ADAPTATION FUND

AFB/PPRC.32/21
10 October 2023

Adaptation Fund Board
Project and Programme Review Committee
Forty- first Meeting
Bonn, Germany

Agenda Item 13.

DRAFT GUIDANCE ON OPTIONAL COFINANCING IN THE CONTEXT OF THE ADAPTATION FUND BASED ON THE CURRENT INTERPRETATION OF THE FULL COST OF ADAPTATION

Introduction

1. This draft guidance document on optional cofinancing in the context of the Adaptation Fund (the Fund) has been prepared for consideration by the Project and Program Review Committee (PPRC), following discussions held on paper AFB/PPRC.29/41, during the twenty-ninth meeting of the PPRC and the subsequent Adaptation Fund Board (the Board) decision B.38/40. Specifically, the Board decided:

(a) To request the secretariat to develop, through a consultative process, guidance on optional cofinancing based on the current interpretation of the full cost of adaptation, which, inter alia:

(i) Defines the scope and parameters for Adaptation Fund cofinancing;
(ii) Identifies the suite of financial instruments that can be utilized;
(iii) Outlines pathways to address potential risks;

(b) To present the draft guidance for the consideration of the PPRC at its thirty-first meeting.

Decision B.38/40

2. The draft guidance document builds on previous work presented to the PPRC, specifically *"Proposal clarifying the scope of application of the full cost of adaptation reasoning criterion"* (document AFB/PPRC.20/4); *"Update on the scope of application of the full cost of adaptation reasoning criterion"* (document AFB/PPRC.22/25); *"Note on the process for updating the full cost of adaptation reasoning"* (document AFB/PPRC.27/3); and *"Full cost of adaptation reasoning and cofinancing*" (document AFB/PPRC.29/41).

Background

Context: Adaptation finance is insufficient

3. One of the key messages reported by United Nations Environment Programme (UNEP), through its 2022 Adaptation Gap report, similarly to previous such reports, is that international adaptation finance flows to developing countries are 5-10 times below estimated needs and that the gap continues to widen. The report suggests that "without a step change in support, adaptation actions could be outstripped by accelerating climate risks, which would further widen the adaptation implementation gap[1]". Additionally, the cost estimated for adaptation needs is USD 160-340 billion annually by 2030[2].

4. The gap between the current levels of adaptation and the current levels needed to respond to the adverse effects of climate change is in part attributable to limited adaptation finance. In view of this, it is critical that the impact of adaptation financing is broadened. This is especially important in climate sensitive sectors where investments for development, whether public or private, dwarf the public adaptation finance. For this reason, developing country governments have long utilized various cofinancing approaches to scale up the impact of their climate change adaptation projects financed by Green Climate Fund (GCF), Global Environment Fund (GEF), or Climate Investment Fund (CIF) resources. Through optional cofinancing the Adaptation Fund has

[1] UNEP, 2022, Adaptation Gap Report 2022, Key messages https://wedocs.unep.org/bitstream/handle/20.500.11822/41080/AGR2022_KMEN.pdf?sequence=10
[2] Ibid.

an opportunity to generate adaptation benefits potentially much greater than from the Adaptation Fund investment only.

5. The Sharm el-Sheikh Implementation Plan, adopted by the Conference of the Parties of the United Nations Framework Convention on Climate Change (UNFCCC) at its twenty-seventh session (COP 27) through decision 1/CP.27, noted “with serious concern the existing gap between current levels of adaptation and levels needed to respond to the adverse effects of climate change in line with findings from the contribution of Working Group II to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change” (IPCC AR6).[3] The summary and recommendations of the fifth biennial assessment and overview of climate finance flows conducted by the UNFCCC Standing Committee on Finance and presented at COP 27, reports that private finance mobilized through multilateral and bilateral channels between 2016-2020 was skewed towards mitigation (86 percent) of USD 66.8 billion. The report further indicates that, resources for adaptation concentrated on mining and construction industries with SIDS and LDCs receiving one percent and eight percent respectively of total private finance mobilized.[4]

6. There has been an increasing consensus that mobilizing private sector is critical to funding adaptation. This is evident through efforts such as the Adaptation and Resilience Collaborative initiative whose members committed to “support the public and private sector collaboration needed to (a) assist developing countries with identifying and articulating their adaptation needs and potential private sector opportunities to address these, and (b) create the conditions for accelerating private sector finance for the adaptation and resiliency solutions required to deliver their country and/or sub-national level adaptation plans and strategies[5].”

COP decisions and Adaptation Fund policies and guidelines

7. The Fund was established with the mandate to finance concrete adaptation projects and programmes in developing countries that are Parties to the Kyoto Protocol (KP) through a decision of the COP of the UNFCCC[6]. Subsequently the COP serving as the Meeting of the Parties to the KP (CMP) also decided that one of the principles of the Fund would be to provide “funding on full adaptation cost basis of projects and programmes to address the adverse effects of climate change”[7]. This decision is reflected in paragraph 14 of the Strategic Priorities, Policies and Guidelines of the Fund (SPPG) adopted by the CMP[8]. The Operational Policies and Guidelines for the Parties to Access Resources from the Adaptation Fund (OPG) also contains the language. While the decisions by the COP and CMP above do not explicitly elaborate the rationale for the full-cost principle, it is understood that it was seen as closely related to the concept of Common-But-Differentiated-Responsibilities (CBDR) contained in the UNFCCC (1992), and the perception that should cofinancing be required, it might constitute an impediment for developing countries' access to finance.

