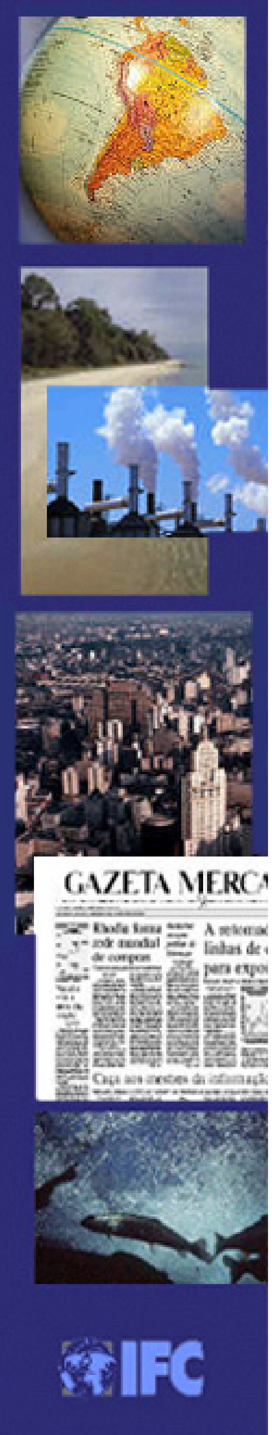


IFC's Experience with Contingent Finance Facilities

Lessons from partial guarantee & technical assistance programs to leverage private investment, develop market capacity, and facilitate EE investment

GEF

IFC

Ian Crosby
International Finance Corporation

What’s he going to talk about?

- What has IFC done and how did we do it?
- What have we learnt?
- Where is it taking us?
- What keeps us awake at night?!

HEECP Overview

Objective

Expand availability of commercial financing for energy efficiency projects in Hungary

Energy efficiency improvements generate:

GEF Benefits

Decreased GHG emissions from avoided power generation

Economic Benefits

Decreased operating costs for companies and hence increased international competitiveness for Hungary

The Problem and the DIAGNOSIS

Critical Starting Point

Problem

In Hungary in mid-1990s, local financial intermediaries (FIs) were not lending for much-needed energy efficiency improvements

DIAGNOSIS*: *The underlying cause was not …

- **Lack of funds – sufficient liquidity in financial system**
- **Lack of loans – FIs were lending (but only to ‘blue chips’)**
- **High interest rates – common problem for all borrowers**
- **Lack of incentives – energy prices were rising**

The DIAGNOSIS continues …

***Two key barriers were identified*:**

- ***Perception* of high credit risk by FIs**
  - **FIs had little experience with energy efficiency (EE), project finance or SMEs (except using grants/subsidies)**
- **Poor capacity to prepare projects**
  - **High preparation costs and weak preparation capacity by sponsors and Energy Service Companies (ESCOs)**

***And several potential opportunities*:**

- **Liberalizing markets**
- **Maturing FIs**
- **Increasing competition – openness to new products**

The Prescription

Break down the barriers:

- **Risk Management Tool**
  - **<u>Share</u> the risk by providing <u>partial guarantees</u> for loans from domestic FIs such as leasing companies and banks**
  - **FIs take the lead: find projects, review credit, etc.**

- **Capacity Building Tool**
  - **Technical assistance (TA) to FIs, ESCOs, and SMEs using <u>targeted, limited grants</u>**
  - **TA helps FIs and ESCOs to prepare projects and market services**

And exploit market forces:

Competition for new business makes EE attractive

Avoid conventional approaches, such as:

- **Grants to end users or government institutions**
- **Interest rate subsidies**

The Programs

Pilot Program – Funded by GEF

- **US$ 4.25 M partial risk guarantees**
- **US$ 0.30 M technical assistance grant**
- **US$ 0.45 M program administration grant**

Expanded Program – Funded by IFC, GEF, Bilaterals

- **US$ 12-16 M partial risk guarantees:**
  - **$8-12 M from IFC on commercial terms**
  - **$4 M from GEF *supporting IFC guarantee* (carry over from pilot)**
- **US$ 0.55 M technical assistance grants:**
  - **$0.35 M grants from Austria and the Netherlands**
  - **$0.20 M from GEF**
- **US$ 0.50 M program administration grant from GEF (new)**

