IEO BRIEF

The GEF Nongrant Instrument

Twenty years since the GEF Council incorporated nongrant instruments in the Strategy, the IEO undertakes a comprehensive study of the nongrant portfolio.

Nongrant projects in the GEF refer to projects in which GEF financing is used in products and mechanisms that have the potential to generate financial returns. Concerns of crowding out commercial finance, and donor reluctance to provide "free" money to the private sector through traditional grant-based financing, led to support of nongrant instruments to augment the GEF's offerings. Moreover, the nongrant instruments lend themselves to tailored structuring, allowing better alignment of mitigation measures to the risk being covered—not only helping to ensure the principle of minimum concession but also minimizing market distortions.

FINDINGS

1. **High-leverage ratio of cofinancing to GEF grant.** On average, every dollar of GEF grant spent for nongrant projects leverages $10 in cofinancing. Not only is the overall leverage ratio the highest among the private sector portfolio, it is also the highest across the general GEF portfolio. Notably, this ratio has improved in GEF-5 and GEF-6. For every $10 leveraged by a GEF nongrant, $4.70 comes from private sector investment. Forty-eight percent of this financing is in the form of equity, followed by 28 percent in other forms of investment, and 17 percent in grants.

2. **Increasing trend in global nongrant projects.** Historically, Europe and Central Asia implemented the largest numbers of nongrant projects (28 percent of the portfolio), followed by Asia (20 percent). However, in GEF-6, seven of the eight projects are multicountry efforts, representing a significant increase over previous cycles.

3. **Diversification over time.** The vast majority of nongrant projects (81 percent) is in the climate change area. However, among nongrant projects in GEF-5 and GEF-6, there is a relative increase in non–climate change projects (7 out of 27). The GEF-6 projects in particular show greater diversity in the sectors covered, with an increased focus on biodiversity and land degradation.

4. **New implementing partners.** Traditionally, over one-third of nongrant projects (34 percent) were implemented by UNDP, followed by the World Bank Group (31 percent). Of the eight projects

PURPOSE AND METHODS: The purpose of this study is to assess the Global Environment Facility's (GEF's) nongrant instrument activities in order to provide insights and lessons for GEF-7. A mixed-methods approach was used, based on evidence from a nongrant instrument portfolio analysis, review of terminal evaluations of completed projects, interviews with relevant stakeholders, and desktop research of pertinent project documents. The completed study will provide recommendations to enhance the design and use of nongrant instruments going forward.

WEB PAGE: www.gefieo.org/evaluations/study-non-grant-instrument-gef

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ABOUT US: The Independent Evaluation Office (IEO) of the GEF has a central role in ensuring the independent evaluation function within the GEF. www.gefieo.org

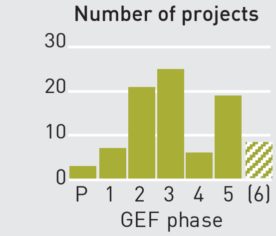
SIXTH COMPREHENSIVE EVALUATION OF THE GEF

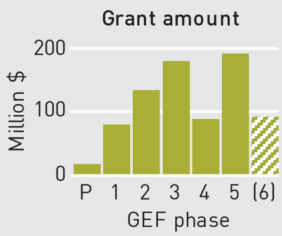
PORTFOLIO HIGHLIGHTS

89
projects

$0.7 billion
in grant funding

$7.2 billion
in cofinancing

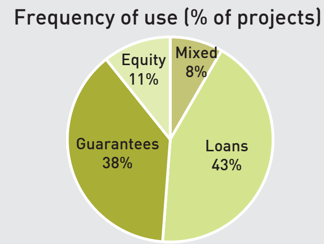


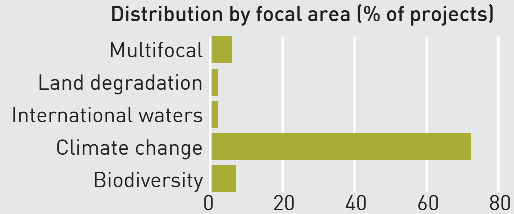


Project modality
91% full-size projects
9% medium-size projects

Top 3 Agencies
34% UN Development Programme
31% World Bank Group
9% Inter-American Development Bank

Regional distribution
28% Europe and Central Asia
20% Asia
18% Africa
18% Latin American and Caribbean
9% Global
7% Regional





approved in GEF-6, two are being implemented by Agencies that have not previously led GEF projects: the Development Bank of Southern Africa (DBSA) and Conservation International. At the same time, two previously active agencies—the International Finance Corporation (IFC) and the United Nations Development Programme (UNDP)—are absent.

