NAMA Facility

Financial Mechanisms in the NAMA Facility

Financial mechanisms are an important topic as they are at the core of the NAMA funding. This lessons learned fact sheet provides an analysis of the financing mechanisms that have been proposed to the NAMA Facility so far. It may also serve as orientation for future applicants.

Why are the financing mechanisms so important?

The NAMA Facility was designed to finance the implementation of Nationally Appropriate Mitigation Actions (NAMAs). Initially, the underlying assumption was that a sufficient number of developed »implementation ready« projects are already out there waiting for the funding of their ambitious goals. A crucial evaluation criterion for NAMA Support Projects (NSP) is their transformational change potential. Both implementation readiness as well as the transformational change potential heavily relies on the implementation of viable financing mechanisms.

Both terms – implementation readiness and transformational change potential – lack a definition. The NAMA Facility has developed an interpretation for these terms (see »General Information Document« and »Monitoring and Evaluation Framework«) to provide a more concrete understanding of what NSPs should aim at.

- **Implementation readiness** means that a NSP is developed, feasible and ready for implementation. This includes financial mechanisms and sufficient safeguards concerning the contributions from the public and private sector. While a fully defined financial mechanism at the Outline Stage is not expected, it should be detailed enough to ensure that it can be finalized during further project preparation/appraisal and kick in at the beginning of the implementation. Certain projects characteristically lack »implementation readiness« as requested by the NAMA Facility, e.g.:
  - Research activities
  - Technological pilots. It is expected that a pilot has already been done. Ideally, the pilot should not only concern technical feasibility but also the business model as a basis for funding.
  - Outlines proposing the development of financial mechanisms and a business model only during the implementation of the NSP

- **Transformational change potential** is crucial for NSPs. The NAMA Facility defined a set of sub-criteria such as embeddedness in national/sector policies and wider NAMAs, catalytic effect, scalability, replicability and innovation potential. This requires to sustainably reverse/steer the flow of public and private funds towards greenhouse gas (GHG) mitigation actions. The political will and decisions towards GHG mitigation translates into laws and regulations as well as in the reallocation of financial streams: Where are public funds (e.g. subsidies) flowing into? The financing mechanisms of a NSP should kick start this broader reversal of fund flows. Therefore, a financing mechanism is not a secondary feature, but it is at the very core of the NSP rationale.

Financing mechanisms of approved NSP

The Nama Facility has received 138 NSP Outlines in three calls. Some of the selected NSPs from the first call are already under implementation while others are still in the appraisal phase or awaiting approval by the NAMA Facility Board. In many cases, the description of the proposed financing mechanisms has been rather vague and requires further development during the implementation phase. Financial mechanisms proposed in the 1st and 2nd call (9 selected projects) can be categorized as follows:

1. Concessional loans and loan guarantees for financial intermediaries

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2. Small-scale direct investment subsidies/grants to private sector investors
3. Grant funding of public infrastructure or public entities
4. Policy-based lending.

The findings so far are:

- Most NSPs foresee a mix of at least two financing mechanisms targeting different levels of the financial system. Often it is **(1)** concessional loans for users / consumers by setting up a revolving fund and **(2)** grant funding elements either for the public sector or producers / developers / consumers or **(3)** guarantees for banks.
- Some NSPs integrate results-based financing – although on a grant basis which limits the reach and scalability of NAMA Facility funding.
- The financial support mechanisms to be applied cover only a small part of the existing range of financing mechanisms (an overview of potential financial mechanisms is provided in the table below).
- Financial support mechanisms are often not explicitly defined in NSPs, neither at the outline nor at the proposal stage. The same applies to business models/cases that would serve as a basis for the selection of a suitable financing mechanism.

Financing mechanisms in the third call

During the 3rd Call a number of NSP Outlines with more innovative financing mechanisms were submitted such as:

- Concessional loans whose NSP grant element is scaled according to the mitigation potential of the investment
- Concessional loans combined with an insurance scheme (performance guarantee) for the end users, which might be particularly useful for energy efficiency projects
- First-loss funds for energy efficiency investments, which could serve as a kind of guarantee
- Tax subsidies for PPP models related to the operation of utilities (e.g. waste plants)
- Equity funding of private sector initiatives. This approach is generally possible but needs to assure an open, criteria-based and competitive access.

However, these financing mechanisms were presented in most cases as sketches lacking a viable design of a financing scheme and the required **institutional arrangements**. It is difficult to confirm the feasibility of a NSP on this basis.

