The Three Country Energy Efficiency Project

Making Delivery Mechanisms for Bank Financing of Energy Efficiency Work

Final International Cross Exchange

Jeremy Levin

World Bank

May 19, 2006

Challenge and Findings

- Key challenge: development and sustained operation of EE financing mechanisms
  - Marketing/project development, technical and financial requirements
  - Key source of sizeable and sustainable finance is the local banking sector

- This presentation covers the key issues identified during the 3CEE project for establishing the following types of programs
  - Programs in partnership with local banks
  - Guarantee Programs
  - DFIs/Special Revolving Funds

View From Local Banks

- Energy Efficiency lending represents a small niche business
- Project finance based upon negative cash streams/cost savings is non-conventional practice
- Banks lack familiarity with energy efficiency technologies
- New lines of business must fit in with existing procedures
- Customer relations are important
- Transaction costs for small projects is a key issue

Dealing with Banking Systems/Markets in transition and under development

- Policy and operating environment may be severely distorted
  - Record of FI projects under these conditions is poor
  - May require alternative interventions until sector metrics improve

Working with Local Banks

- Programs must **begin** with identification of local financial intermediaries interested in EE lending
- Design program that conforms with their specific business interest and market strategies
  - SMEs, targeted industry sector, housing sector, equipment financing, etc
- In many cases, some energy efficiency investments are financed with existing bank products
  - Modification/tailoring can expand market and increase uptake

How EE lending may be attractive to Local Banks

- Bank interest in EE Programs
  - Narrow market, or….
  - Tool to meet broader strategic objectives
    - Enter/strengthen position in specific market or business line
    - New product for existing customers--Strengthen existing relationships and improve asset quality
    - Corporate social responsibility/good citizen
  - Outside donor/govt. programs can offer additional support to local bank institutions
    - Gain experience with new international product offerings
    - TA to develop mechanisms, partial guarantee to reduce risks, performance incentives

EE Lending through Local Bank Schemes

- Key focus is recognize and define the cost-reducing negative cash flows and incorporate these benefits in appraisal and securitization process
- Structure loan repayment to match project cash flow
- Can use other options to mitigate repayment risk
  - Escrow accounts, performance guarantees, ESCO aggregated projects, program to recover payments through utility bills

Partial Risk Guarantees

- Recent success of Multilateral Programs
  - emerging lessons from programs recently launched (Hungary, China) have provided useful experience
- High country interest in replication
  - Can defray risk- very useful for new concepts such starting EE lending where perceived risk > actual risk
  - Could be critical to development of EE market in Brazil
- But…not a panacea
  - May not address main barriers

Guarantee Fund Characteristics

- Provides a partial guarantee to participating financial institutions against default
  - Allows for significant leveraging of funds
  - Many types of guarantees offered
    - First loss/pari-pasu
    - Single transaction vrs portfolio
    - Many types of arrangements for who operates the fund
  - Market-based fee charged for coverage
    - May not cover full program costs
  - Standard security arrangements

Guarantee Fund Programs

- Useful when
  - Banking system functions well
    - healthy competition and experienced institutions
  - Good liquidity and availability of medium term funding
    - Attractive interest rates
  - Energy prices provide correct incentives
  - Potential market is large
  - Good market capacity to deliver EE projects

Use of DFI and Revolving Specialized Funds

- Publicly owned (IREDA, CECIC)
  - Or public/private
- Advantages of this Option
  - Concentration/specialization on energy efficiency lending
  - One-stop shop
  - May be only option in sectors where financial sector is not-optimal (ie mid-structural shift, partial reforms,)
- Disadvantages
  - Procedurally cumbersome
  - May not be flexible enough to adapt to changing market conditions
- Dilemma
  - products become commercially accepted-high initial risks but DFI may not be able to compete with local commercial finance sector (and gain from low risk and transaction costs if lending is scaled up) once initial experience is gained

Key Principles for New Financing Mechanisms

- Program must provide for all functions of project cycle
- Careful Diagnostic Review at outset, followed by customized institutional approach
- End-user clients should face commercial terms

Diagnostic review

- Includes a review of the following:
  - Financial sector situation, local capacities, energy efficiency market, govt/donor activity and experience, local contracting/legal framework
- Match approaches to market needs
  - Liquidity and access to lending
  - Interest rates/Macro situation
  - Incentives
  - Project development capacity
- Different sectors will require different specialized credit products

Commercial terms

- Commercial returns provide the key foundation for market sustainability
  - Key driver for end users is the underlying cost-effectiveness of the EE investment
  - Subsidies can provide good demonstration, but ultimately can distort market, allowing only limited participation (further limited by amount of available subsidy resources)—the target ee market is often too large
  - Good justification for use of subsidies/grants to launch new institutional mechanism
    - (ie higher transaction costs during start up, buy down risks to enter new markets, pilot new approaches and products, ta)
  - May be associated societal benefits which support use of long term subsidy but must have longer term government support for this decision

New financing programs catalyzed as a result of the 3CEE project

- India
  - State Bank of India Project Uptech for Energy Efficiency
  - Followed by programs at Canara Bank, Union Bank, Bank of India, Bank of Baroda
- China
  - New World Bank Onlending Program
- Brazil
  - PROESCO Scheme