[3] FCCC/CP/2022/10/Add.1, Decision 1/CP.27, V. Adaptation, paragraph 20

[4] FCCC/CP/2022/10/Add.2, Decision 14/CP.27, Annex * Summary and recommendations of the fifth Biennial Assessment and Overview of Climate Finance Flows, paragraph 25

[5] Global Center on Adaptation , 2021, Adaptation and Resilience Collaborative presents new plan to the G7 to increase the resilience of economies threatened by the climate emergency, https://gca.org/news/adaptation and resilience collaborative.

[6] Decision 10/CP.7, FCCC/CP/2001/13/Add.1

[7] Decision 5/CMP.2, FCCC/KP/CMP/2006/10/Add.1, para 1 (d)

[8] Decision 1/CMP.4, FCCC/KP/CMP/2008/11/Add.2, para 6 and annex IV

8. Paragraph 15 of OPG defines full cost of adaptation as “the costs associated with implementing concrete adaptation activities that address the adverse effects of climate change[9].” It also indicates that “the Board may provide further guidance on financing priorities, including through the integration of information based on further research on the full costs of adaptation and on lessons learned[10]. Consequently, providing justification for funding requested, focusing on the full cost of adaptation reasoning forms part of the project and programmes proposal submission template and instructions as indicated in OPG Annex 5, Part II section I entitled “Provide justification for funding requested, focusing on the full cost of adaptation reasoning”.

9. OPG Annex 5, Part II paragraph I, indicates that “[t]he Adaptation Fund does not require cofinancing for the projects and programmes it funds. The principal and explicit aim of the projects and programmes should be to adapt and to increase resilience of a specific system or communities, to the adverse effects of climate change and variability. Therefore, the proposal should demonstrate that the projects and programmes activities are relevant in addressing its adaptation objectives and that, taken solely, without additional funding from other donors, they will help achieve these objectives.” At the same time, it also indicates that, although cofinancing is not required, it is possible and often cost-effective to implement Adaptation Fund projects in parallel with projects funded from other sources. In such a situation, the Adaptation Fund project should be able to deliver its outcomes and outputs regardless of the success of the other project(s). It is possible to include activities which, taken out of context, could be considered “business-as-usual” development but these should be justified in the context of achieving the adaptation goals of the project.

Board decisions and results of further work requested by the Board

10. At the nineteenth meeting of the PPRC, a proposal for enhancing capacity of Micro, Small and Medium Enterprises (MSMEs) in the agriculture sector, and their resilience to climate change through the provision of financial and non-financial services was presented. The proposal indicated that the project was to be funded partly by a grant from the Fund and partly cofinanced through loan with twenty percent of the loans to be refunded through an Adapt-Award incentive scheme funded by the Fund. This proposal was not approved by the Board, as reflected in decision B.28/22, which indicated that the proposal did not meet the criterion of full cost adaptation reasoning. The proposal which was presented indicated that the Fund-financed component would be highly dependent on the successful implementation of the cofinanced element, thereby failing to meet the requirement outlined in the OPG Annex 5, Part II paragraph I, which states that the Adaptation Fund project should be able to deliver its outcomes and outputs regardless of the success of other project(s). The Board requested that the Secretariat present a proposal for consideration by the PPRC at its twentieth meeting clarifying the scope of application of the full cost of adaptation reasoning criterion (decision B.28/33).

11. Following decision B.28/33, the pros and cons of four options, on the approach to understanding the full cost of adaptation in the context of cofinancing were presented. The options presented were as follows:

> Option 1: Status Quo (For proposals with cofinanced adaptation activities, the Adaptation Fund component should be able to deliver on its related outcomes and outputs regardless of the success of the cofinanced component).

[9] Operational Policies and guidelines for Parties to access resources from the Adaptation Fund (OPG), amended October 2022, https://www.adaptation-fund.org/wp-content/uploads/2017/08/Amended-OPG_Oct-2022_2.pdf
[10] Ibid.

Option 2: The Board could fund proposals with cofinanced adaptation activities, for which the delivery of the Adaptation Fund component' outcomes and outputs could be tied with the delivery of the cofinanced component.

Option 3: The Board could fund proposals with cofinanced adaptation activities, for which the delivery of the Adaptation Fund component's outcomes and outputs could be tied with the delivery of the cofinanced component, under certain conditions.

Option 4: Status quo (For proposals with cofinanced adaptation activities, the Adaptation Fund component should be able to deliver on its related outcomes and outputs regardless of the success of the cofinanced component) and request the secretariat to perform an analysis of the full costs of adaptation.

12. Through decision B.29/3, the Board reconfirmed the definition of "full cost of adaptation" as stated in the OPG (re-stated in paragraph 8 above) and requested the Secretariat to "perform an analysis and collect lessons learned on how the full costs of adaptation has been applied by the Fund and make recommendation on the way forward including potential further conceptual development of applying the full costs of adaptation."[11]

13. Through decision B.31/23, the Board requested the Secretariat to prepare an analysis of the full-cost-of-adaptation-reasoning criterion considering the views of stakeholders and the Medium-Term Strategy (MTS) of the Fund. Subsequently, through decision B.36/29, the Board requested the Secretariat to develop a report including elements for defining the scope of application of the full cost of adaptation reasoning criterion, taking into consideration the programmatic developments of the Fund and to conduct this work in a two-step manner.

14. Further to this, the Secretariat engaged Board members, Implementing Entities (IEs), Designated Authorities (DAs), Fund's CSO Network and other climate funds, on the consideration of cofinancing in Fund-supported projects and programs. A survey administered to support the elaboration of a paper on the full cost of adaptation reasoning and cofinancing, which was presented as AFB/PPRC.29/41, showed that 67 percent of survey respondents expressed an openness to the Fund pursuing cofinance as an option. They also recognized its role in broadening the scope and maximizing the impact of projects, as well as potentially increasing the level of ownership of projects[12].

