GREEN
CLIMATE
FUND

Private Sector Facility: Working with Local Private Entities, Including Small and Medium-Sized Enterprises

GCF/B.09/12

5 March 2015

Meeting of the Board
24-26 March 2015
Songdo, Republic of Korea
Agenda item 16

Recommended action by the Board

It is recommended that the Board:

(a) Take note of the information presented in document GCF/B.09/12 *Private Sector Facility: Working with Local Private Entities, Including Small and Medium-Sized Enterprises*; and

(b) Adopt the decision presented in Annex I to this document.

Private Sector Facility: Working with Local Private Entities, Including Small and Medium-Sized Enterprises

I. Introduction

1. Paragraphs 42 and 43 of the Governing Instrument for the Green Climate Fund (the "Fund") state that the operation of the Private Sector Facility (PSF) will be consistent with a country-driven approach and that the facility will promote the participation of private sector actors in developing countries, in particular local actors, including small and medium-sized enterprises (SMEs) and local financial intermediaries. The facility will also support activities to enable private sector involvement in small island developing States (SIDS), least developed countries (LDCs) and African States.

2. At its fourth meeting, the Board re-emphasized that the PSF will promote the participation of private sector actors in developing countries, in particular local actors, including SMEs and local financial intermediaries, and in SIDS, LDCs and African States. Modalities will be developed for consideration by the Board (decision B.04/08, paragraph (c)). Furthermore, the Board emphasized that the Fund needs to pay specific attention to Africa and to adaptation activities at the national, regional, and international levels (decision B.04/08, paragraph (e)).

3. At its fifth meeting, the Board established the Private Sector Advisory Group (PSAG) to make recommendations to the Board on the Fund-wide engagement with the private sector and modalities to that end (decision B.05/13). The PSAG's mandate is to make recommendations to the Board on promoting the participation of private sector actors in low-emission and climate-resilient development in developing countries, in particular local actors, including SMEs and local financial intermediaries.

4. At its seventh meeting, the Board requested the PSAG to provide advice on the implementation of decision B.04/08 for consideration at the eighth meeting of the Board, with a focus on modalities to promote the participation of private sector actors in developing countries, in particular local actors, including SMEs and local financial intermediaries in SIDS, LDCs and Africa, and with a special emphasis on adaptation (decision B.07/08).

5. At its eighth meeting, the Board considered document GCF/B.08/14 *Working with Local Private Entities, Including Small and Medium-Sized Enterprises*. There was broad support for the approaches outlined in the document, but, owing to time limitations, the draft decision annexed to the document was not adopted. The draft decision was revised based on guidance received from the Board and the recommendations presented by the PSAG, and is included in Annex I to this document.

6. The purpose of this document is to outline how the Fund can promote the participation of private sector actors in climate change programmes and projects in developing countries, including local financial intermediaries, developers and private companies.

II. Linkages with other documents

7. Many of the approaches outlined in document GCF/B.09/11 *Private Sector Facility: Potential Approaches to Mobilizing Funding at Scale* will be relevant for private sector actors in developing countries. However, the present document will focus on the additional needs of the local private sector in developing countries and how the Fund can respond to them.

III. Private sector investments in developing countries

8. A key feature of the private sector and the financial sector in developing countries is their diversity, scale and scope. In some cases, private sector actors in developing countries are on a par with, or ahead of those in developed countries, while in other developing countries these actors may be small or have inadequate capacity to undertake climate-related investments. Some markets may be global, while others may be too small to assure the financial return of certain attractive investments. The financial sector may be too shallow to assure debt financing of adequate maturity or may not provide appropriate financial instruments. The policy or regulatory environment in the country may disincentivize investors because of market distortions or investment uncertainty.

9. This document will seek to outline means through which the Fund can provide support to private SMEs in developing countries. In particular, it looks at providing concessional resources to SMEs to offset the lack of access to financial markets, through a proposed SME Pilot Programme. These resources could include a non-refundable grant component to be used for SME capacity-building.

10. The Board may wish to establish a programme-based approach to reach SMEs in a way that is cost-effective through accredited entities that would be responsible for approving and assuming the administrative management of the Fund's SME Pilot Programme and exposure to SMEs.