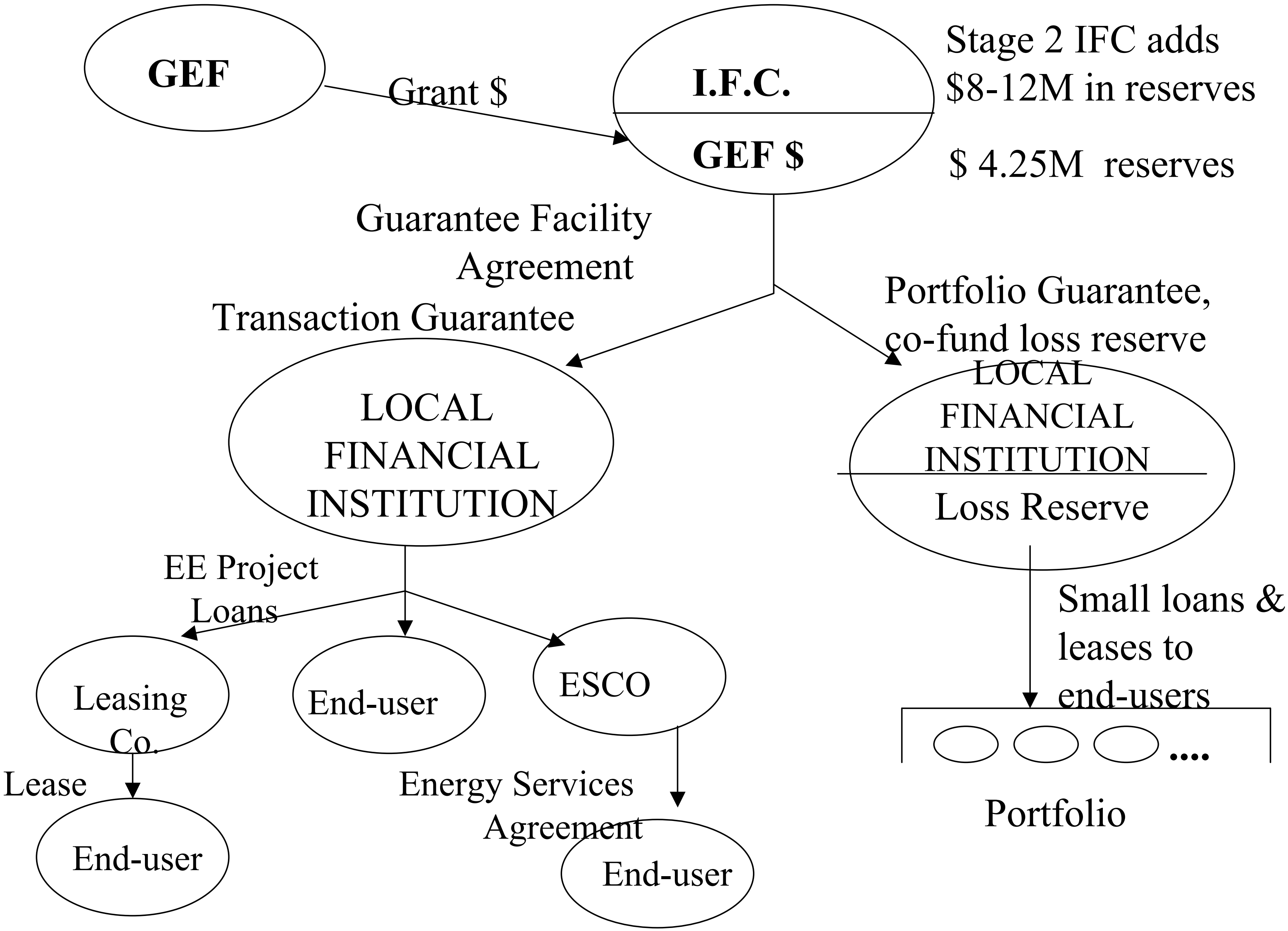
What is involved in the Program?

