GREEN
CLIMATE
FUND

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GCF/B.22/15/Rev.01

20 February 2019

Review of the amounts to be set aside for the operating costs of the Green Climate Fund and the foreign exchange commitment risk buffer for solvency risks

Summary

This document presents, for the Board's consideration, the amounts to be set aside for the operating costs of GCF for 2020 and the foreign exchange commitment risk buffer for solvency risks.

The Budget Committee has reviewed this document and is presenting to the Board for its consideration a draft decision included in Annex I for Board consideration.

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I. Introduction

1. Through decision B.21/14, the Board noted that the timing of the first replenishment process of GCF is still to be decided, it would be prudent for the Board to make provision for the operation of GCF through 2019 and into early 2020 out of the remaining GCF commitment authority for the initial resource mobilization. This will provide assurance to GCF stakeholders that critical functions, such as the ongoing work of the Board, the Secretariat, the independent units and the Trustee the delivery of the Readiness and Preparatory Support Programme and the implementation of the Project Preparation Facility (PPF) will continue uninterrupted.

2. The Board, via decision B.21/14, paragraph (f), requested the following:

> the Budget Committee to present to the Board for its consideration at its twenty-second meeting a draft decision covering a set-aside for the operating costs of the Green Climate Fund (including administration of the Board, Secretariat, Trustee, and independent units) and foreign exchange commitment risk buffer for solvency risks for 2019 and 2020 as required;

3. The “commitment authority” refers to the level of resources available for funding decisions, which typically refers to the total amount of actual cash in the GCF Trust Fund plus the promissory notes deposited in a designated custody account, minus net funding commitments (cumulative funding approvals minus cash disbursed) at any given point in time.

4. Solvency risk refers to inability of GCF to meet its financial commitments due to a shortfall in its available funds relative to its commitments. GCF will take all necessary measures to avoid any solvency events during its operations.

5. As an operating entity of the Financial Mechanism of the United Nations Framework Convention on Climate Change, GCF receives financial contributions in a variety of currencies from contributors. Until the twenty-first meeting of the Board (B.21), GCF made its financial commitments in United States dollars and euros. Due to the changes in the foreign exchange rates the value of contributions fluctuate compared to the currencies in which the funds financial commitments are made. These variations may be substantial, especially in periods of high foreign exchange rate volatility. In order to ensure that GCF is able to meet its financial commitments, the Board, via decision B.19/04, required the fund to maintain a risk buffer. The foreign exchange commitment risk buffer will mitigate the solvency risks related to the fluctuations in the exchange rates.

II. Linkages with other documents

6. This document has actual or potential linkages with the following items:

(a) “Initial Risk Management Framework and adoption of a risk register” (decision B.12/34);

(b) “GCF risk management framework” (decision B.17/11);

(c) “GCF risk management framework” (decision B.19/04); and

(d) “Analysis of options for the financial planning of the commitment authority of the Green Climate Fund for the remainder of the initial resource mobilization period, 2019, and 2020” (document GCF/B.21/33/Rev.01).

III. Analysis of operating costs of GCF for 2020 and foreign exchange commitment risk buffer for solvency risks

3.1 Operating costs of GCF for 2020

7. At B.21 via decision B.21/09, the Board approved an administrative budget of the Green Climate Fund for the period 1 January 2019 to 31 December 2019 in the amount of USD 72,568,002, which included 30,278,395 in new funding, as well as the USD 42,289,607 for 2019 staff salaries and emoluments that were approved by the Board in decision B.18/12. In the same decision, the Board also approved USD 48,517,729 for projected staff salaries and emoluments for 2021.

8. The Board via decision B.18/12 approved an administrative budget of the GCF for the periods 2019 and 2020 in the amounts of USD 42,289,607 and USD 44,107,723, respectively, to cover estimated staffing costs.

9. At B.21, the Board also approved the 2019 budget of the independent units as follows:

(a) Budget of the Independent Redress Mechanism amounting to USD 1,161,220 via decision B.21/10;

(b) Budget of the Independent Evaluation Unit (IEU) amounting to USD 4,502,800 via decision B.21/11; and

(c) Budget of the Independent Integrity Unit amounting to USD 2,300,000 via decision B.21/12.

