Financial Mechanisms

Applications under the NAMA Facility

Factsheet

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

Why are financial mechanisms so important?

The NAMA Facility was designed to finance the implementation of Nationally Appropriate Mitigation Actions (NAMAs), building blocks for Nationally Determined Contributions (NDCs) under the Paris Agreement. Initially, the underlying assumption was that a sufficient number of "implementation-ready" projects were already out there, awaiting funding for their ambitious goals. A crucial evaluation criterion for NAMA Support Projects (NSPs) is their transformational change potential. Both implementation readiness and transformational change potential heavily rely on the implementation of viable financing mechanisms.

The NAMA Facility interprets implementation readiness and transformational change potential, which NSPs should exhibit, (see "General Information Document" and "Monitoring and Evaluation Framework") as the following:

Implementation readiness signifies that an NSP is at an advanced stage of development, is feasible and ready for implementation. While a fully defined financial mechanism at the NSP Outline Stage is not expected, it should be detailed enough to ensure that it can be finalised during the Detailed Project Preparation (DPP) phase.

Certain projects characteristically lack "implementation readiness" as requested by the NAMA Facility, e.g.:

- Research activities
- Technological pilots. It is expected that the viability of a technology has been proven already. 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 has developed a set of sub-criteria such as embeddedness in national/sector policies and wider NAMAs, catalytic effect, scalability, replicability and sustainability. This requires projects to sustainably steer the flow of public and private funds towards greenhouse gas (GHG) mitigation actions. The political will and decisions taken towards GHG mitigation translates into laws and regulations, as well as into the reallocation of financial streams. In which areas or activities do such public funds (e.g., subsidies) flow? The financing mechanisms of an NSP should kick start this broader reversal of fund flows. Therefore, a financing mechanism is not a secondary feature; rather, it is at the very core of the NSP rationale.

Financial Mechanisms of Approved NSPs

The NAMA Facility received 476 NSP Outlines by Ambition Initiative – Round Two (as of June 2022). In many cases, the description of the proposed financing mechanisms has required further development during DPP, and in some cases, adjustment during the Implementation Phase. Financial mechanisms can include the following approaches or tools:

1. Concessional loans and loan guarantees for financial intermediaries
2. Small-scale direct investment subsidies / grants to private sector investors
3. Grant funding of public infrastructure
4. Result-based financing for private sector.

The findings so far are:

- Most NSPs foresee a combination of at least two financing mechanisms targeting different levels of the financial system. Often, the combination involves (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) loan guarantees for financial intermediaries.
- Some NSPs integrate results-based financing, albeit on a grant basis, which limits the scalability of NAMA Facility funding; however, this type of financing mostly supports changes of systems that aim to increase the NSP's impact over time.
- 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). financing mechanism.
- Details regarding the financial support mechanisms are not fully defined at the NSP Outline stage. The same applies to business models/cases that would serve as a basis for the selection of a suitable

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 with respect to public sector funding, there is a great diversity of options in addition to grant financing.

What type of detail is expected at the NSP 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; and
- a reasonable phase-out concept.

Business models for typical investments are important because they can determine if a NSP has a chance for economic success and sustainability. They can provide a foundation for the design and selection of a financial mechanism. The key question is how an appropriate or balanced incentive can be provided so that beneficiaries will take up the offer. At the same time, the incentive ought to be used efficiently without creating market distortions. Making a decision on the appropriate financing mechanism requires the proper identification of any financial/economic determinants of a particular investment, e.g. the life span and the pay-back period under market conditions and the cost of alternatives. Therefore, a sound analysis of the business model is crucial to setting up financial mechanisms.

Financing Instruments of the NAMA Facility

Public sector sourcing instruments	Public sector operational instruments	Private sector financing instruments
• Environmental fiscal return	• Grants	• Equity
• Loans	• Purchase contracts for goods	• First-loss (mezzanine, 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 tarrif; 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

The design of an **appropriate financing mechanism**, requires the proper identification of any financial/ economic determinants of a particular investment, e.g. the life span and the pay-back period under market conditions and the cost of alternatives. Therefore, 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 lies 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. through an insurance scheme, in order to allow for the investment in technologies with uncertain results;
- A subsidised interest rate for certain investments could employ various possible instruments, such as 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 basis of the business model and the respective market conditions. In addition, financing mechanisms should be selected in a way that will maximise 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 responsible entity/entities 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 must be taken into account for efficiency and sustainability reasons. During Implementation Phase I, all institutional arrangements shall be put in place for the successful implementation of the financial mechanism(s).

Phase-out concept: NSPs have a lifetime of up to 60 months (or an equivalent of 5.5 years). It must 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). Therefore, the institution handling the funds should ensure that it will further serve its purpose and thereby upscale the results. There should also be an estimate of how much longer the funds will be available (e.g., in the case of a guarantee or first-loss fund), how the default risk will 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 utilisation after the NSP should also be depicted. risk will 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 utilisation after the NSP should also be depicted. Sustainability of the financial mechanism remains a key issue to reach the transformative effect expected by the NAMA Facility.

Recommendations

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

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

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

For more information
on the NAMA Facility, scan me!

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