15. The report on full cost of adaptation reasoning and cofinancing (document AFB/PPRC.29/41) indicates that cofinancing can refer to grant and non-grant financial instruments and, in some cases, in-kind contributions from communities and governments which are used to support project implementation. The document presented three options for consideration as follows:

Option 1 – *Status quo* – for proposals with cofinanced adaptation activities, the Fund's project component should be able to deliver on its related outcomes and outputs regardless of the success of the cofinanced component.

[11] Report of the Twenty-ninth Meeting of AFB (14-17 March, 2017), paragraph 37, https://www.adaptation-fund.org/wp-content/uploads/2017/06/AFB-B-29-report-final-approved.pdf
[12] AFB 2022, Document AFB/PPRC.29/41, *Full Cost of Adaptation Reasoning and Cofinancing*.

Option 2 – Maintaining the status quo with the provision of guidance on cofinancing.

Option 3 – Major changes to the current interpretation of full cost of adaptation in relation to cofinancing.

16. Through decision B.38/40 the Board requested the Secretariat to develop, through a consultative process, guidance on optional cofinancing based on the current interpretation of the full cost of adaptation which is consistent with option 2 of paragraph 15 above and to elaborate the elements set out in paragraph (a) and (b) of the decision, as stated in paragraph 1 of this document.

17. Importantly, the Adaptation Fund's MTS Implementation Plan (MTS-IP) introduces windows that may also be served by leveraging non-public resources. As the Fund considers its continuing relevance within this rapidly evolving context, engagement with private sector in adaptation action, and an exploration of the issue of cofinancing is timely.

Cofinancing Typology

18. Cofinancing is commonly utilized in the areas of international sustainable development and development finance. Within the realm of climate finance, it is used to maximize the impact of limited resources, by leveraging additional finance and to catalyse climate impact and sustainability of project outcomes. Cofinancing is usually considered to be spent during the implementation period of a project or programme. Some organizations have set a desired cofinance ratio. In other organizations, the cofinancing amount is left to be proposed by the project proponent. Where funds have already been expended, these are sometimes considered baseline financing. Although various definitions of cofinancing are proffered in the development community, the development community recognizes two main distinctions namely, parallel and joint cofinancing.

19. The first modality is ***parallel cofinance*** which operates to support the implementation of a project alongside another project or programme. This could mean that a main project can be divided into separate parts and the various parts can be funded in parallel by different funders[13]. It could also mean funds being invested to separate projects with related outcomes[14]. With parallel cofinance separate rules may govern the implementation of the project which is financed alongside the main project depending on the terms agreed by the parties.

20. Parallel cofinance or "operating alongside another project or programme" often does not require that the activities funded in parallel will be occurring at the same time. At times, components being financed by parallel cofinance may be already undergoing implementation, and, at times, their implementation begins some time after the intervention funded by primary financing. In such cases, the function of the parallel cofinance may lean more towards serving as "baseline" or "scale-up" finance, respectively.

[13] ADB, 2023, "What is the difference between joint cofinancing and parallel cofinancing" https://www.adb.org/business/how-to/what-difference-between-joint-cofinancing-and-parallelcofinancing#:~:text=In%20parallel%20cofinancing%2C%20the%20project,on%20untied%20or%20tied%20terms.

[14] GCF/B.24/17, Annex XXVIII: Policy on cofinancing

21. The second modality is ***joint cofinance***. In the case of joint cofinance, funds from different sources will be combined with each other to finance various activities within the same project or programme.

Cofinance in the context of Adaptation Fund project and programmes

22. Several Adaptation Fund projects have included parallel co-financing: either as money invested by another organization, or as an in-kind contribution. In such cases, the technical review of the proposal for that project has ensured compliance with OPG Annex 5, Part II paragraph I. No Fund project has been financed through joint cofinance: this would not have been practically possible in accordance with the existing OPG guidance.

23. One of the considerations with cofinance is the application of policies by the different contributing organizations. Should parallel cofinance be applied to a Fund's project, this could mean that the additional funds presented to support the Fund's project or programme may not be governed by the Fund's policies since the Fund would not have decision authority over either the projects or components of the project funded by the parallel finance.

24. In this sense, there may be risks associated with this type of cofinance. For instance, a component of a broader intervention that is financed independently would not be subject to Adaptation Fund's safeguards, unless the other organization would voluntarily agree to take it upon itself to comply with them. Should such a component result in a violation of the Adaptation Fund's Environmental and Social Policy, this could expose the cofinanciers – Adaptation Fund included – to reputational risk. It is also relevant to note that the risk may also vary depending on the sequencing of the parallel cofinance vis-à-vis Fund-financed intervention, i.e. there may be a different level of risk involved, as well as possible risk-management measures, depending on whether the Fund's investment is implemented before, during or after that of the parallel cofinance. The sequencing, size, and specific focus or approach of the parallel cofinance may all have a bearing on whether the Fund-financed project or component of the overarching intervention should be able to deliver its outcomes and outputs regardless of the success of the other project(s) (or components). The level of risk, including safeguards risk, overall project risk and other areas of risk, can be gauged to certain degree during the review of the project proposal. However, the residual risk – one that could not be identified and mitigated during the review of the proposal – is much more difficult to manage during project implementation in the case of investments funded through parallel cofinance, compared to activities funded by the Adaptation Fund itself, since the Fund does not have, by default, direct influence on the risk management of the other organization.