10. In summary, the Board has already approved the 2019 operating costs of GCF and also partly approved the operating costs of 2020 and 2021 i.e. related to the staff costs of the Secretariat. As shown below in table 1, the additional amount to be set aside is the amount needed for the operating costs of 2020 minus the amount already approved by the Board towards the staff costs for 2020.

11. The amounts proposed to be set aside herewith are not an approval of the 2020 operating cost budget. A detailed budgeting exercise, along with the work program, for 2020 will be undertaken by the Secretariat and independent units and presented to the Board at its last meeting of 2019.

12. Please note that the proposed amount to be set aside does not include the compensation payments on the projects, as may arise. There are four scenarios under which liabilities could arise. These are as follows:

(a) Recommendations for compensation payments to project-affected persons or communities made by the Independent Redress Mechanism to the Board under its updated terms of reference, and accepted by the Board;

(b) Additional costs of conducting problem-solving or compliance reviews by the Independent Redress Mechanism as a result of the filing of complaints or reconsideration requests beyond the number and level of complexity estimated in the Independent Redress Mechanism's annual budget;

(c) Legal liabilities arising from potential lawsuits filed against GCF, as GCF does not enjoy privileges and immunities in all countries; and

(d) Other liabilities arising out of other risks generally managed by the Office of Risk Management and Compliance.

13. To derive the 2020 operations costs, the following main assumptions are made:

(a) Staff costs for 2020 are calculated based on the assumption that 250 staff will be employed for the full year; As opposed to the earlier year's when a substantial portion of staff costs were budgeted for less than 12 months, in 2020, it is assumed that all the 250 staff will be on board for 12 months in the year;

(b) Costs for Board operations, consultancies, travel costs, office utilities and other operation costs will remain at the level approved in 2019, save for inflation adjustments; Inflation adjustments have been made at 3% as normal budget practice;

(c) Secretariat Contractual services, communication and information and communication technology costs will increase by at least 5 per cent as the organization moves further into the implementation phase. Professional service firms that provide assistance to the Secretariat are budgeted under the line item contractual services. Related assistance supplements the substantive work programme in areas where it is more efficient to hire outside assistance than it is to procure full time staffing. It is expected that more funds will be required for external counsel, to document GCF impact and other activities during the implementation phase; and

(d) The Trustee services will increase by about 10 per cent from the 2019 approved budget given the increase in activities in the implementation phase.

14. For the budgets of the independent units, the following assumptions are made:

(a) The IEU budget for 2020 caters for four evaluations that are part of the promised IEU work program. It includes a budget for increasing the IEU staff by two more professional staff, bringing total staff strength to 14. Professional services include procuring services for four evaluations, including LORTA (learning oriented real-time impact assessment). It also includes the IEU Geographic Information System (GIS) analyses capabilities in its data lab. This includes bringing expertise in house to analyse GIS data as well as geocode GCF interventions. The travel budget includes field missions for its professional staff as well as a small meeting of IEU stakeholders to build their capacity in creating better measurement systems. It also includes building communication platforms and caters for some additional equipment costs, which the IEU is being asked to pay for;

(b) As the organization starts implementing and matures, it is projected that there will be an increase in complaints both within the organization and outside the organization hence the reason for the extra provision. The increase projected for the IIU is USD 0.45 million. The increase in these activities will require increased support of external investigators on an ad hoc basis, translations fees for complaints received, transcription services, and need for more Investigation IT tools;

(c) The increase projected for the IRM is USD 0.34 million. This includes a provision of USD 0.25 million (22% of 2019 budget) towards the contingency for unforeseen costs of case handling has been made in the Independent Redress Mechanism budget;[1] The increase is in line with the assumption on the investigations above; and

(d) A contingency amount of USD 2.16 million, representing 2.4 per cent of the budget has been added to cover any unforeseen operating expenses or initiatives, which the Board may consider for 2020. This is based on experience wherein, apart from the annual budget, additional amounts were requested of the Board or approved by the Board.