- **Provides a *risk management tool* to enable inexperienced FIs to make money moving assets into a new business line**
  - **EE Project Finance**
  - **SME lending**
- **Provides a *capacity building tool* to assist FIs in developing and marketing EE finance products**
- **Two types of guarantees**
  - **Transaction guarantees [issued project-by-project]**
  - **Portfolio guarantees, for groups of projects [high leverage tool]**

Key Terms of Guarantee Facility

- **KEY TERMS of Guarantee**
  - **Partial guarantees to support investors/project developers (up to 50% of project principal)**
  - **Guarantee to the financial institution involved against default by debtor/lessee**
  - **Market based Guarantee Fee charged to the financial institution involved**
  - **Pooled (portfolio) funds provide greater leverage (multiple projects linked to same loss reserve/guarantee)**
  - **HEECP2 uses subordinated recovery guarantee while CEEF will use parity guarantee (pari pasu recovery)**

Program Structure



How the Program Works

- **Procedures**
  - Project initiation by end-user, ESCO, participating FI, IFC, partners.
  - Technical and financial preparation by sponsor
  - FI submits project appraisal to IFC
  - IFC approves or requests further information
  - Financial closing, contracts signed
  - IFC issues guarantee
  - FI executes loan

Results to Date: HEECP2

- Clear evidence of market transformation
  - Competitive lending market for EE projects
  - FIs lending for EE projects (without guarantees) replicating investments previously requiring IFC guarantees
  - FIs only seeking guarantees for the new frontier:
    - Blockhouse projects
    - Very large projects (industrial modernizations, biomass cogen., complex transactions)
    - Multi-project lending facilities with ESCO as FI partner
    - Aggregated small transactions (small municipalities)

Results to Date: HEECP2 (part2)

- Guarantee facility fully committed with GFAs presently under negotiation (6 FIs)
- Streamlined credit approval procedures in place to execute new specialized multi-project facilities representing $12 mil. Loans
- Portfolio of loans leveraged by HEECP (to be confirmed by M&E): est. $25 mil.
  - Loans directly supported by guarantees: c. $5 mil.
- HEECP "TA and operational technology" transferred to CEEF, Russia, Asia, other IAs

Results to Date: HEECP2 (part 3)

- Substantial ESCO Capacity Development
  - TA supported dev’t of 50 projects with 20 ESCOs
- IFC technical support for emerging ESCOs to assist in capitalization, business dev’t, and JV partnerships
  - TA preparation facilitates potential equity investments in Hungarian ESCOs
  - TA support for expanding marketing capacity of ESCOs (block housing sector)

HEECP 2: Adopting Lessons Learned During Pilot Phase

- Increase TA focus on EE businesses
  - necessary to accelerate deal flow
  - necessary to strengthen ESCOs (technically & financially)
  - increased development impact in SME sector
  - spur projects not requiring guarantee mechanism
- Upgrade TA effort with FIs
  - more proactive training of existing bank staff across participating FIs
  - Subsidized loan officer important for first stage buy-in by lead FI

HEECP 2: Adopting Lessons Learned During Pilot Phase (part 2)

- Use TA resources to expand sectoral foci of EE developers and the deals presented
- Different EE end-use sectors require specialized credit products
    - multi-unit (block housing)
    - single family housing
    - commercial/industrial
    - Institutional/ municipal sector
    - ESCOs’ own credit barriers, (espec.SME clients)

HEECP 2: Adopting Lessons Learned During Pilot Phase (part 3)

- CEEF uses Pari Pasu guarantee structure in order to maintain FI's central role & enable streamlined administration of guarantees
- Active management by facility administrator necessary
  - Cultivate FIs
  - Prime the deal pump
  - Manage portfolio
- Strong FI relationships and credit analysis capacity important for guarantee facility administrator

HEECP 2: Adopting Lessons Learned During Pilot Phase (part 4)

- Obligation fee an important motivator for FI
  - Risky during start-up phase
- Guarantees have no real impact on interest rates
  - They will impact tenor and FI appetite for new borrower class & deal structure.
- Interest rates and energy prices are critical determinants of dealflow

And then there was CEEF …

Commercializing Energy Efficiency Finance (CEEF)