25. In the case of joint cofinance, in which funds are effectively merged, it would not be feasible to distinguish different policy regimes to govern different elements of investment. Therefore, the same policy regime would need to be applied to all elements, which would mean that for the Fund to be able to contribute to such joint cofinance, the Fund's policies, guidelines and procedures, as a minimum, would need to extend to govern the administration of the joint funds – including non-Adaptation-Fund funds – by the implementing entity. Jointly cofinanced projects or programmes would need to be fully compliant, *inter alia*, with the Fund's Environmental and Social Policy, as it may not be possible to ensure in a jointly cofinanced project or programme that Fund's funding alone will be compliant otherwise. This may serve as a deterrent for providing joint cofinance, if the administrative requirement cannot be met for any reason (e.g. policy, legal, administrative or technical). At the same time, it is possible that there are categories of projects where the risk to violating the Fund's ESP policy differs. For example, a low-risk Fund project that

is topped up with additional funding to continue the interventions over time may not be a significant ESP risk. Moreover, Fund's projects that have unidentified sub-projects (USPs) as key elements defer much of the work around ESP risk assessment for the interventions to the implementation stage, after the identification of USPs has taken place, which means that adding cofinancing to the intervention would not necessarily add to the cofinancier's administrative burden.

26. Likewise, it is possible that different types of projects and different windows may not all have the same risk of non-delivery of Fund-financed project or component of the overarching intervention, should the cofinancing fail to materialize. For example, projects that are primarily or exclusively designed around devolved finance mechanisms, including small grants for innovation or locally-led adaptation, could simply be more scaleable – whether upwards or downwards – without essentially compromising the delivery of the intended outcomes of the intervention.

27. Further discussion of risk is presented in the section "*Parameters for optional cofinancing and pathways to address potential risks*" below.

28. It is notable that cofinancing is readily used by the Fund's IEs and DAs in their engagement with other organizations and that there are several definitions of cofinancing proffered by various agencies with which DAs and IEs are familiar. For instance:

- The GEF defines cofinancing as "financing that is additional to GEF Project Financing and supports the implementation of a GEF-financed project or program and the achievement of its objective(s)"[15].
- The GCF defines cofinancing as "the financial resources required, whether public finance or private finance, in addition to the GCF proceeds to implement funded activity for which a funding proposal has been submitted"[16], and
- The UNFCCC defines cofinancing as "use of development capital (public sector or philanthropic) to mobilize commercial capital (private sector) toward investments in sustainable development"[17].

Proposed Adaptation Fund Definition of Cofinancing

29. In light of the OPG and particularly its Annex 5, it is clear that the word "parallel" as used in OPG Annex 5 leaves room for interpretation. The guidance contained therein focuses on the need to ensure that the Fund project will be viable, even when the cofinancing does not materialize, but does not elaborate between different types of cofinancing or their preferability. Furthermore, it could be argued that Adaptation Fund projects with joint cofinance, given that they would be subjected more thoroughly to the Fund's safeguards are perhaps more likely to deliver on their outcomes and outputs.

30. The existing instructions on the full cost of adaptation reasoning stipulate that cofinancing is not required but possible on an optional basis and often considered cost-effective:

> *"Although cofinancing is not required, it is possible and often cost-effective to implement Adaptation Fund projects in parallel with projects funded from other sources."*

[15] The GEF 2018, Updated cofinancing policy, GEF/C.54/10/Rev.01, https://www.thegef.org/sites/default/files/council-meeting-documents/EN_GEF.C.54.10.Rev_.01_Cofinancing_Policy.pdf
[16] GCF 2019, Policy on cofinancing, https://www.greenclimate.fund/sites/default/files/document/policy-cofinancing.pdf
[17] UNFCCC 2023 "What is climate finance" https://unfccc.int/topics/introduction-to-climate-finance

31. While the possibility of cofinancing and its potential benefit for cost-effectiveness are acknowledged, the instructions also include the following specification and caveat, which has also been referred to during the technical review and/or Board consideration of the relevant proposals:

> *"In such a situation, the Adaptation Fund project should be able to deliver its outcomes and outputs regardless of the success of the other project(s)."*

32. This part of the instructions has been interpreted in essence as a requirement that cofinancing or the cofinanced activities should not constitute a risk for the delivery of the concrete adaptation outcomes and outputs of Adaptation Fund-funded activities, compared to the situation where Fund funding alone is used – for example, should the expected cofinancing fail to materialize or pose other risks to the achievement of activities financed by the Fund. This understanding is further supported by the following instruction:

> "*The principal and explicit aim of the project/programme should be to adapt and to increase resilience of a specific system or communities, to the adverse effects of climate change and variability. Therefore, the proposal should demonstrate that the project/programme activities are relevant in addressing its adaptation objectives and that, taken solely, without additional funding from other donors, they will help achieve these objectives.*

33. To provide further clarity on this issue definitions for optional cofinance in the context of the Fund are proposed in the "*Guidance on Optional Cofinancing in the Context of The Adaptation Fund*", contained below in this document.

Interpretation of the Full Cost of Adaptation reasoning in the context of cofinancing

34. The existing instructions on the full cost of adaptation reasoning explained in paragraphs 7-11 above, being relatively general, have not provided as clear as possible guidance for application, which may have contributed to the technical review of proposals adopting a cautious approach (see for example Decision B.28/22 as discussed in paragraph 10 above).

35. To provide clearer guidance, the Board could outline how proposals with cofinancing should provide information on how to manage potential risks. This has not yet been specified in the instructions on the full cost of adaptation reasoning.

