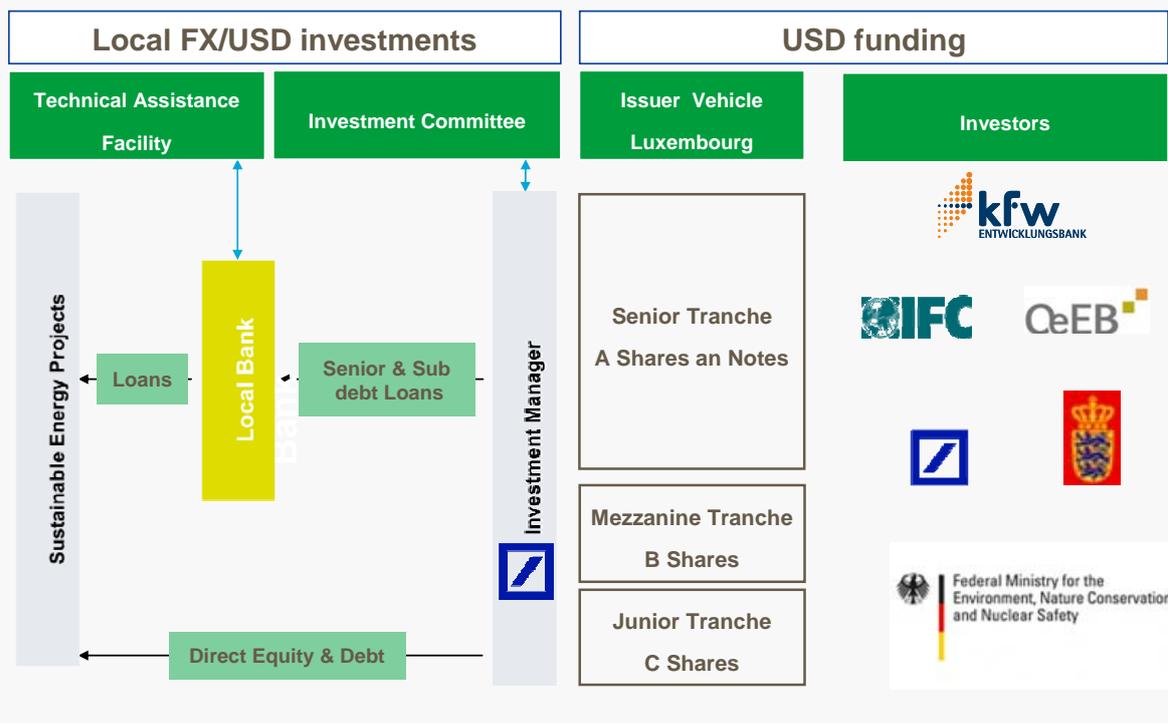
Financing instruments: senior loans, subordinated loans, guarantees, mezzanine instruments.

Technical Assistance: grant-based, sponsored by donors, providing capacity building for partner banks to set up EE and RE lending operations as well as support of companies in the form of energy audits or EE and RE project implementation.

#### Fund Structure, Total Commitments and Management

- Currently 6 investors (German, Austrian and Danish Government, KfW, IFC, Deutsche Bank) have committed over USD 200 million to the Global Climate Partnership Fund. Additional Investors (i.a. EIB, British Government, ADB) are interested to also support the GCPF.
- Issuance of different share tranches (C, B and A Shares) and later on A-Notes offering investors different risk-return profiles
- C Shares constitute the "Equity Tranche" providing a risk cushion for "Mezzanine Shares" (B Shares) and "Senior Shares" (A Shares) and eventually Note Holders
- Managed by Deutsche Bank, with investors in Supervisory Board and Investment Committee

KfW is experienced in the implementation of innovative structures for mobilizing private capital. The first and most important one is the G 20 award winning EFSE Microfinance Fund implemented by KfW in 12/2005 with over 30 investors, thereof over 20 private, who have committed EUR 238 million since inception. Following the model of EFSE, also the GCPF intends to acquire private investors, which requires a minimum track record of 3 years. In a mid-term perspective, the issuance also of A-Notes is foreseen, which are fixed income debt instruments potentially attractive also for institutional investors like pension funds.



### **AFD: The Interact Climate Change Fund, a Risk Sharing Instrument**

The Interact Climate Change Fund was created on May 2010 as a joint climate change fund by the European Investment Bank (EIB), the French Development Agency (AFD) and 12 European Development Finance Institutions (EDFI): BIO (Belgium), CDC (United Kingdom), COFIDES (Spain), DEG (Germany), FINNFUND (Finland), FMO (the Netherlands), IFU (Denmark), NORFUND (Norway), OeEB (Austria), PROPARCO (France), Sifem (Switzerland) and SWEDFUND (Sweden). The Parties established an investment matching facility to invest in private sector climate change projects in Africa, the Caribbean and the Pacific, Asia and Latin America. The total finance capacity of this initiative is up to EUR 400 million. The initiative has the twin aim of promoting sustainable development of private sector climate change projects and strengthening meaningful co-operation between European Development Finance Institutions, AFD and the European Investment Bank. Partners seek to demonstrate the financial attractiveness of climate-friendly projects to private sector investors in developing countries and emerging markets and commit to act as catalyst lead investors to attract additional long-term investments. The institutions will further promote use of clean technology as an integral part of economic development and provide long term financing for renewable energy projects in countries facing acute energy shortages and restricted energy access, further contributing to economic development.

