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CONCESSIONAL LOAN OPTIONS
(Submitted by the World Bank)

Concessional Lending for ODS Phaseout

1. This paper examines the administrative feasibility of concessional lending through mechanisms which would provide the best and most effective service to enterprises that are phasing out the consumption of Ozone Depleting Substances (ODS).

Background and Objectives

2. The Executive Committee (ExCom) of the Multilateral Fund for the Implementation of the Montreal Protocol (the Fund) has, on a number of occasions, indicated the need to consider the use of concessional lending (or an analogous lending mechanism) as a means of leveraging the limited resources available through the Fund. Concessional lending was also implicitly considered to be an effective method of providing the needed resources to enterprises whose projects were inherently profitable, but which could not initiate implementation due to shortage of capital or lack of incentive.

3. Furthermore, in assessing the extremely limited lending experience of the Fund (in the one case of on-lending) and the need to further leverage the Fund's limited resources, the Study on the Financial Mechanism of the Montreal Protocol (the "Cowi report") recommended a step-wise procedure to explore the potential benefits of the concessional loan provision. The first step in this recommended procedure is that, "the implementing agencies wishing to become involved in the provision of concessional loans should be encouraged to take a stronger interest in promoting the concept; this should be accompanied by incentives for them to develop projects for loans and for their direct or indirect loans administration".[1]

4. Consequently, as requested by the ExCom at its 16th Meeting, the World Bank is examining the concept of concessional lending for ODS phaseout operations from its perspective as an implementing agency of the Fund. The basis for this request is the ExCom's policy that concessional loans may be provided for investment projects with short payback periods and/or with net incremental savings[2]. In addition, the ExCom has also encouraged the provision of concessional loans from other financial institutions such as Regional Development Bank, national development banks and commercial banks as well for projects that are ineligible for Fund financing but which will achieve ODS phaseout[3].

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[1] UNEP, Study of the Financial Mechanism of the Montreal Protocol, COWIconsult, March 1995., para 638.

[2] UNEP/OzL.Pro/ExCom/3/18/Rev.1, and UNEP/OzL.Pro/13/42.

[3] UNEP/OzL.Pro/ExCom/13/47 (para 176).

5. The principle objective of this paper is to identify and evaluate concessional-lending mechanisms within the framework of the Montreal Protocol, and to assess these mechanisms for their operational feasibility.

6. The legal and administrative feasibility of these mechanisms are assessed in terms of the legal obligations and requirements of the Multilateral Fund and the Bank, and the operational changes required to implement such mechanisms.

Rationale for Concessional Lending

7. The ExCom has sought to establish a concessional lending mechanism in order to overcome the credit squeeze faced by enterprises in financing the non-grant component of ODS phaseout project costs. The current practice of the ExCom is to compensate the incremental phaseout costs at the enterprise level through grants. Within the framework of this current practice, ExCom guidance seeks to restrict concessional lending to ODS-phaseout project costs that are otherwise eligible for Fund support, and loan amounts to the non-grant component of project cost. These would largely cover those amounts that have been deducted from the total incremental cost because of incremental operating savings. Loans could also be considered for projects where the grants are much smaller than the eligible incremental costs because of deductions due to multinational ownership, exports to non Article-5 countries, etc.

8. Apart from this issue, loans are generally considered preferable to grants because the economic discipline associated with repayment necessitates that project objectives be realized efficiently and expeditiously. The enterprise then has a vested interest in ensuring that the ODS phaseout project costs are minimized, and that the substitute technology is efficient and reliable. These would maximize the impact of the Fund's resources, as well as ensure that the phaseout is technologically and commercially irreversible.

Legal and Policy Framework

9. The Montreal Protocol, with the London and Copenhagen Amendments, requires the Multilateral Fund to meet the agreed incremental costs of phasing out ODS production and consumption in Article-5 countries. This implies that the Multilateral Fund has to compensate countries for the incremental costs associated with ODS phaseout. Consequently, concessional loans cannot be viewed as alternatives to Multilateral Fund grants to Article-5 countries, unless specifically agreed to by the Parties to the Protocol.

10. Within this context, and the current practice of the ExCom to compensate incremental costs of phaseout at the enterprise level, the concessional lending mechanism can be appropriately utilized to finance the non-grant component of phaseout project costs.

11. An alternative mechanism could establish concessional onlending facilities in the Article-5 countries through incremental-cost grants to these countries (rather than to

enterprises in the countries). The countries could offer a mix of grants and/or concessional loans to enterprises as incentives for effective and expeditious phaseout. The only case of concessional lending of resources provided by the Multilateral Fund (in Turkey for a domestic refrigerator conversion project) utilized a mechanism of this type.

Implementation of the Concessional Lending Mechanisms

12. There are potentially two types of concessional lending mechanisms. The challenge in developing these mechanisms is that they meet the basic needs of the Article-5 countries and participating enterprises, while utilizing the operational efficiencies that have been developed over the last three years of MP operations. It is therefore desirable that a concessional lending mechanism have the following characteristics:

- given the scarcity of Multilateral Fund resources, a concessional lending mechanism should leverage available resources.
- given the processing efficiencies gained over the last 3 years, the concessional lending mechanism should utilize existing processing procedures and require minimum amendments to agency-ExCom agreements or other aspects of the legal framework now covering the flow of funds from the Multilateral Fund to participating enterprises.
- the spirit of the Montreal Protocol and the Multilateral Fund should be maintained through any type of concessional lending arrangements.