3.1 Key barriers to climate-related investments

11. The barriers to increased private sector investment in climate-related projects and programmes can exist at several levels:

(a) **Policy and regulatory environment constraints**. These typically introduce market distortions which reduce the economic and financial attractiveness of climate-related investments (e.g. price and tariff controls) or increase the uncertainty relating to investment outcomes (policy uncertainty). It is not proposed that the PSF would directly address such policy and regulatory constraints.[1] Rather, if the Fund were requested by the country to help to address such barriers, it would do so through policy support (grants or concessional lending) to governments and government agencies. Such support would take the form of policy-based grants or concessional loans from the Fund's mitigation or adaptation windows to finance the cost of such policy changes;

(b) **Information gaps leading to market failure**. Investors and financial intermediaries may not pursue attractive climate-related investments because of inadequate information concerning available technologies, resource availability (e.g. geothermal resources, energy savings potential), financing possibilities or other information gaps;

(c) **Weak or shallow financial markets**. Many developing countries lack debt or equity markets that can match domestic savings to the long-term financing needs of climate-related investments, and they may also lack important financial products needed to successfully finance climate-related investment (e.g. leasing finance, venture capital, secondary markets to provide take-out finance for investors). These constraints mean that financially viable investments do not obtain the financing they need;

[1] The PSF has been designed to work with the private sector. While policy and regulatory issues affect private sector actors in developing countries, addressing such barriers would require action by governments, which is a task that would be more appropriate for the mitigation and adaptation windows of the Fund to undertake.

(d) **Capacity constraints**. Some developing countries may not have certain specialized skills in the local economy (e.g. to develop or appraise complex projects) needed to successfully develop climate-related investments; and

(e) **Market size and transaction costs**. The Fund seeks to minimize the transaction costs of working with SMEs by having accredited entities originate, approve, administer and manage SME financing for and on behalf of the Fund through a programmatic approach.

IV. Role of the Green Climate Fund in addressing key barriers to private sector investment

12. In order to fulfil its function of supporting private sector climate investments in developing countries, the Fund must use mechanisms of support for developing country actors that will address the barriers outlined above. As indicated earlier, it should be noted that policy and regulatory environment constraints (see (a) and (b) below) will be addressed through the Fund's mitigation and adaptation windows:

(a) **Information-related market failure and capacity constraints** will require the use of concessional resources to assist developing country actors in overcoming the information gaps and capacity constraints. A particular need is to assist SMEs in enhancing their audited financial reporting standards, business plans, risk studies and/or feasibility studies; and

(b) **Weak or shallow financial markets** can be tackled successfully by the use of additional financial instruments. The use of such financial instruments, including grants, concessional loans (senior and subordinated), equity and guarantees, is enabled by decision B.08/12. In addition, for small actors such as SMEs, tailored approaches – for example providing concessional resources deployed programmatically through accredited intermediaries – would be more appropriate.

13. In order to cover these areas, the Board will need to consider providing the following forms of assistance:

(a) A mechanism for SMEs to offset their lack of access to financial markets (i.e. the SME Pilot Programme). This could include a non-refundable grant component to be used for the capacity-building of SMEs; and

(b) Use of financial instruments (including the provision of grants in innovative ways) as enabled by decision B.08/12.

14. Descriptions and examples of the use of the assistance mechanisms are provided in Table 1 below.

Table 1: Examples of approaches to working with small and medium-sized enterprises in developing countries

Assistance Mechanisms	Description	Example Of Use
Small and Medium-Sized Enterprise Pilot Programme	Provision of concessional resources to small and medium-sized enterprises (SMEs) through accredited entities on a programme/portfolio basis. These resources could include a non-refundable grant component to be used for capacity-building of SMEs	Examples: • Conversion from diesel independent power generators to hybrid electrification in industry and/or agri-foods • Solar water heaters • Energy efficiency programmes • Irrigation, to enable farmers to adapt to climate change • Upgrading to energy-efficient industrial refrigerators in the agri-food industry • Capacity-building to prepare and audit financial statements, business plans, risk studies and/or feasibility studies
Use of financial instruments See decision B.08/12	Providing, through accredited entities, tailored concessional financial instruments to offset shallow domestic financial markets	Examples: • Concessional lending to allow for credit-sale of hybrid generators • Nth loss guarantee on an SME portfolio to attract financing by multiple investors

4.1 Support programme proposed for the private sector

15. This section outlines the mechanism on which the Board may wish to make a decision based on the information in this document. This mechanism will be used in line with the Fund's eight strategic result areas, towards which it will channel its resources (decision B.07/04), and the Fund's policies and procedures for the initial allocation of Fund resources (decision B.06/06), and will be consistent with a country-driven approach, as per paragraph 42 of the Governing Instrument. This will ensure that the proposed mechanism is maximizing the Fund's climate change impact and contributing to the Fund's objectives.