36. Furthermore, the formulation in OPG Annex 5, Part II paragraph I, that the proposal should demonstrate that the adaptation project activities, without additional funding from other donors, "*will help*" in achieving the adaptation objectives of the project/programme, can be understood to mean that the Fund's project alone is expected to help achieve the adaptation objectives, which can be complemented by other relevant parallel projects and cofinanced activities. It can also be understood that a funding proposal to be submitted to the Fund is not prohibited from including cofinancing as long as it can contribute to the adaptation objectives and its successful delivery does not affect the achievement of the goals of the Fund-financed activities.

37. It should be noted that in certain types of cofinancing – for example in the case of baseline financing – where the point "regardless of the success of other projects" becomes moot. Where the funding has already been expended, either fully or to a sufficiently large extent, any risk to an intervention financed by the Fund that builds upon the baseline is easier to assess.

Cofinancing instruments utilized by Adaptation Fund Stakeholders

38. Through a survey of the Fund's stakeholders conducted in 2022, the following cofinancing instruments were identified as those most commonly used by the respondent stakeholders. As such, this paper builds on the previous work presented to the Board and aims to define those types of cofinancing previously considered by the Fund's stakeholders.

a. **Grant** refers to transfers made in cash, goods or services for which no repayment is required.[18]
b. **Guarantee** - A financial guarantee is an agreement that guarantees a debt will be repaid to a lender by another party if the borrower defaults. A third party acting as a guarantor promises to assume responsibility for a debt should the borrower be unable to keep up on its payments to the creditor.[19]
c. **Concessional loan** refers to transfers for which repayment is required,[20] and has a measure of the "softness" of a credit reflecting the benefit to the borrower compared to a loan at market rate.[21]
d. **Equity**: Equity finance is a method of raising fresh capital by selling shares of the company, in the primary market, to public, institutional investors, or financial institutions. The buyers are referred to as shareholders of the company because they have received ownership interest in the company.[22]

39. In addition, non-financial cofinance such as technical assistance and in-kind contributions from communities, governments and NGOs, or other agencies participating in the project or programme are also reported as part of project support according to the survey. In-kind contributions refer to non-monetary contributions through goods, services and skills which support projects and programmes. They typically resemble grants in that no direct return is expected on the provision of the in-kind contribution. Unlike grants made in money, however, the specific value of the in-kind contribution is subject to interpretation. Technical assistance is defined by the World Bank as "the transfer or adaptation of ideas, knowledge, practices, technologies, or skills to foster economic development, and which can be classified as policy development, institutional development, capacity building, and project or programme support.[23]

Benefits and challenges in utilizing cofinancing

40. There are positive aspects to incorporating cofinancing, the most obvious of which is increasing impact.

41. Cofinancing can lead to long term results and positive environmental, social and developmental impacts in addition to fostering positive partnerships.[24]

42. Cofinancing also results in increased ownership of project outcomes when certain instruments are utilized and risks thereby shared. In the case of projects which include

[18] https://www.oecd.org/dac/dac-glossary.htm#Grant accessed 8th February 2023
[19] https://www.investopedia.com/terms/f/financial-guarantee.asp accessed February 2023
[20] https://www.oecd.org/dac/dac-glossary.htm#Loans accessed 8th February 2023
[21] https://www.oecd.org/dac/dac-glossary.htm#Concessionality 8th February 2023
[22] https://economictimes.indiatimes.com/definition/equity-finance accessed 18th February 2023
[23] The World Bank, 1997 Applying economic analysis to technical assistance projects https://documents1.worldbank.org/curated/zh/676101468766768234/pdf/multi0page.pdf , accessed 8th August 2023
[24] GEF 2020 - GEF/C.59/Inf. 07 "Progress Report on the Implementation of the Updated Cofinancing Policy"

communities mobilizing cofinancing resources, there can be better ownership of project outcomes and deliverables.

43. Cofinance presents a market-building opportunity in developing countries for adaptation where market instruments such as equity is utilized.[25] This may also encourage private sector engagement and participation where the appetite for investments is enhanced by risk-sharing instruments.

44. Cofinance can also be used to de-risk public and private sector investments. For instance, the Fund grant funding could serve as a concessional element under a loan portfolio structure to unlock lending and investment aimed at innovative climate action for Micro Small and Medium Enterprises (MSMEs) and infrastructural investments. The risk associated with an investment that is funded by two or more sources is moderated and shared among those sources, which can be an effective hedging strategy, particularly for interventions with a higher-risk profile.

45. Cofinancing can be challenging to mobilize, and within desired time frames.

46. For instruments which are readily utilized to attract the private sector such as equity investment, there may be low interest if the requirements are seen as being too onerous[26].

47. Cofinancing may not readily flow into the sectors and initiatives that need it. Some sectors of adaptation such as water resources management and agriculture are more attractive for private sector and other cofinanciers.

<u>Cofinancing in Adaptation Fund portfolio</u>

48. In the context of the Fund's portfolio, cofinancing has mostly been reported during project implementation through PPRs and not at design stage. Over the years, the Fund has received proposals which referenced various types and uses of cofinancing including grants from the Fund being used to fund a subsidiary project to a larger programme; cofinancing utilized in parallel to other programmes; in-kind (non-cash) contributions from communities and governments and grants from the Fund being used to climate-proof initial investments.[27]

Applicability of cofinance in the context of the Fund

49. It would be beneficial for the Fund to elaborate in a holistic and inclusive way an approach to optional cofinancing, both joint and parallel. The approach should allow countries the flexibility on if and how cofinancing will be used in the context of the concrete adaptation action supported by the Fund. This would be consistent with the OPG's statement that "the Board may provide further guidance on financing priorities, including through the integration of information based on further research on the full costs of adaptation and on lessons learned"[28].