5. Role of technical assistance. Nongrant projects have made use of a large range of instruments, with technical assistance often integrated into nongrant financing mechanisms. Project documents reviewed from the portfolio revealed that technical assistance, when included, is almost invariably financed by the GEF.

6. Reflows. Reflows are the financial returns transferred to the GEF Trust Fund. Because of the growth in use of nongrant instruments in later GEF cycles, projects in earlier cycles were structured to recover principal at best. In later cycles, there was an expectation of a positive financial return. To date $8.2 million in reflows has been received. It should be noted that GEF-5 and GEF-6 projects have not yet begun generating reflows, and the long time frames involved in the activities financed means that reflows would be generated 10–20 years into the future.

HISTORY

During the GEF pilot phase, three projects used revolving funds to accelerate adoptions of environmentally friendly technologies. Nongrant instruments were first mentioned formally in GEF-2. In GEF-4, the 2006 "GEF Strategy to Enhance Engagement with the Private Sector" envisioned "strategic use of nongrant/risk mitigation instruments" as one of the main instruments, together with a public-private partnership (PPP) fund and knowledge management tools to achieve the goal. At this time, the GEF Earth Fund was established with delegated authority to IFC and other Agencies to prepare and approve projects more quickly, in line with private sector expectations.

In 2011, another strategy paper was developed to enhance private sector engagement with expanded use of nongrant instruments as a key tool available to the GEF for building PPPs and attracting greater private sector financing. In GEF-5, the private sector set-aside amounted to a total of $80 million, focusing entirely on providing catalytic financing through the use of nongrant instruments. Drawing on its past experience in utilizing debt, equity, and risk mitigation products, the GEF launched a $115 million pilot program in GEF-6 to demonstrate and validate the application of nongrant financial instruments to combat global environmental degradation. The pilot program funds proposals with the potential of generating reflows.

RESULTS

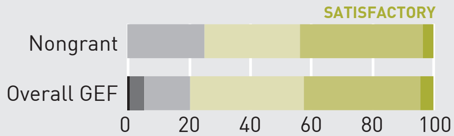
Performance. Overall, 78 percent (37) of the 41 nongrant projects for which outcome ratings are available are rated as moderately satisfactory or higher on outcomes; this is largely comparable to the performance across the entire GEF portfolio as reported in the most recent GEF annual performance report (APR 2015). Sixty-six percent of projects (35) for which ratings are available have sustainability ratings of moderately likely or higher, based on the likelihood of project benefits continuing past project closure; this is also comparable to sustainability ratings across the GEF project portfolio. Sixty-one percent of rated projects have efficiency ratings in the satisfactory range. With regard to monitoring and evaluation (M&E), 62 percent have satisfactory implementation ratings, and 74 percent have satisfactory design ratings.

Reflows. In all cases reviewed in this study, project-level reflows remain in the country and continue to be used as originally intended or deployed to other agreed-upon uses. The first projects to structure GEF finance in the expectation of GEF reflows were the private sector initiatives undertaken by IFC. In some cases, remaining balances in a project were rolled over into a successor project.

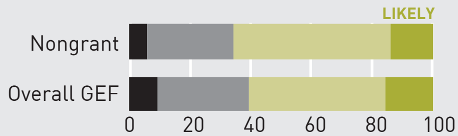
The terminal evaluation for the Hungary Energy Efficiency Project indicates that the project was highly successful, with no guarantees having been called, and that remaining balances were rolled over into the second Hungary Energy Efficiency Co-Financing Project. The Environmental Business Finance Program was funded in part from reflows emanating from the Small and Medium Enterprise Project

PERFORMANCE HIGHLIGHTS

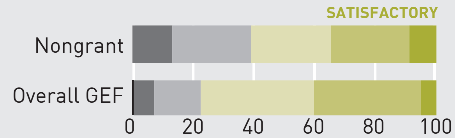
Outcome ratings (% of projects)