Financial mechanisms in climate finance

The table below provides an overview of the myriad of potential financial mechanisms for both the public and private sector that could be used in NSPs. The table illustrates that especially for public sector funding there is a great diversity of options in addition to grant-financing.

Instruments of NAMA financing

Public sector sourcing instruments	Public sector operational instruments	Private sector financing instruments
☐ Environmental fiscal reform	☐ Grants	☐ Equity
☐ Loans	☐ Purchase contracts for goods	☐ First-loss (mezzazine, junior debt)
☐ Bonds	☐ Purchase contracts for services	☐ Loans
☐ Dedicated credit lines	☐ Additional payments (e.g. premium price)	☐ Bonds
☐ Risk cover guarantees	☐ Regulation (e.g. feed-in tariff, quotas)	☐ Risk Cover, guarantees
☐ Grants	☐ Public procurement guidelines	☐ Project finance
	☐ Tax credits, reductions/exemptions	☐ Grants
	☐ Variable or accelerated depreciations	
	☐ Removing subsidies	
	☐ Loan schemes	
	☐ Guarantee schemes	

Source: Soren E. Lütken: Financial engineering of climate investment in developing countries, Anthem Press 2014.

What level of detail is expected at the Outline Stage?

Implementation readiness of the financial mechanism is closely linked to the:

- analysis/provision of business models for the typical investment(s)
- reasoning for the selection and description of a particular mechanism
- institutional arrangements
- a reasonable phase-out concept

Business models for typical investments are important because they can show if a NSP has a chance for economic success and sustainability. It provides a basis for the design and selection of a financial mechanism. Not all but many NSPs are based on concessional loans to investors/producers or users/consumers. The question is how an appropriate/balanced incentive can be provided so that beneficiaries will take up the offer, while at the same time the incentives are used efficiently without creating market distortions. In order to make a decision on the appropriate financing mechanism including the share of the grant element, one needs to know the financial/economic determinants of a certain investment, e.g. the life span and the pay-back period under market conditions, the cost of alternatives, etc. That is why a sound analysis of the business model is crucial for setting up financial mechanisms.

The design of an appropriate **financing mechanism** should be based on a business model and on a brief analysis of the specific (financial) market.

Examples:

- The risk of investments for energy efficiency is rather with the investor than with the bank. The risk for the bank only arises if the overall energy efficiency investment puts the economic/financial stability of the investor at risk. In this case, it would be more reasonable to cover the investor's risk, e.g. by an insurance scheme, in order to allow for the investment in technologies with uncertain results.
- A subsidized interest rate for certain investments could employ a number of possible instruments like straight interest subsidies or guarantee schemes. A tax exemption or a subsidy on specific tariffs is possible as well.

It is important to justify the selection of the financing mechanisms on the background of the business model and the respective market conditions. In addition, financing mechanisms should be selected in a way to maximize the use of the grant element by generating high leverage rates.

Institutional arrangements of financing mechanisms are important in terms of national embeddedness, reach and accessibility. The respective entity shall apply fair, transparent and effective selection criteria for beneficiaries and/or intermediaries as well as fiduciary operations, good governance and an efficient and transparent fund management. Transaction costs have to be taken into account for efficiency and sustainability reasons.

Phase-out concept:
NSPs have a life time of max. 5 years. It needs to be clearly depicted how the sustainability, scaling up and replication of the financing mechanisms will be secured. At the end of the life span of the NSP – depending on the financial mechanism – there might be funds left (e.g. in a revolving fund). The institution handling the funds should assure that it will further serve its purpose and thereby upscale the results. There should also be an estimate on how much longer the funds will be available for. E.g. in case of a guarantee or a first-loss fund, how will the default risk be estimated and how much of the initial fund will be left at the end of the project. Ownership and oversight on the funds and their utilization after the NSP should also be depicted. Sustainability of the financial mechanism is a key issue to reach the transformative effect expected by the NAMA Facility.

Recommendations

A future task for all technical and advisory organizations involved in NSP preparation is to consider and integrate financing schemes right from the beginning of the development of a NSP. It is also recommended that NAMA readiness programmes should integrate the financing sector from the very beginning of the NSP preparation.

Financing mechanisms shall be designed in a way to maximize the use of the NAMA Facility's grant funds by creating a high leverage of funds, by being based on realistic and sustainable business models and avoiding to create market distortions.

Countries, advisory organizations, and implementing partners are encouraged to be innovative/creative in designing adequate financial mechanisms for NSPs.

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