[25] OECD 2023, Summary report CoP-PF4SD Conference: Time to step up private finance for the SDGs
[26] Document AFB/PPRC.29/41, *Full Cost of Adaptation Reasoning and Cofinancing*.

[27] AFB 2022, Document AFB/PPRC.29/41, *Full Cost of Adaptation Reasoning and Cofinancing*.
[28] Operational Policies and guidelines for Parties to access resources from the Adaptation Fund (OPG), amended October 2022, https://www.adaptation-fund.org/wp-content/uploads/2017/08/Amended-OPG_Oct-2022_2.pdf

50. In view of the Fund's mission to foster "country-driven adaptation projects and programmes, innovation, and learning with concrete results at the local level that can be scaled up", cofinancing is particularly relevant in the context of the MTS 2023-2027 and its implementation plan. Cofinance instruments such as guarantees and concessional loans can be used by the Fund's IEs in a catalytic and demonstrational way when applying for resources under the Action and Innovation pillars of the Fund. Under the Action pillar, for example, guarantees can de-risk a national development bank wishing to invest in adaptation measures despite the perceived high risk among borrowers and their intended investments. Table 1 explores further possible ways in which cofinancing can be utilized in the context of the Fund.

Table 1: Possible utilization of cofinancing under MTS IP 2023-2027

Indicative examples of cofinance under Adaptation Fund (AF)			
Pillars	**Cofinancing type (instruments/in-kind)**	**Project examples/possible uses**	**Role of AF resources**
Action	In-kind	Community land or public land used to implement adaptation activities (agriculture, EBA, etc)	AF grant to support concrete adaptation activities on area allocated by public or community
	Concessional funding	MDB concessional loan to support deploy smart agriculture products to small holder farmers through local MFI	AF grant mobilized to public entities to setup a smart agriculture financing instruments and capacity building for local smallholders in partnership with local microfinance (MFI)
	Guarantee	Government guarantee to local banks or MFI to offer micro-loans to support adaptation activities (agriculture or EBA for example). AF Guarantee issued to a National Bank or national development bank that has adaptation development interests similar to AF could mobilize public capital to work more inclusively.	AF funding to support EBA or agriculture adaptation activities that can be scaled up by micro-loans guaranteed by government. AF funding could through a guarantee reduce high collateral demands, increase loan tenor periods, and potentially also lower interest for debt finance for national financial institutions' on-lending for adaptation purposes.
Innovation	Guarantees Loans Equity Grants, In- kind	**Small innovation grant** Strengthening of a Replicable Micro Ecosystem for Accelerated Development of Technologies for Climate Change Adaptation of the Dominican Republic - Phase I - Disruptive Modular Dynamic Floating Breakwater Technology submitted by Instituto Dominicano de Desarrollo Integral (IDDI) in 2021 to support entrepreneurial innovation. and testing both in lab and in situ and enabling redesign along the way is an innovative form of Research and Development.	Engaging Private sector at the local level to develop innovative technology. AF funds could serve as funded guarantee capital to de-risk a commercial financial institution's on-lending in climate change adaptation technology.

Indicative examples of cofinance under Adaptation Fund (AF)			
Pillars	**Cofinancing type (instruments/in-kind)**	**Project examples/possible uses**	**Role of AF resources**
		Large innovation grant: (endorsed concept) Unlocking investments in gender and youth-inclusive early-growth stage adaptation Small and Medium-sized Enterprises in Kenya and Uganda to fulfill the potential of adaptation Small and Medium Enterprises to provide cost-effective and localized adaptation solutions to vulnerable communities in Kenya and Uganda.	De-risking investment for Private sector and to facilitate transitioning SMEs from early to growth stage.
Learning	In-kind	Mobilize in-kind contribution (human resources) by government to expand AF project learning components through dissemination of KM products or digitalization of AF funded training as e-learning courses. Example Armenia Digital Education innovation project	Develop the Knowledge Management, e-learning and other training products.

Innovation window

51. Advancing adaptation under the innovation window of the Fund which seeks to “accelerate, encourage and enable innovation for effective, long-term adaptation to climate change”, would benefit from utilization of monetary cofinancing. Under the Medium-term Strategy II (2023-2027), the innovation pillar outlines four expected results at the strategy level. Expected result 1 & 2 as follows:

- New innovations and risk-taking encouraged and accelerated: Development of innovative adaptation practices, tools and technologies encouraged and accelerated, including solutions with high impact potential even if it comes with a higher risk of failure;

- Successful innovations replicated and scaled up: Innovative adaptation practices, tools technologies that have demonstrated success in one country spread to new countries/regions or are scaled up from smaller to larger scales.

Therefore, the innovation pillar both implicitly expects to rely on cofinancing for replication and scaling up, while explicitly allowing for undertaking riskier approaches in order to achieve solutions with high impact potential, which could also include approaches related to cofinancing. For example, allowing cofinance for both the small innovation grants under AFCIA and the large innovation grants, can exponentially increase the impact, scale and scope of Fund projects and programmes, by leveraging additional resources through new partnerships.

52. Already, the innovation window has received proposals with the potential for scale up and for cofinancing possibilities of replicated projects including:

- "Unlocking investments in gender and youth-inclusive early-growth stage adaptation Small and Medium-sized Enterprises in Kenya and Uganda" seeks to fulfil the potential of adaptation Small and Medium Enterprises to provide cost-effective and localized adaptation solutions to vulnerable communities in Kenya and Uganda, submitted by UNIDO.