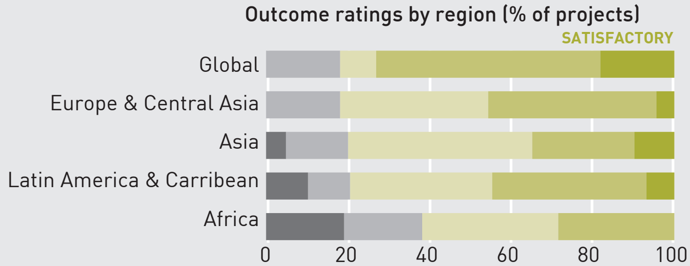
Sustainability ratings (% of projects)



Efficiency ratings (% of projects)



Outcome ratings by region (% of projects)



and is still generating reflows for the GEF. Reflows on the IFC Earth Fund are also beginning. Notably, starting with GEF-5, project appraisal documents presented for Chief Executive Officer (CEO) endorsement contain an annex where reflows are to be explicitly addressed. There has been a clear evolution in reporting practice, with better descriptions of the reflow mechanism and quantification of returns to the GEF where applicable.

Instruments. The GEF classifies nongrant instruments into three broad types: loans, guarantees, and equity.

- **Loans.** Debt instruments are the most popular financing structures in the portfolio (42 percent). These are used either on their own or in a blended manner. The concessionality could be a lower interest rate, a longer maturity, or a subordinated position. They are also often provided in conjunction with a multilateral development bank facility, which takes a more senior position. For instance, the GEF-5 European Bank for Reconstruction and Development (EBRD) Russian Federation Green Shipping Program blends subordinated GEF financing with an EBRD senior loan. In GEF-6, the GEF's subordinated financing—which includes technical assistance—earns a lower return than the EBRD fund provided in the EBRD Green Logistics Program. Among debt instruments, a revolving fund is the most commonly encountered financing vehicle. In GEF-6, the structure is employed in the African Development Bank's Investing in Renewable Energy Project Preparation under the Sustainable Energy Fund for Africa (SEFA). The GEF financing is to be used to finance project preparation grants, which are reimbursable when the project is completed, thereby creating reflows that improve the SEFA's financial sustainability.

- **Guarantees.** These instruments are the second most used financing vehicle (37 percent), often used in conjunction with loans; they are typically structured to cover first loss tranches in financial intermediaries. The GEF's first use of guarantees dates to 1997, in the Hungary Energy Efficiency Co-Financing Program executed by IFC. The rationale for a guarantee is to overcome the reticence of financial intermediaries in lending to the activity in question by providing a risk-sharing mechanism. The evidence on the effectiveness of the guarantee instrument is mixed. The Poland Energy Efficiency Project included a partial credit guarantee to cover 50–70 percent of the loan principal on first loss. The terminal evaluation states that the project was restructured in 2011, because of very limited demand from banks for the guarantee. In other cases, the guarantee appears to have been highly successful in expanding energy efficiency lending. In at least five cases, a guarantee was used with minimal or no losses, proving the soundness of the business case and the underlying premise. These initial collaborations on energy efficiency projects allowed IFC to test and refine a model of blending GEF concessional finance with IFC commercial finance and other private finance—leading to the creation of a blended finance unit in IFC, which now structures concessional investments beyond the environmental sector.

The study also brought to light a few cases where other climate finance providers were involved in GEF projects. One such project is the World Bank's India Partial Risk Sharing Facility for Energy Efficiency. This project involves GEF financing of $18 million, Clean Technology Fund (CTF) financing of $25 million, and other cofinancing of $127 million; $12 million of the GEF financing is used to fund a risk-sharing facility, which is "backstopped" by $25 million of CTF contingent financing. Although classified as a guarantee, the GEF financing is really a capital grant to fund the facility. No GEF reflows are foreseen. This example demonstrates the different risk profiles of the two multilateral climate finance providers (GEF and CTF), with the GEF taking the highest risk position. A question that arises is whether this is the role the GEF sees for itself. *Prima facie*, the GEF appears to be subsidizing the CTF, since the CTF is being remunerated while the GEF is not, and since any unused funds revert to the CTF at the end of the project.

- **Equity.** Equity investment have recently become more prevalent. Four of the eight projects in GEF-6 involve some sort of equity structure. GEF-6 also marks the first appearance of a *pari passu* risk/return-sharing feature. Equity is the riskiest form of capital in the stack, and it stands to reason that a mission investor such as the GEF take this position. Another reason for the greater use of equity could be the potential for returns.