4.1.1 Small and Medium-Sized Enterprise Pilot Programme

16. In order for the Fund to achieve its objective of promoting a paradigm shift towards low-emission and climate-resilient development, demand from SMEs for climate change activities will be of key importance. The Fund will use its concessional resources to improve SMEs' access to finance through its SME Pilot Programme.

17. This is in line with paragraph 43 of the Governing Instrument, which stipulates that the PSF will promote the participation of private sector actors in developing countries, in particular local actors, including SMEs.

18. SMEs, particularly SMEs that export goods and services, play an important role in the economic fabric of developing countries and in contributing to the growth and prosperity of such countries. SMEs represent more than 50 per cent of gross domestic product in Organisation for Economic Co-operation and Development countries as opposed to less than

20 per cent in developing countries.[2] Yet they are restricted in accessing capital, even in its simplest form as bank loans. When they are able to access bank financing, it is under highly unfavourable and sometimes debilitating conditions. There are more than US$ 2 trillion of unmet SME credit needs in developing countries.[3]

19. The Fund has a unique opportunity to address the aforementioned issue while addressing climate change. In particular, the Fund can mobilize SMEs towards pursuing both climate change mitigation and adaptation. Mitigation could be achieved through, for example, the financing of energy-efficient equipment, upgrading of heating and ventilation equipment and improvements to transportation logistics, etc. Adaptation could be achieved through, for example, financing reductions in water use and continuity of business plans that help SMEs better prepare for and adapt to the adverse climate change impacts on their businesses' revenues and costs.

20. The SME Pilot Programme will provide concessional financing to SMEs through accredited entities. These concessional resources could be useful when applied in the context of supply chain financing and terms of trade financing.

21. For example, a facility could be made available to make it possible for SMEs selling solar panels to offer credit to their clients so as to have terms of trade that are in line with that of their conventional competitors. They could also be particularly useful for adaptation activities by financing continuity of business plans (e.g. financing a back-up operational site) for SMEs.

22. The Fund will issue a request for proposals (RFP) to entities that are able to demonstrate:

(a) A track record of successfully working with and financing SMEs;

(b) The ability to monitor the results achieved through the SME Pilot Programme; and

(c) The ability to use Fund resources to create a significant climate impact.

23. Particular attention will be paid to SMEs that have a sustained track record of financial and commercial viability and that have weathered economic peaks and troughs. This will help to ensure that Fund resources are directed towards financially/economically robust entities that have "staying power" and that can make the greatest impact in terms of reach and outcome.

24. As the Fund requires that its resources are channelled through accredited entities, respondents to the RFP must either become accredited in due course by the Fund or work through an accredited entity.

25. SMEs – particularly smaller entities – can suffer from not having audited financial statements and/or adequate feasibility studies. This can impair their access to capital. As such, selected respondents to the RFP who will administer and manage the Fund's SME Pilot Programme will be allocated a capacity-building component to fund the appropriate and adequate preparation and auditing of financial statements and/or feasibility studies by the SMEs that require such capacity-building to access financing for use in climate-sensitive investments.

26. In line with the revised programme of work on readiness and preparatory support, the Fund will aim to allocate at least 50 per cent of this capacity-building component to particularly vulnerable countries, including SIDS, LDCs and African States (decision B.08/11, paragraph (e)).

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[2] Ayyagari M, Beck T and Demirguc-Kunt A, *Small and Medium Enterprises across the Globe: A New Database*, World Bank, 2003.
[3] Stein S, Goland T and Schiff R, *Two Trillion and Counting: Assessing the Credit Gap for Micro, Small, and Medium-size Enterprises in the Developing World*, International Finance Corporation, McKinsey, 2010.