Some advantages of a mechanism of this type are: on one side, financial actors involved usually have complementary financial or technical capacities that can be valued through a common instrument. On the other side, through this instrument, those financial actors can decide to focus more on specific themes, areas or some type of counterparts, that probably none of them could have reach solely for technical or financial reasons. They have to share a minimum basis of common operational requirement such as professional standards and diligences.

Resources are pledged by these actors in a flexible financial vehicle, the risk sharing instrument, with specific governance and these usually have to co-invest in the project to ensure quality of the investment. Depending on different criteria, notably the financial capacity and the comparative advantages of the participants, resources are structured in order to maximise cost effectiveness of the action through equity/loan participation, first-loss piece or guarantee schemes. The implementing institution is responsible for the whole implementation of the financing on behalf of all the participants.

In conclusion, those mechanisms are flexible highly leveraging tools, easy to create and optimizing existing resources and actors' capabilities. They can contribute to a strong leverage effect on financial flows with quick and effective implementation. They add real value to the actions of existing institutions and contribute to qualitative effects on investments.

## **4. Leveraging public and private climate resources: a smart partnership**

The International Development Finance Club is a group of national and sub-regional development banks<sup>4</sup>, which has an expressive history in climate financing. The IDFC's

<sup>4</sup> Agence Française de Développement (AFD/France), Banco Estado (BE/Chile), Bancoldex S.A. (Colombia), National Economic and Social Development Bank (BNDES/Brazil), Black Sea Trade and Development Bank (BSTDB/Greece), Caisse de Dépôt et de Gestion (CDG/Morocco), China Development Bank (CDB/China), Banco Centroamericano de Integración Económica (BCIE/Honduras), Cooperación Andina de Fomento (CAF/Venezuela), Croatian Bank for Reconstruction and Development (HBOR/Croatia), Development Bank of Southern Africa (DBSA/South Africa), Indonesia Exim Bank (Indonesia), Industrial Development Bank of Turkey (TSKB/Turkey), Japan International Cooperation Agency (JICA/Japan), KfW Bankengruppe (Germany), Korea Finance Corporation (KoFC, South Korea), Nacional Financiera (NAFIN/Mexico), Vnesheconombank (VEB/Russia), Small Industries Development Bank of India (SIDBI/India)

development agenda includes climate financing as a central focus in 2012; therefore, the leverage of climate resources is a fundamental component of this agenda.

It is not possible to imagine a low-carbon economy without the massive participation of the public and private sectors, either as investors or beneficiaries of financial resources. In this case, development banks will have strategic participation, because they maintain a close relationship with the industrial sectors, which are their largest customers, as well as access to institutional and regulatory decision-makers, allowing the promotion of the best possible institutional legal framework for the market. In short, the construction of a new and effective smart partnership is needed between the different players in society, in which development banks play an indispensable role.

The IDFC members are at the disposal of national governments and the international community as a whole in order to help build and implement all types of financial instruments to leverage climate resources, whether it is credit, equity, grants or de-risking instruments. They also consider it important and are available to collaborate in establishing nationally appropriate mitigation actions (NAMAs) – preparing the way so that national economic sectors can develop into a low-carbon economy – and carbon markets, with carbon prices that stimulate climate projects; besides financing mechanisms capable of increasing climate resilience in regions with greater vulnerability, especially in least developed countries.

The resources promised by developed countries for the Green Climate Fund (GCF) will be fundamental within this flow of climate resources. The application of such resources must be not only aligned with national strategies for combating climate change, but also submitted to social and environmental safeguards and robust fiduciary standards. In this sense, development banks become natural candidates for distribution channels of these resources and are at the disposal of the international community to help construct and implement the GCF.

The IDFC members also emphasize that their operations are not merely limited to economic development, but have an important relationship with social and environmental development. Pursuing social inclusion and poverty relief is essential in building a society with greater climate resilience. If adaptation actions can be considered as “good development”, the development banks have much to contribute. In this sense, they will seek to balance the adaptation and mitigation investments, so as to leverage the social results of their investments.

The IDFC members are also committed to advancing in monitoring, reporting and verification of their climate investments, a fundamental practice not only to provide transparency to what they do with the resources entrusted to them, but also to understand the path of climate investments and point out any adjustments that may be required.

Development banks are in a privileged position to face the challenge of leveraging climate resources, because they know society's demands and are in the interface between the government and the private sector. Therefore, they are capable of not only understanding the barriers that inhibit the presence of private entrepreneurs, but also coordinating, together with local governments, the development of instruments to overcome them [the barriers], thus ensuring the existence of a favorable environment for investments towards a low-carbon economy.