- Innovative Financial Incentives for Adaptation in wetland livelihoods (IFIA) which seeks to to pilot, systematize learning and institutionalize financing instruments for scaling up adaptation in coastal livelihood activities (e.g., eco-aquaculture, eco-tourism, and non-timber forest products – NTFP – from mangroves), including through incentivizing private sector engagement with small-scale coastal producers in joint innovation processes in adaptation technologies. This proposal was submitted by IFAD for Vietnam.

53. Adaptation Fund projects can also come alongside an investment opportunity for the private sector (including MSMEs) which may encounter high collateral demands, deposit requirements, and high interests rates (in formal and informal financial market) to access debt finance, Fund resources could here be used to de-risk the investment under the innovation pillar. For instance, grant funding could be used to incentivize adaptation action through the private sector by de-risking its investments and mobilizing additional capital through innovative financial instruments, such as guarantees.

Guidance on optional Cofinancing in Adaptation Fund Projects and Programmes

54. The following draft guidance for optional cofinancing is presented for consideration by the PPRC. While developed without prejudice to specific investments, it is very relevant given the level of ambition in the MTS 2023-2027 Implementation Plan, which includes the introduction of new windows and the current global landscape on urgent adaptation needs and calls for scale up resources.

55. The draft guidance seeks to comply with the Board requirements in decision B.38/40. The three broad areas requested to be addressed were: (i) defining the scope and parameters for adaptation cofinancing; (ii) identifying the suite of financial instruments that can be utilized and (iii) outlining pathways to address potential risks. Based on the linkages with parameters and pathways to addressing potential risk the information is presented below in the following sections: (i) Scope of optional cofinancing in the Adaptation Fund (ii) Financial instruments acknowledged as cofinancing in Adaptation Fund projects and programmes and (iii) Parameters for optional cofinancing and pathways to address potential risks.

<u>Definitions of optional cofinancing in the Adaptation Fund</u>

56. ***Cofinance*** *refers to funding resources that are additional to the Adaptation Fund project or programme funding and that contribute to the effectiveness, efficiency, and/or sustainability of the outcome of the Fund's projects and programmes. Cofinancing can be in the form of parallel cofinancing or joint cofinancing.* <u>*All cofinancing in the context of the Adaptation Fund is optional, and the provision of cofinancing will not be used as a factor to prioritize projects over one another.*</u>

*57. **Joint cofinance** refers to the funding from other sources that are combined with the Fund's resources to finance activities and components with the same project or programme proposal submitted to the Fund.*

*58. **Parallel cofinance** refers to funding for project activities and components provided by the IE or other identified sources as presented in project/programme proposals submitted to the Fund and that contribute to the objectives of the project/programme through distinct activities, or to those of other, complementary projects/programmes in a broader framework but which are administered separately from the Fund's funding of the project or component.*

Scope of optional cofinancing in the Adaptation Fund

59. The scope for optional cofinance in the context of the Adaptation Fund is proposed to be along the following lines:

a. Optional cofinancing in the context of Fund projects and programmes refers to monetary or non-monetary contributions, presented as either parallel or joint financing.

b. Whereas optional parallel cofinancing will not be subject to Fund OPG and ESP and GP, unless the cofinancing organization would voluntarily agree to take it onto itself to comply with them, optional joint cofinancing will always be subject to Fund's OPGs, ESP and GP.

c. Optional cofinancing can be presented for single country or regional projects under all funding windows.

d. Optional cofinancing may be presented in project proposals submitted by all IEs of the Fund.

e. All Fund projects and programmes shall be given equal treatment, regardless of whether they are cofinanced or not cofinanced. Projects and programmes that are not cofinanced should not be impacted directly nor indirectly in favor of cofinanced projects and programmes.

Financial instruments acknowledged as optional cofinancing in Adaption Fund projects and programmes

60. The following financial instruments can be utilized in the context of optional cofinancing for projects financed by the Fund subject to their compliance with these guidelines. Expansion of the suite of financial instruments can be considered by the Fund at a later time. The definition of these financial instruments are as described in the "*Cofinancing instruments utilized by Adaptation Fund Stakeholders"* section of this paper.

a. Grants
b. Guarantees and
c. Concessional loans

61. In addition, non-financial types of cofinancing such as technical assistance, in-kind contributions from communities, governments and NGOs, or other agencies participating in the project or programme can also be utilized.

Parameters for optional cofinancing and pathways to address potential risks

62. The Fund recognizes the parameters and risk mitigation pathways to guide cofinanced projects and programmes presented in table two below.

Table 2: Parameters and risk mitigation pathways to guide Adaptation Fund cofinanced projects and programmes