V. Emphasis on adaptation

27. The Fund is to approach adaptation in such a manner that a balance is sought between adaptation and mitigation (Governing Instrument, paragraph 3) and will aim for a 50:50 balance between mitigation and adaptation over time (decision B.06/06, paragraph (a) (i)). Furthermore, the Fund will aim for a floor of 50 per cent of the adaptation allocation for particularly vulnerable countries, including LDCs, SIDS and African States (decision B.06/06, paragraph (a) (ii)).

28. One of the key barriers to private investment in adaptation activities is that such activities often provide common goods or services without a clear or perceived revenue stream to match their economic benefits.

29. There needs to be recognition that adaptation represents a material operational risk for the private sector companies that operate in climate vulnerable areas. There are direct and indirect costs of disaster recovery and continuity of business related to climate change (including supply chain disruptions).

30. Private sector companies that address adaptation-related risks derive the following two competitive advantages:

(a) Resilience; and

(b) Lower cost of funding (because of lower operational risk as measured and monitored by credit agencies);

31. The Fund's SME Pilot Programme could promote the following type of investments into adaptation activities by SMEs in developing countries:

(a) Investments in supply chain management that incorporate climate adaptation risk management (e.g. supply source diversification, crop changes in agriculture); and

(b) Promoting guarantees to enable bank and supply-chain (i.e. accounts receivable/payable) debt rescheduling in the face of business disruptions resulting from temporal material/adverse climate change impacts.

VI. Conclusion and next steps

32. The Board may wish to adopt the decision as contained in Annex I to this document.

Annex I: Draft decision of the Board

The Board, having reviewed document GCF/B.09/12 *Private Sector Facility: Working with Local Private Entities, Including Small and Medium-Sized Enterprises*:

(a) Decides to create a Small and Medium-Sized Enterprise Pilot Programme (SME Pilot Programme) of US$ 100 million to provide financial support to small and medium-sized enterprises (SMEs);

(b) Decides to apply a cap of US$ 50 million in the SME Pilot Programme per accredited entity;

(c) Requests the Secretariat to issue a request for proposals (RFP) based on the terms of reference detailed in Annex II to this document to seek proposals from interested entities with knowledge and experience in financing SMEs and managing the associated risks;

(d) Requests the Secretariat to report to the Board, at its eleventh meeting, on the progress of the SME Pilot Programme RFP process, and to submit for the Board’s consideration and potential approval, well-ranked proposed programmes as an outcome of the RFP.

Annex II: Draft terms of reference for the Small and Medium-Sized Enterprise Pilot Programme

I. Background

1. In accordance with its Governing Instrument and the decisions of its Board, the Green Climate Fund (the Fund) is launching a Small and Medium-Sized Enterprise Pilot Programme (SME Pilot Programme) aimed at engaging local actors, including small and medium-sized enterprises (SMEs) and local and regional financial intermediaries, taking a country-driven approach. The Programme will pay particular attention to private sector involvement in small island developing States (SIDS), least developed countries (LDCs) and African States. The Programme will also pay particular attention to adaptation activities designed to assist climate-vulnerable communities better cope with the adverse effects of climate change.

2. The SME Pilot Programme was established for the purpose of promoting the participation of SMEs in climate change activities in developing countries which are Parties to the United Nations Framework Convention on Climate Change. It aims to offset SMEs' lack of access to financial markets by providing concessional resources (including grants, concessional loans, equity and guarantees) to improve their access to finance for investments in climate change related activities.

3. The SME Pilot Programme is important as SMEs play a particularly important role in the economic fabric of developing countries, representing 20 per cent of gross domestic product. However, SMEs often lack access to financing through traditional channels. The Fund is therefore seeking to engage with SMEs to provide them with the much-needed financing to undertake climate-sensitive investments and thus promote a paradigm shift towards low-emission and climate-resilient development pathways.

4. Given the small unit size of SMEs and the high transaction costs that are a result of interacting directly with such actors, the Fund will rely on accredited entities to manage and implement the SME Pilot Programme.

II. Objective of the request for proposals

5. The request for proposals (RFP) is designed to select one or more accredited entities that will manage and implement the SME Pilot Programme.

6. The proposals should:

(a) Improve SMEs' access to financing for climate change mitigation and adaptation activities;

(b) Promote the adoption of newer technologies and/or processes by local SMEs;

(c) Attract co-financing from local financial institutions into local SMEs;

(d) Generate sustainable development co-benefits; and

(e) Create a model of success that can be replicated and/or scaled up.

