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Establishment of the Canadian Climate Fund for the Private Sector in Asia II

CURRENCY EQUIVALENTS

(as of 24 March 2017)

Currency Unit	–	Canadian Dollar (CAD)
CAD1.00	=	\$0.76
\$1.00	=	CAD1.31

ABBREVIATIONS

ADB	–	Asian Development Bank
CFPS	–	Canadian Climate Fund for the Private Sector in Asia
CFPS II	–	Canadian Climate Fund for the Private Sector in Asia II
PSOD	–	Private Sector Operations Department

NOTES

- (i) The fiscal year (FY) of the Government of Canada and its agencies ends on 31 March. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2008 ends on {day month} 2008.
- (ii) In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. This paper provides information on the establishment of a stand-alone, ADB-managed, single-donor trust fund designed to provide concessional cofinancing for ADB's non-sovereign climate adaptation and mitigation projects. The fund also aims to improve gender equality in private sector climate projects, particularly the empowerment of women and girls. This paper outlines issues relating to the acceptance and administration of contributions for the resources to be received from the Government of Canada, acting through Global Affairs Canada. The fund is referred to as the Canadian Climate Fund for the Private Sector in Asia II ("CFPS II" or the "Fund").

II. BACKGROUND AND RATIONALE

2. The Government of Canada has had a long term relationship with the ADB as a non-regional member since 1966. In recent years, Canada has scaled up its commitments to private sector climate initiatives. Following the 2009 Copenhagen Accord, the Government of Canada committed approximately USD 1.1 billion¹ (CAD \$1.2 billion) in "fast-start financing", a portion of which supported private sector climate initiatives with multilateral development banks including the ADB, the International Finance Corporation and the Inter-American Development Bank.

3. Following this decision, the Government of Canada approached ADB in 2012 to discuss establishing a cofinancing vehicle for private sector climate initiatives using a concessional financing model. As a result of discussions, in March 2013, ADB established a trust fund, the Canadian Climate Fund for the Private Sector in Asia ("CFPS"), with an \$81.5 million contribution² (CAD \$82.4 million) comprised of concessional financing and technical assistance from the Government of Canada. The CFPS was established to provide cofinancing on concessional terms and conditions for ADB's non-sovereign climate related transactions. The CFPS was established under the umbrella of the ADB's Expanded Clean Energy Financing partnership Facility³.

4. Since 2013, the CFPS has been instrumental in financing a number of key ADB non-sovereign transactions. These include the Sarulla Geothermal Power Generation Project in Indonesia, the Adjaristsqali Hydropower Project in Georgia and others currently under processing. The CFPS has also supported a number of pioneering ADB climate mitigation and adaptation technical assistance projects including the Institutional Capacity Building of Indonesia Eximbank Project in Indonesia, the Renewable Energy for Nationwide Telecommunications Project in Myanmar, the regional Climate Friendly Agribusiness Value Chains Development and the Hazelnut Value Chain Development Project in Bhutan.

5. The CFPS concessional loans and technical assistance grants have been successful at bringing private sector transactions to market that would not normally have proceeded on a purely commercial basis. Through this catalytic role, the fund has been successful at crowding in commercial financing from the private sector and other development finance institutions. By addressing some of the early stage risks and other barriers to financing private sponsors, the

¹ Based on 2009 currency conversion rates

² Based on 2013 currency conversion rates

³ This ADB facility houses several trust funds within ADB's Sustainable Development and Climate Change Department and aims to improve energy security and reduce the impacts of climate change in ADB's developing member countries (DMCs) through climate mitigation initiatives.

CFPS has also helped to establish a track record of private sector climate financing in the Asia Pacific region. The CFPS's investment period ends March 31, 2018 and, as of March 2017, is nearing full allocation of resources.

6. Based on the same concessional financing model used for the initial fund, the Government of Canada approached ADB in early 2017 to discuss establishing the Canadian Climate Fund for the Private Sector in Asia II (CFPS II). Canada's contribution to this Fund is part of the Government of Canada's November 2015 commitment to provide roughly \$2 billion⁴ (CAD \$2.65 billion) to support developing countries in their transition to low-carbon, climate-resilient economies.