Parameters and risk mitigation pathways for optional cofinancing in Adaptation Fund (AF) Projects and Programmes	Applicability for cofinancing type	
	Parallel Financing	Joint Financing
Optional cofinancing: All cofinancing mobilized under AF funded projects are mobilized on an optional basis only and not at the request of the AF.	☒	☒
Cofinance sources: Cofinancing may be drawn from public, private or multilateral sources. The project proponents may provide more than one type of cofinancing to support the project and/or programme, provided that the required information and "**Clarity of information related to cofinancing proposed"** section below is submitted to the AF.	☒	☒
Secured cofinancing: IEs presenting cofinanced projects must provide evidence of commitment of the cofinanced amount, outlining any uncertainties related to commitment. This should be submitted along with the proposal package to the AF for consideration at the fully developed proposal stage.	☒	☒
Mandatory reporting on cofinancing: IEs should report cofinancing amount at each stage of project from design and implementation including: • Expected cofinancing at design stage: IEs should include in project documents at design stage and fully-developed proposal) the amount of cofinancing based on ex-ante estimation (preconcept, concept note) and commitment letters (fully-developed proposal). • Change in cofinancing amount during implementation stage: IEs should report at any stage of project implementation through PPR any change on the estimated amount of expected cofinancing including as part of the mid-term evaluation and project results tracker. • Realized cofinancing at completion stage: Upon completion of project, IEs should report as part of final PPR, results tracker and completion summary report the amount of cofinancing amount that has been realized.	☒	☒
Compliance with OPG: The IE should ensure that projects proposed as being cofinanced through joint financing arrangements will demonstrate commitment and ability to comply with the Operational Policies and Guidelines of the AF. Although compliance with the Fund's risk management framework is not required for parallel financing, unless the other organization voluntarily agrees to take it onto itself to comply with it, the IE will be required to present the risk management framework to be applied for the parallel financing, with the expectation that it is either functionally equivalent with that of the AF or that it complies with international best practices. The adequacy of the risk management framework for the parallel financing will be assessed during the review of the project proposal presented for consideration by the Adaptation Fund.	☐	☒

Parameters and risk mitigation pathways for optional cofinancing in Adaptation Fund (AF) Projects and Programmes	Applicability for cofinancing type	
	Parallel Financing	Joint Financing
Compliance with ESP and GP: The IE should ensure that in projects proposed as being cofinanced through joint financing arrangements, the cofinanced component will comply, as a minimum, with the most recent environmental and social policy as well as most recent gender policy approved by the AF Board throughout all the project/programme implementation phases, including design, execution, monitoring and evaluation. The Board may consider exceptions for joint cofinanced projects with a compelling rationale for inclusion of private sector investment. Although ESP and GP compliance is not required for parallel financing however, IE will be required to demonstrate to the AF that the parallel financed project presents a risk management framework that is either functionally equivalent with that of the AF or complies with international best practices.	☐	☒
Absence of minimum cofinancing amount: The AF will not establish a minimum cofinancing threshold for proposed projects. The IE may propose cofinance amount based on the scale and impact which is agreed upon between the IE and DA for the proposed project.	☒	☒
Contribute to sustainability: The IE should ensure that the proposed cofinanced components of the project will demonstrate sustainability of the project outcomes beyond the AF contribution.	☒	☒
Contribute to scale up of AF grant outcomes: The IE should demonstrate in its proposal, how the cofinanced component of the project contributes to scalability and/or replicability of the project outcomes. This can include, inter alia, indicating if the cofinanced components forms part of a scalability framework or other arrangement, or if the design of the project lends itself to being scalable or replicable.	☒	☒
Clarity of information related to cofinancing proposed: The IE should work with the DA and the EE (if applicable) to ensure that all project/programme proposals (pre-concept, concept, proposal document) with cofinancing component(s) contain full information on the cofinancing component including; a. Cofinancing amount b. Cofinancing instrument c. Source of cofinancing amount d. Component(s) of the project to which the cofinance will be applied. e. Cofinance commitment letter or signed agreement related to the cofinanced amount. f. In the case of in-kind cofinancing an indication of estimated cofinancing amount should be provided. g. For parallel financing, which are not subject to AF OPG, ESP and GP, unless the other organization voluntarily agrees to take it onto itself to comply with them, the IE will be required to present the risk management framework to be applied for the parallel financing, with the expectation that it is either functionally equivalent with that of the AF or that it complies with international best practices.	☒	☒
Alignment with national policies: The IE should illustrate how the cofinancing is in line with the national adaptation plans and other relevant instruments of the country.	☒	☒

Parameters and risk mitigation pathways for optional cofinancing in Adaptation Fund (AF) Projects and Programmes	Applicability for cofinancing type	
	Parallel Financing	Joint Financing
The IE should also ensure that arrangements for cofinancing comply with national policies relevant to cofinancing of projects and programmes.		

Proposed recommendations

63. Having considered the guidance document on optional cofinancing in the context of the adaptation fund based on the current interpretation of the full cost of adaptation, and given B.40/72 which seeks to facilitate the implementation plan for the MTS 2023-2027, the Project and Programme Review Committee (PPRC) may want to consider the following options and make a recommendation to the Board:

64. **Option 1**

(a) To approve the "*Draft guidance on optional cofinancing in the context of the Adaptation Fund*" as contained in document AFB/PPRC.32/21;
(b) To approve the cofinancing definitions as presented in the draft guidance;
(c) To request the secretariat, with a view to operationalizing optional cofinancing in the context of the entire portfolio of the Adaptation Fund;

(i) To review the Fund's standard legal agreement in the context of the Fund's project with cofinancing component, and report on the progress of this review at the 33rd Project and Programme Review Committee (PPRC) meeting;
(ii) To review the Fund's project proposal template and project review criteria contained in the Annex 5 to the Fund's Operational Policies and Guidelines (OPG) as well as the project performance report template and report on the progress of this review at the 33rd PPRC meeting.

(d) To request the Secretariat to explore, through a consultative process, options for mobilizing cofinancing, including from private capital sources, and to report on the progress to the 33rd PPRC meeting.

65. **Option 1 bis**

(e) To request the Secretariat to explore, through a consultative process, the establishment of a suitable approach which may incentivize private sector to support the projects of the Fund, including additional arrangements required for operationalization, and to report on the progress to the 33rd PPRC meeting.