The two types of mechanisms are evaluated here in terms of their administrative feasibility, particularly in the perspective of these characteristics.

<u>Interest-Buydown Grants to Enterprises</u>

13. The concessional lending provided by the Multilateral Fund would be in addition to the current practice of providing grants for eligible incremental costs. In such a case, an enterprise would receive both a grant for incremental project cost, as well as the facility to avail of the concessional lending mechanism for the non-grant component of the project cost.

14. In order to provide a concessional lending facility, the Multilateral Fund would, at the very least, have to provide the resources to buydown part of the market-interest on any loan taken by an enterprise for ODS phaseout; this buydown is what would make the loan concessional. The rationale for this concessional lending mechanism is the shortage of credit in the country, and the consequent high interest rates of borrowing capital. The interest buydown should correspond to the difference in the national and international costs of capital to reflect the incremental opportunity cost to the national economy.

15. The key financial feature of concessional lending is the buy-down of market interest; the source of the loan itself does not necessarily have to be the Multilateral Fund. The effectiveness of Multilateral Fund resources would be maximized by utilizing the Fund resources to only provide an interest buydown grant in order to leverage the entire loan amount from financial institutions.

16. The World Bank provides financial sector and/or environmental sector loans to countries which express interest in this area. These loans are utilized to establish onlending facilities for eligible enterprises in these countries. These sectoral onlending facilities can be utilized to provide loans to finance ODS phaseout projects as well. In countries where there are no World Bank industrial sector loan programs, the national financial intermediaries could be asked to establish a consortia of financial institutions that could provide loans to enterprises for ODS phaseout projects at nationally-competitive rates of interest for such projects.

17. In China, the National Environmental Protection Agency has been facilitating the provision of loans from the China Investment Bank for the non-grant component of ODS phaseout project costs from a World Bank environmental sector loan.

18. After negotiating a loan (but before finalizing it), the enterprise could present a proposal for an interest buydown grant to the Multilateral Fund. On approval, the grant would be channeled through the national financial intermediary, and disbursed in synchronization with the loan repayment.

19. This implementation of this mechanism would require the establishment of a new process for approving interest-buydown grants. However, the process can be accommodated within the existing operational mechanisms and agreements, and no operational changes would be required. No significant change in administrative costs is expected; the costs of the financial intermediary may increase but that increase will probably be absorbed in the cost of the national loans.

National Grants for On-lending Facilities

20. This mechanism combines the economic discipline associated with loans, with the Montreal Protocol agreement to compensate countries for the incremental costs associated with ODS phaseout. This mechanism would be appropriate for use with national sectoral (or subsectoral) ODS phaseout strategies which are backstopped by legal and/or market-based instruments to ensure time-bound sectoral/subsectoral phaseout.

21. The Multilateral Fund would provide an agreed grant to a country to cover the incremental costs of ODS phaseout in specific sectors/subsectors. The country would establish an onlending facility (through a financial institution, probably the national financial intermediary) to provide a mix of loans and/or grants to eligible enterprises. Other financial institutions could also be drawn into this facility to provide loan capital, and the government could also provide capital for loans/grants.

22. This mechanism would be most appropriate for sectors in which the economic benefits of ODS phaseout are not completely captured by the enterprises, e.g., aerosol filling, foam blowing, etc.; or, in which common costs (testing equipment, training, etc.) are a major component of the sectoral costs, e.g., recycling, halon banking, etc.; or, in which there are a very large number of small enterprises.

23. The implementation of this mechanism would require a further upgrade of the ODS phaseout management capacity within the Article-5 countries, and the establishment of new operating procedures within the countries. These will result in administrative cost increases; but, to a large extent, these increases will be absorbed in the cost of the national loans. Some increase in the cost (particularly that associated with the monitoring and evaluation of the sectoral strategies) is expected to be passed on to the Multilateral Fund. However, much larger savings in administrative costs will result from the transfer of project preparation and review responsibilities from the Multilateral Fund Secretariat and the Implementing Agencies to appropriate national institutions.

Conclusions and Recommendations

22. Two different mechanisms for concessional lending are feasible: providing interest-buydown grants to enterprises (in addition to incremental-cost grants) on non-Multilateral Fund sourced loans for the project cost component not covered by the grant; and providing sectoral incremental-cost grants to Article-5 countries for concessional onlending to enterprises. Neither of these mechanisms requires any changes in the operational structure and agreements between the Multilateral Fund, the Implementing Agencies, and the Article-5 countries. No increase in overall administrative costs is expected. The latter mechanism would, however, require major operational changes at the country-implementation level.

23. The Interest-Buydown Grant mechanism would require the ExCom to consider the operational issues associated with larger grants to projects. Operational guidelines for calculating the interest-buydown grant, and for processing the grant request would need to be prepared; and the enhancement of the scope of responsibilities of the financial intermediaries would need to be defined.

24. The National Onlending Facility mechanism would require identification of countries and sectors where this mechanism can be utilized advantageously, followed by discussions on strategy preparation and implementation with the countries. The ExCom may wish to establish broad guidelines for the implementation, and the monitoring and evaluation of such strategies.