III. OBJECTIVE AND SCOPE

7. Similar to the first fund (CFPS), the purpose of CFPS II is to support greater private sector participation in climate change mitigation and adaptation in low and lower middle income countries and upper middle-income small island developing states in Asia and the Pacific. The Fund will also seek to promote gender equality and the empowerment of women and girls in projects supported by the Fund.

8. CFPS II will aim to play a key role in helping the private sector overcome development risks (including market risks, technology risks, financing risks, regulatory and other risks) by offering financing on concessional terms and conditions to projects that would not proceed solely on a commercial basis. Concessional financing will be used to help offset cost hurdles and initiate, scale-up and replicate high impact projects in markets that show strong potential for growth. ADB will be judicious in its use of concessional financing resources so as to not distort local markets, and will be guided by a set of principles on the use of concessional finance.

9. The Fund was established as a trust fund, and will provide co-financing alongside ADB's ordinary capital resources for non-sovereign projects. Fund resources will not be used to finance stand-alone transactions, meaning ADB participation will be necessary in all transactions. ADB is responsible for the administration and management of the Fund, including the selection and approval of projects. ADB, acting as trustee of the Fund will be responsible for the origination, processing, approval and monitoring of transactions in accordance with the Fund arrangement. ADB will be the lender of record, or guarantor of record, as applicable, for transactions supported by the Fund.

IV. CONTRIBUTION

10. Global Affairs Canada will make a repayable contribution to ADB for the establishment of the Fund in three tranches for a maximum amount of CAD \$200 million (approximately \$151 million⁵). Global Affairs Canada's first contribution tranche of CAD \$148.5 million (\$110.7 million) was transferred to ADB upon signing of the Fund arrangement. Additional tranches will be conditional upon ADB delivering a logic model and performance measurement framework for the Fund to the satisfaction of Global Affairs Canada and ADB. The contribution will be held by ADB as trustee of the Fund and will be used for financing of eligible projects and to pay for eligible costs and expenses involved in operating the Fund for its expected 25 year lifetime.

⁴ Based on 2016 currency conversion rates

⁵ Based on April 2017 currency conversion rates/ Funds will be converted from Canadian dollars to United States dollars at the time of the receipt of the contribution.

ADB will return to Global Affairs Canada the Fund's reflows according to terms and conditions stipulated in the Fund's arrangement.

V. IMPLEMENTATION AND ADMINISTRATIVE ARRANGEMENTS

A. Eligible Project Types and Development Benefits

11 The Fund will invest in a combination of private sector led climate mitigation and adaptation activities. For mitigation this includes, but is not limited to, clean and renewable energy generation, energy efficiency, transmission and distribution systems for renewable energy projects, process emissions, sustainable transport, waste management and wastewater projects. For adaptation, this includes, but is not limited to, water supply and management, agriculture and forestry, land use management, natural resource management, resilient infrastructure, coastal protection and disaster risk management. Projects supported by the Fund will contribute to increased gender-responsive economic development in eligible countries, and will integrate gender equality outputs.

12 To the extent applicable, projects supported by the Fund will maximize development co-benefits. These may include efforts to: (i) invigorate local economies, (ii) increase the number of incremental jobs in communities, (iii) benefit consumers, (iv) improve health benefits through reduced pollution and (v) improve countries' competitiveness and sustainable development initiatives, including economic diversification.

B. Eligible Countries

13 The Fund will support projects in ADB's low and lower-middle income developing member countries and upper-middle income small island developing states⁶. This includes: Afghanistan, Armenia, Bangladesh, Bhutan, Cambodia, Fiji, India, Indonesia, Kiribati, Kyrgyz Republic, Lao PDR, Maldives, Marshall Islands, Federated States of Micronesia, Mongolia, Myanmar, Nepal, Pakistan, Palau, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Tajikistan, Timor-Leste, Tonga, Tuvalu, Uzbekistan, Vanuatu and Vietnam.