  From GEF-5, one such investment as part of the PPP platform occurred with the Inter-American Development Bank's (IDB's) Multilateral Investment Fund (MIF), which requested $15 million in reimbursable resources from the GEF for this program to invest in three venture capital funds. The MIF approved $5 million for the MGM Sustainable Energy Fund (MSEF), $3 million for Ecoenterprises II, and $4 million for the Honduras Renewable Energy Financing Facility (H-REFF). The MIF is administering GEF investments of $7 million, $5 million, and $3 million, respectively. In addition to the investments, the MIF will provide a total of $1.95 million in nonreimbursable resources for technical assistance in the three funds. GEF resources have also attracted other investors. For the MSEF, additional investors including the Japan International Cooperation Agency (JICA) were attracted by the fact that the GEF and the MIF were investors; the Calvert Foundation was interested in adding to the GEF-MIF investment in the H-REFF.

  Another interesting use of equity can be seen in the GEF-6 nongrant investment in the Meloy Fund with Conservation International. The Meloy Fund is an $18 million impact investment fund devoted to providing debt and equity capital to scalable enterprises that can play a key role in incentivizing sustainably managed community small-scale fisheries, contributing to the maintained integrity and functioning of coral reef ecosystems in Indonesia and the Philippines. No grants will be provided through the fund. Funds will be deployed to finance the scaling-up of enterprises to move them toward environmentally responsible product lines, with a significant portion of invested capital to be used for the acquisition or upgrading of fixed assets. Borrowing entities are expected to include fisher cooperatives, aggregators and processors, and early stage enterprises. As with other nongrant projects, the Meloy Fund will provide need-based technical assistance in the form of mentoring, operations and product technical support, financial management, corporate governance, etc., to its investees to support their development, as well as to maximize positive social and environmental impacts.

  Based on the terminal evaluations reviewed, equity instruments are experienced as challenging. The need for high returns and a secure exit further complicate sourcing of deals in "difficult" sectors like climate change and biodiversity, as evidenced by the terminal evaluations for completed equity deals such as the Solar Development Capital and the Renewable Energy and Energy Efficiency Fund projects. The equity transactions in GEF-6 appear to be more complex and consist of several moving parts. It is too early to gauge performance, as none of the GEF-5 or GEF-6 projects have been evaluated, and thus the effect of this complexity on project performance is yet to be determined.

ISSUES TO ADDRESS

1. Diversification. The GEF may be operating in a crowded climate finance landscape, but can distinguish itself and continue to support private markets in biodiversity and land degradation where external financing is a viable growth option for private firms and where the GEF remains one of the few financiers of other Convention areas.

2. Complexity in financial structures. Blended funds and programs focused on small and medium enterprises (SMEs) are generally successful, but more resource intensive to deliver. A number of terminal evaluations point to the challenges involved in implementing innovative structures, and advocate for simplicity in design. Moreover, even using similar financial instruments, success in one country is not necessarily replicable in another and depends on a variety of factors that cannot be addressed by structuring alone.

3. Ambitious targets. Terminal evaluation reviews revealed that many nongrant projects set overly ambitious targets for implementation results which require midcourse correction, resulting in implementation delays and additional transaction costs. Projected reflows in GEF-5 and GEF-6 seem overly optimistic.

LOOKING AHEAD

- **Nongrant project design and delivery should be as simple as possible.** The GEF should avoid greater or more sophisticated financial instruments that result in overly complicated structures. Similarly, multiple agency involvement and/or multiple partners for implementation can be difficult to manage, entail greater transaction costs, and lead to delays, according to some terminal evaluations.
- **Technical assistance plays a significant role in most projects.** The GEF is an important financier of technical assistance on competitive terms and thus has a comparative advantage. The GEF should consider integrating this role going forward, particularly when GEF financing is mixed with other nongrant funds.
- **Defining a niche in the nongrant space.** The market has changed, with environmental finance becoming a more mainstream activity and therefore more amenable to a wider range of providers and financial instruments. There are several areas of overlap and potential for duplication with comparative private sector programs.
- **Nongrant Projects should be systematically tagged.** The GEF Secretariat's Project Management Information System (PMIS) does not adequately provide information on type of nongrant instruments used, investment allocations, and projected reflows. Moreover, classification of instruments in project documents can lead to confusion and create inconsistencies. There is a need to standardize formats and reporting requirements.