15. Based on the above assumptions it is proposed that an additional amount of USD 45 million should be set aside for the 2020 operations. (It is important to note that the Board

[1] The Independent Redress Mechanism budget does not include (1) potential compensation payments to project-affected people, (2) payments of costs of proceedings to countries succeeding in reconsideration requests, or (3) additional costs incurred by the Independent Redress Mechanism for problem-solving or compliance reviews, if a greater number, or more complex cases are filed than estimated in its annual work program and budget.

already approved USD 44.11 million towards the staff cost for 2020.) Table 1 below shows the breakdown of costs between the Board, the Secretariat, the Trustee and the independent units.

Table 1: Breakdown of costs between the Board, the Secretariat, the Trustee and the independent units

	USD (in millions)		
	2020 budget	**2019 approved budget**	**% Change**
Board	3.57	3.44	4%
Secretariat	71.41	67.07	6%
Trustee	2.2	2.07	6%
Independent Evaluation Unit	5.51	4.5	22%
Independent Integrity Unit	2.75	2.3	20%
Independent Redress Mechanism	1.51	1.16	30%
Contingency	2.16		-
Total	**89.11**	**80.54**	**10%**
Already approved for 2020	–44.11		
Additional amount needed	**45.00**		**-**

3.2 Foreign exchange commitment risk buffer for solvency risks

16. The need for the foreign exchange commitment risk buffer for the solvency risk was recognized through decision B.19/04, wherein the Board adopted the risk management framework component and the funding risk policy, which was set out in annex VI to the decision. The relevant portion of the funding risk policy as approved by the Board is provided in annex II.

17. As per the above decision, in order to meet its financial commitments, GCF will take all necessary measures to avoid any solvency events during its operations.

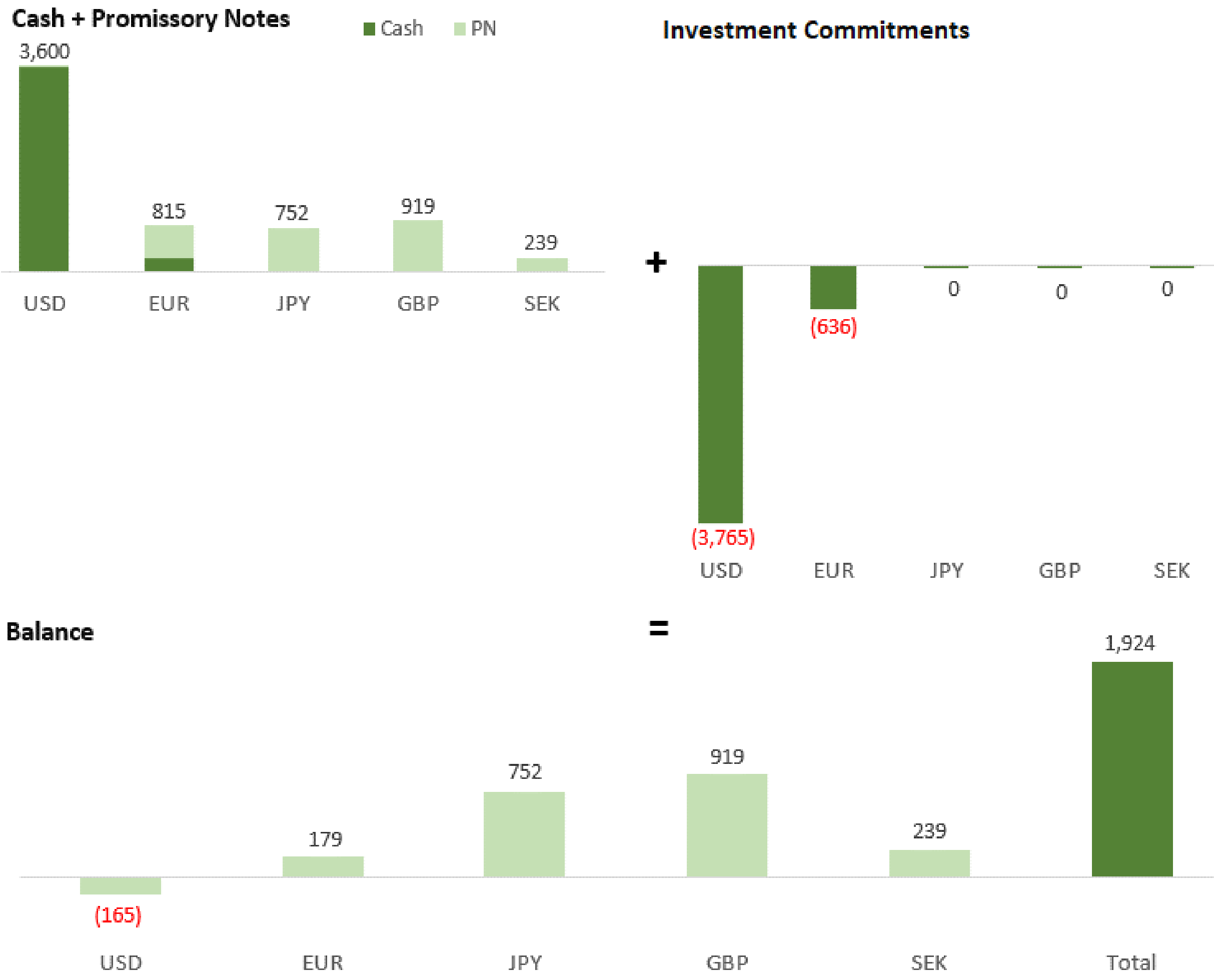
18. The foreign exchange commitment risk buffer arises because GCF makes its investment commitment in certain currencies (i.e. United States dollars and euros), whereas it receives its contributions in multiple currencies. The foreign exchange fluctuation risk remains until the time these contributions, in currency other than the one in which investment commitments are made, are received in cash or promissory notes are encashed and converted into the required currencies.