C. Fund Life and Return

14 The Fund has an expected life of twenty five (25) years including an initial investment period of six years, with repayment to Canada starting upon receipt by ADB of the first reflows. Financing will be managed at the portfolio level to a targeted nominal average return (expected at project approval) agreed between ADB and Global Affairs Canada. To ensure a balanced portfolio and avoid concentration risk, the Fund has a series of exposure limits including a single transaction limit, a single country limit, a limit on the amount of mezzanine financing (subordinated debt), and a limit on the amount of unhedged local currency financing.

D. Financing Instruments and Local Currency

15 The Fund has been designed to provide concessional financing in the form of senior loans, subordinated loans, risk participation or other types of debt products offered by ADB. Fund resources will not be invested as equity or any instruments convertible into equity. Similar to the first fund, CFPS II has provision for unhedged local currency financing in some markets

⁶ As determined at the time of establishment of the Fund

subject to an overall ceiling. Unhedged local currency solutions will only be provided in circumstances where the swap market in the relevant country is not mature, or the majority of debt financing for a project is being provided in local currency. The Fund may also provide hedged local currency in circumstances where the borrower is willing to pay for the cost of hedging local currency and where ADB is also providing local currency financing with ordinary capital resource financing. Any foreign exchange loss arising out of local currency solutions related to the Fund's investments will be absorbed by the Fund.

E. Terms and Conditions of Concessional Financing

16 Given the Fund's catalytic purpose, all financing provided using Fund resources will be concessional. ADB will document the terms, conditions and justification for the use of concessional financing on a case-by-case basis in accordance with ADB's policies and procedures for non-sovereign financing. In more detail, concessional financing may:

- (i) be priced below ADB's financing in the same transaction or below market-based lending rates;
- (ii) have longer tenors and/or different repayment profiles than the financing provided by ADB in the same transaction;
- (iii) be subordinated in priority of payment and in any other respects to the financing provided by ADB in the same transaction and/or have different or no security than the financing provided by ADB in the same transaction;
- (iv) upon default, enjoy lesser rights to default interest and to debt recovery than are enjoyed by ADB in the same transaction;
- (v) be used to provide unhedged financing in local currency; and/or
- (vi) be exposed to greater foreign exchange risk than the local currency financing provided by ADB in the same transaction.

17. However, to qualify for funding, proposed projects must also align with an established set of principles governing the use of concessional finance. These include:

- (i) Clear development and economic rationale - there will be clear and monitorable development outcomes for projects financed with concessional resources and documented rationale including factors such as overcoming development risk, perceptions of risk, responding to market distortions and/or addressing "first mover" costs and disadvantages;
- (ii) Additionality – concessional financing will be additional in nature, that is, only used for projects that are in need of a portion of concessional financing for the project to be bankable;
- (iii) Minimum concessionality – financing terms and conditions will be concessional only to the level where projects become acceptable from a risk-reward perspective;
- (iv) Leveraging investment - concessional financing will be provided specifically to crowd-in sustainable non-sovereign financing; and,
- (v) Financial sustainability - concessional financing will seek to temporarily incentivize certain investments and influence markets towards sustainable development outcomes without creating permanent market distortions.

F. Governance and Approval Process

All transactions financed by the Fund will be processed, approved and administered in accordance with ADB's policies and procedures. In addition to ADB eligibility criteria, the use of

the Fund's resources will be subject to the applicable project selection criteria outlined in the Fund arrangement. Fund transactions will generally be processed in tandem with transactions using ADB capital and thus be subject to ADB's standard processes for the selection and approval of non-sovereign projects.

G. Duty of Care and Potential Conflicts of Interest

19 As the trustee of the Fund, ADB will exercise the same duty of care and diligence in the administration and management of the fund as it exercises with respect to other third party resources of a similar nature.

20. ADB will structure transactions using Fund resources in accordance the aforementioned principles for the use of concessional finance. For any Fund transaction that is subordinated to ADB's resources, separate ADB project teams will represent the Fund's resources and ADB's resources so as to actively manage and reduce conflicts of interest and represent Global Affairs Canada's interests to the best of ADB's ability as trustee. In the event of any default, restructuring, or workout, separate ADB project teams will represent the Fund's resources and ADB's resources. However, if it considers it necessary, Global Affairs Canada may appoint an arm's length deal team and/or commercial representation to represent the Fund's interests.