- Approved by GEF (5/02); by IFC Board (6/02)
- Operations began 3/03, 4 year program period – 12 year facility life
- 5 Countries: Estonia, Latvia, Lithuania, Czech Republic and Slovakia
- $45-90 million facility
  - $15 million GEF
  - $30-75 million IFC / $1.3 m IFC trust funds / $1.5m IFC in-kind (mgt., credit, training, legal)
- Leverages up to $225 million in EE finance
- $2.5 million TA program + $2 million management and administration budget (9 person field team)

CEEF’s first Guarantee

- 1^{st} Guarantee issued July 2003
- Innovative co-generation system at commercial fruit and vegetable producer
- Energy efficiency plus CO2 capture
- Classic project finance structure

Emerging Lessons From CEEF

- Need to achieve the right business dynamic – the FI's should drive the deal
- Importance of pre-selling the "product"
- Opportunity to bundle a portfolio of carbon reduction projects
- Standardized reporting system we can use for GEF and Emission Reduction verification
- Unresolved GEF "double-dipping"problem
- Challenges of EE carbon sales

Appropriate Markets: Where are loan guarantees effective?

- Adequate liquidity, attractive interest rates, competition, & reasonably mature institutions in the capital markets
  - guarantee used to *mobilize existing* resources
- Existence of credit risk barriers to EE investment
  - gap between real risk vs. perceived risk by FIs
- Market capability to deliver EE products/services
- Availability of economically viable EE investments
  - Energy prices
  - Interest rates < high teens
  - [technical potential usually not a critical factor]

Critical Success Factors

❶ ***Innovative*: Project complements and catalyzes private sector activity by combining <u>non-grant financing</u> and <u>targeted, limited grants</u>**

❷ ***Sustainable*: Creates self-sustaining market expansion that continues *after* donor funding ends**

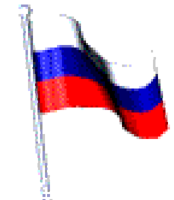
❸ ***Highly Leveraged*: Catalyzes at least 20x GEF funding in commercial financing**

❹ ***Replicable*: Design can be – and currently is being – replicated elsewhere**

❺ ***Efficient*: Private sector uses latest technology and management techniques**

Where is this taking us?

Financing Energy Efficiency in Russia



- Involving FIs in program design phase
- Focus on TA and dedicated credit lines
- Guarantee Facility to play a tertiary role