III. Types of entities to be involved

7. The SME Pilot Programme RFP is open to all applicants that are able to demonstrate:

(a) A track record of successfully working with financing of SMEs;

(b) A dedicated strategy or long-term goal related to financing and investing in SMEs;

(c) An ability to successfully monitor and manage the fiduciary risks associated with financing SMEs, as evidenced by the performance of the applicants' SME portfolio (e.g. non-performing assets ratio, recovery ratio, etc.);

(d) An ability to use concessional Fund resources to generate significant climate change mitigation and adaptation impact while ensuring environmental and social safeguards;

(e) An ability to catalyse additional funding (i.e. crowd-in third party funding); and

(f) Payment of a US$ 5,000.00 processing fee for the proposal/application.

IV. Accreditation of applicants and national designated authority approvals

8. Entities whose proposals are retained by the Board will need to become accredited prior to their proposal receiving final approval. They may alternatively seek to work through an entity that is already accredited by the Fund. This process will ensure that successful institutions are in compliance with the Fund's initial fiduciary principles and standards, and interim environmental and social safeguards.

9. Entities whose proposals are retained by the Board will need to have their proposals approved by the relevant national designated authorities or Focal Points in the form of non-objection letter (Decision B.08/10) prior to their proposal receiving final approval.

V. Type of activities to be undertaken by the applicant

10. Applicants may request a line of credit that they may blend or on-lend to SMEs.

11. Applicants may alternatively propose to act as the Fund's agent and administer, manage and monitor the use of funds for and on behalf of the Fund. In so doing, the applicants may:

(a) Administer grants, loans, equity or guarantees for and on behalf of the Fund;

(b) Create a vehicle through which the applicant, acting as the Fund's agent, will manage and invest the Fund's resources;

(c) Receive debt service or dividends from SMEs, as well as repayment of principal, for and on behalf of the Fund;

(d) Ensure compliance with the Fund's interim environmental and social safeguards;

(e) Undertake due diligence, investment monitoring, portfolio monitoring and management services for and on behalf of the Fund;

(f) Originate, approve and execute individual transactions (including the preparation and execution of the necessary documentation) within the scope of the SME Pilot Programme;

(g) Provide regular monitoring and reporting on the implementation of the SME Pilot Programme;

(h) Monitor and enforce pre- and post-disbursement conditions, and covenants and warrantees; and

(i) Provide financial recovery in the event of defaults.

VI. Type of investments to be targeted by applicants

12. In an effort to promote scalability, replicability and long-term financial sustainability, the Fund's resources should be used to finance SMEs with a track record of long-term sustained financial robustness as demonstrated by a financial and commercial history that has weathered economic peaks and troughs.

13. The Fund's resources could be used to finance SMEs that are seeking to address climate change through activities including, but not limited to:

(a) Upgrading old refrigeration systems;

(b) Improving the insulation of warehouses or offices;

(c) Replacing diesel generators with hybrid generators;

(d) Replacing transportation fleets;

(e) Creating smart distribution networks;

(f) Relocating facilities away from flood zones;

(g) Improving agricultural irrigation systems; and

(h) Investing in crop diversification.

14. The Fund will encourage an emphasis on the commercial feasibility of the proposed SMEs and their related projects.

15. The Fund will encourage an emphasis on enabling private sector involvement in SIDS and LDCs, with specific focus on African States.

16. The Fund will encourage an emphasis on adaptation projects aimed at assisting climate-vulnerable SMEs in adapting to climate change.

17. Respondents to the RFP who will administer and manage the SME Pilot Programme can request a capacity-building component of up to 10 per cent of the amount to fund the appropriate and adequate preparation and auditing of financial statements, business plans and/or feasibility studies by the SMEs that require such capacity-building to access financing for use in climate-sensitive investments.

VII. Time frame of the Small and Medium-Sized Enterprise Pilot Programme

18. The proposals will be received on a rolling basis and will be selected on the basis of the Fund's initial investment framework (Decision B.07/06).

VIII. Financial volume of the Small and Medium-Sized Enterprise Pilot Programme

19. In accordance with these terms of reference, the Fund will seek to allocate US$ 100 million for the SME Pilot Programme by issuing the RFP.

20. No single applicant may seek to manage more than US$ 50 million of the SME Pilot Programme.