H. Special Reserve

21. ADB will allocate \$500,000 from the Fund's revenue for the establishment of a special reserve. The special reserve may be used to pay for extraordinary third party expenses incurred by ADB in pursuing protective measures, enforcement actions, restructurings, workouts, litigation and/or any other dispute resolution in relation to the Fund. It may also be used to cover the costs of any Global Affairs Canada appointed arm's length deal teams or commercial representation. ADB will have no obligation to undertake litigation or arbitration on behalf of the Fund to recover Fund resources, and ADB will undertake such action only: (a) if ADB considers it consistent with its policies and likely to be effective, and (b) to the extent that the balance of the special reserve is adequate to cover the associated costs. ADB will provide Global Affairs Canada with advance notice of any instance where an action would not be pursued, providing Global Affairs Canada an opportunity to replenish the special reserve.

I. Reporting and Financial Statements

22. ADB will provide reports to Global Affairs Canada on an annual, semi-annual and quarterly basis. Reports will include, *inter alia*, summaries of the Fund's projects and activities, assessment of progress on performance indicators, expected and actual results, progress and efforts made on gender equality, lessons learned and a financial summary. ADB will also provide to Global Affairs Canada audited or unaudited special purpose financial statements annually, as agreed. The cost of preparing and auditing financial statements will be charged to the Fund.

J. Fees and Staffing

23. As trustee of the Fund, ADB will deduct management fees from the Fund to cover costs incurred for fund management including costs associated with the origination, processing, approval, monitoring and evaluation of transactions throughout the Fund's estimated twenty-five year life. ADB's Private Sector Operations Department (PSOD) will manage the Fund, oversee the day-to-day operations and serve as the focal point for communication with Global Affairs Canada. As such, PSOD expects to hire a fund administrator and other personnel as required to

adequately cover the additional workload created by the Fund management. Fees will also be available to other departments within ADB for functions such as risk evaluation and monitoring, legal issues, accounting and treasury functions, human resources, and the assessment of climate and gender benefits.

K. Public Recognition

24. To increase public awareness of the support provided to projects by the Fund, ADB will take appropriate measures to publicize Canada's contribution and support. ADB and Global Affairs Canada will develop a communications and social media strategy to publicize the achievements of the Fund.

L. Termination

25. Under the proposed Fund arrangement, Global Affairs Canada may at any time and upon ninety days' notice in writing, terminate the fund arrangement. In such circumstances, ADB will be entitled to set aside from the Fund's resources adequate funds to offset the costs of such termination.

VI. RISK MANAGEMENT AND MITIGATION

26. Risks to ADB from establishing and administering the fund include the following:

- (i) **Non-deployment of fund commitment.** The risk posed by the failure to deploy the full extent of the fund's resources within the prescribed investment period is mitigated by ADB's relatively long track record of non-sovereign climate finance operations. In addition, the fund's terms will include a provision that will allow for ADB and Global Affairs Canada to extend the investment period, if needed.
- (ii) **Failure to receive the full Fund commitment.** The risk posed by the failure by ADB to satisfy Global Affairs Canada's requirements for the Fund's performance management framework hurdle would mean a portion of Global Affairs Canada's contribution would not be fully realized. This risk is mitigated again by ADB's track record of non-sovereign climate finance operations as well as the additional resources that PSOD will use to hire staff dedicated to the Fund.
- (iii) **Nonperforming loans.** The risk posed by the nonperformance of any loan made by ADB as the trustee of the Fund is mitigated by ADB's comprehensive underwriting process and historically low non-performing loan ratio. Additional care will be taken to ensure concessional financing transactions are monitored carefully to track any potential non-performance.
- (iv) **Conflict of interest.** The risk posed by failing to mitigate and safeguard against potential (or perceived) conflicts of interest from ADB's use of concessional resources from the Fund will be mitigated by the use of separate ADB transaction teams, as necessary.