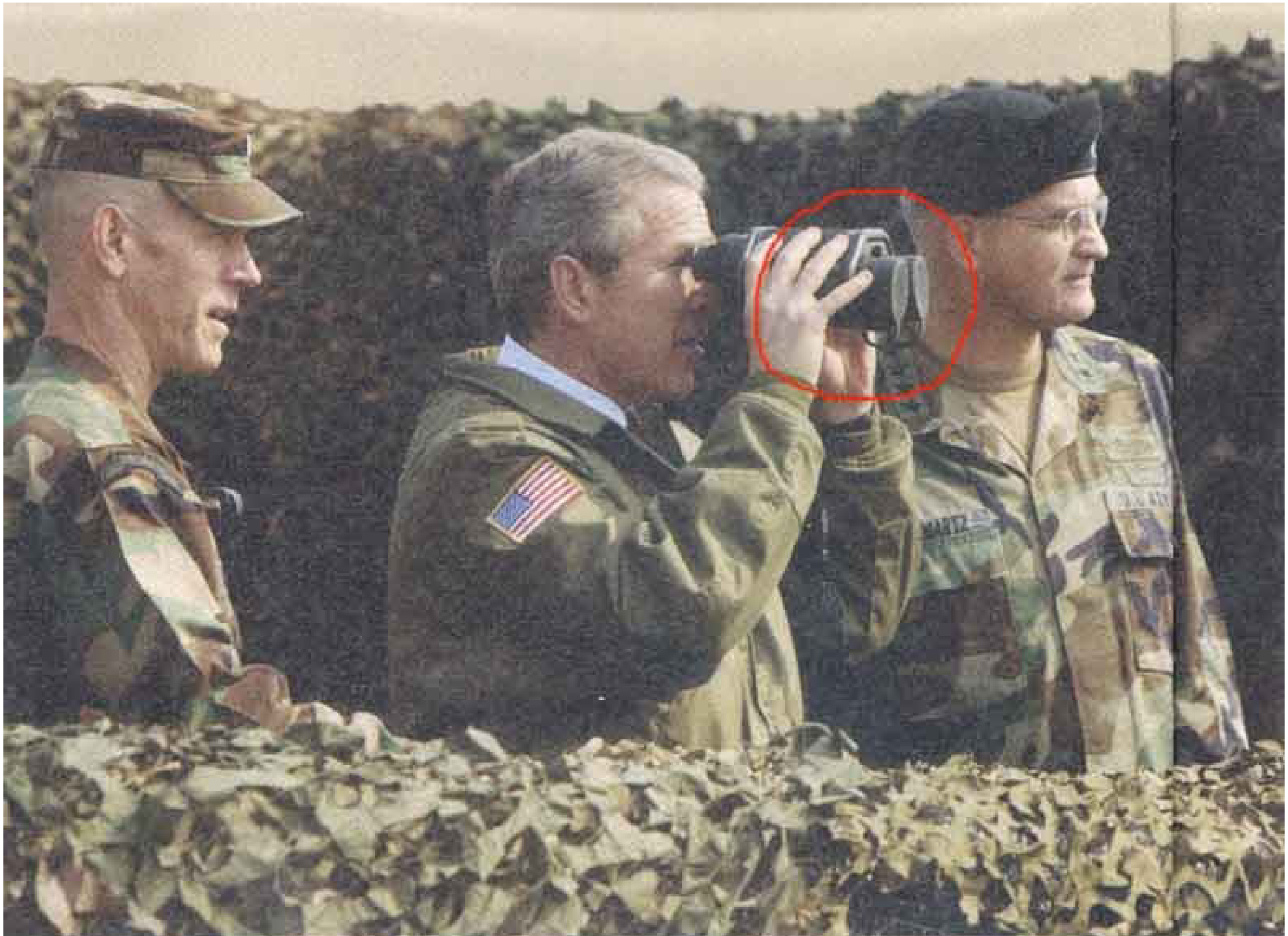
Environmental Business Finance Program

- Provide SMEs with access to financing
- Scorecard to guide selection, pricing of financial products and risk compensation
- Risk incentive structure to reward achieving environmental targets
- Flexible financial products: direct debt, quasi debt, guarantees or partial guarantees
- TA Program

Energy Efficiency Credit Facility

- Evaluating 5 countries (Brazil, Mexico, Philippines, Malaysia, India) to see whether they have right market conditions where a guarantee program may be successful
- Selection of one country based on market readiness and interest from FIs
- Design of program late 2004
- Implementation 2005

What keeps us awake at night?



OMMANNEY/CONTACT PRESS IMAGES

Not another Guarantee Program?!

Egypt Serbia and Montenegro

Russia*

CEEF*

HEECP*

Bulgaria

India

Philippines

Tunisia Croatia Thailand

We’re not making biscuits!

- Careful market assessment needed to determine what else is missing from the picture
  - Credit enhancement is not the answer to every question
- Need dialogue with FIs *before* designing the program/ intervention
  - Pre-selling the “product” to FIs important
  - Improper interventions can <u>hinder</u> development of commercial lending market for EE
- Executing guarantee facility and providing effective TA is tricky business
  - What is the comparative advantage of the executing agent? Do they speak FIs’ language? Do they understand credit issues & lending business?

Model Approach

Careful Diagnosis

Identification of Real Barriers

Design of Appropriate Tools

Stay as close as possible to commercial viability

Prefer non-grant financing

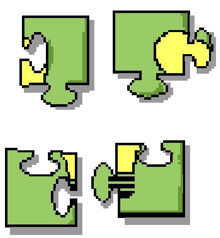
Minimize use of donor funding

Maximize leverage of donor funding

Pay attention to implementation

Loan Guarantees for Energy Efficiency:

Not a magic bullet



Only one piece of the puzzle.

[typically the <u>final</u> piece]