VII. ADB APPROVAL

27. In accordance with ADB's policy paper on *Enhancing Operational Efficiency of the Asian Development Bank* (15 December 2015) and subsequent delegation of the ADB President's authority (25 April 2016) to Head, Office of Cofinancing Operations (OCO) to approve (i) the establishment of trust funds and financing partnership facilities, and participation in global funding initiatives (not exceeding \$200 million in aggregate at the time of establishment), and (ii) acceptance of contributions from any financing partner, OCO has approved:

- (i) the establishment of the single-donor Canadian Climate Fund for the Private Sector in Asia II (the "Fund") in accordance with this provisions set forth in this paper;
- (ii) the acceptance and administration by the Asian Development Bank of contributions to the Fund from the Government of Canada, acting through Global Affairs Canada, in accordance with the terms and conditions set forth in this paper;

and hereby reports this action to the ADB President and ADB Board of Directors.

PRELIMINARY DESIGN AND MONITORING FRAMEWORK

Impact: the Project is Aligned with:

- Increased private sector development and private sector operations in all operational areas, reaching 50% of annual operations by 2020;
- Increased support for environmentally sustainable development and gender equity, including projects to reduce greenhouse gas emissions and to address climate change;
- ADB's lending portfolio targets and operational goals based on Strategy 2020^a

Results Chain	Performance Indicators with Targets and Baselines	Data Sources or Reporting Mechanisms	Risks
Outcome Increased financing for private sector led climate mitigation and adaptation projects demonstrating improved gender equality	Total finance mobilized by the Fund of \$600 million ⁷ by 31 March 2023 (2016 baseline: 0) 20 million tonnes of greenhouse gas emissions (MtCO _{2e}) will be reduced or avoided over the life of the Fund ⁸ 100,000 beneficiaries will be supported to adapt to the effects of climate change ⁹	CFPS II annual reports CFPS II annual reports CFPS II annual reports	Challenges relating to bankability of climate mitigation and adaptation projects demonstrating improved gender equality in ADB's low and lower middle income countries and SIDS Enabling environments create risks beyond what can be mitigated through concessional finance thereby limiting private sector participation
Outputs 1. Establishment of CFPS II Fund 2. Resources are deployed into non-sovereign climate finance transactions with gender benefits in ADB's low and lower middle income DMCs and SIDS	1a. The CFPS II fund arrangement signed by 31 March 2017 2a. 85% of the capital committed to the Fund is deployed for co-financing of ADB non-sovereign transactions by December 2021 (2017 baseline: 0) 2b. At least 30% of projects supported by the Fund are classified by ADB as having "Some Gender	CFPS II annual financial statements CFPS II annual reports CFPS II annual reports	ADB's non-sovereign operations are not able to accommodate additional financing resources The Fund arrangement constrains the deployment of the Fund's capital with regard to exposure limits and/or eligibility criteria

⁷Actual target dependent on the USD value of Canada's contribution, which will be determined upon payment of each tranche.

⁸ when the Canadian Contribution Instalments total CAD 200 million

⁹ when the Canadian Contribution Instalments total CAD 200 million

	Elements (SGE)", and 20% as "Effective Gender Mainstreaming (EGM)"		
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Key Activities with Milestones
<ol style="list-style-type: none"> 1. CFPS II established <ol style="list-style-type: none"> 1.1 Finalization of Fund arrangement – March 2017 1.2 ADB Approval for the Fund – March 2017 1.3 Signing of Fund documentation –March 2017 2. Resources are deployed into non-sovereign climate finance transactions in ADB's low and lower-middle income DMCs and upper middle-income SIDS <ol style="list-style-type: none"> 2.1 Deployment of the Fund's resources – 2017-2023
Inputs <ol style="list-style-type: none"> 1. CFPS II trust fund: CAD 200 million (approximately \$151 million) 2. ADB co-financing: \$150 million 3. Cofinancing from commercial and other investors: \$400 million 4. Equity from sponsors: \$50 million
Assumptions for Partner Financing Not Applicable

ADB = Asian Development Bank, DMC, Developing Member Country, CFPS II = Canadian Climate Fund for the Private Sector in Asia II

Source: Asian Development Bank.

^a ADB, 2008. Strategy 2020: Working for an Asia and Pacific Free of Poverty Institutional Document, April 2008, Manila. Available online at: <http://www.adb.org/documents/strategy-2020-working-asia-and-pacific-free-poverty>