19. As per the policies of the contributions, cash can be deposited by the contributors until 2020 and the promissory note encashment schedule continue until 2023.

20. Given a large number of unknowns, most importantly future foreign exchange rates and currencies in which the funding commitment will be made, it is difficult to come up with a precise estimate of the amount required for the foreign exchange risk buffer that would be required in the future.

21. The figures calculated here are based on a number of assumptions and these assumptions may need to be revisited and adjusted over time. As GCF receives the cash contributions and encashes the promissory notes and converts them into the required currencies it will then actually realize the foreign exchange gains and losses and therefore the amount required for the foreign exchange risk buffer will gradually reduce.

Figure 1: Cash and promissory notes available in the Trust Fund in different currencies (in USD equivalent) and the funding commitments made by GCF until December 2018



Abbreviations: GBP = Great British pounds, JPY = Japanese yen, PN = promissory note, SEK = Swedish kroner.

22. Figure 1 shows the cash and promissory notes available in the Trust Fund in different currencies and the funding commitments made by GCF until December 2018. The funding commitment includes funding proposals, readiness and PPF. This chart is also reported quarterly in the risk dashboard. The risk management framework specifies that GCF will monitor the sufficiency of the foreign exchange commitment risk buffer on a quarterly basis.

23. In order to facilitate planning for 2019, figure 2 shows the projected cash and promissory notes available in the Trust Fund in different currencies as at 31 December 2018 and the estimated new commitment authority to be received in 2019. The estimated funding commitments include the funding commitments made until the end of 2018 and the estimated new commitments to be made in 2019. For the purpose of this exercise, it is assumed that:

(a) The Board will make new funding commitments of USD 1.3 billion[2] in 2019. It is also assumed that out of USD 1.3 billion of the funding commitments USD 1.1 billion will be made in United States dollars, whereas the remaining USD 0.2 billion will be made in euros. This assumption is based on the current experience where about 85 per cent of the current funding proposals are approved in United States dollars;

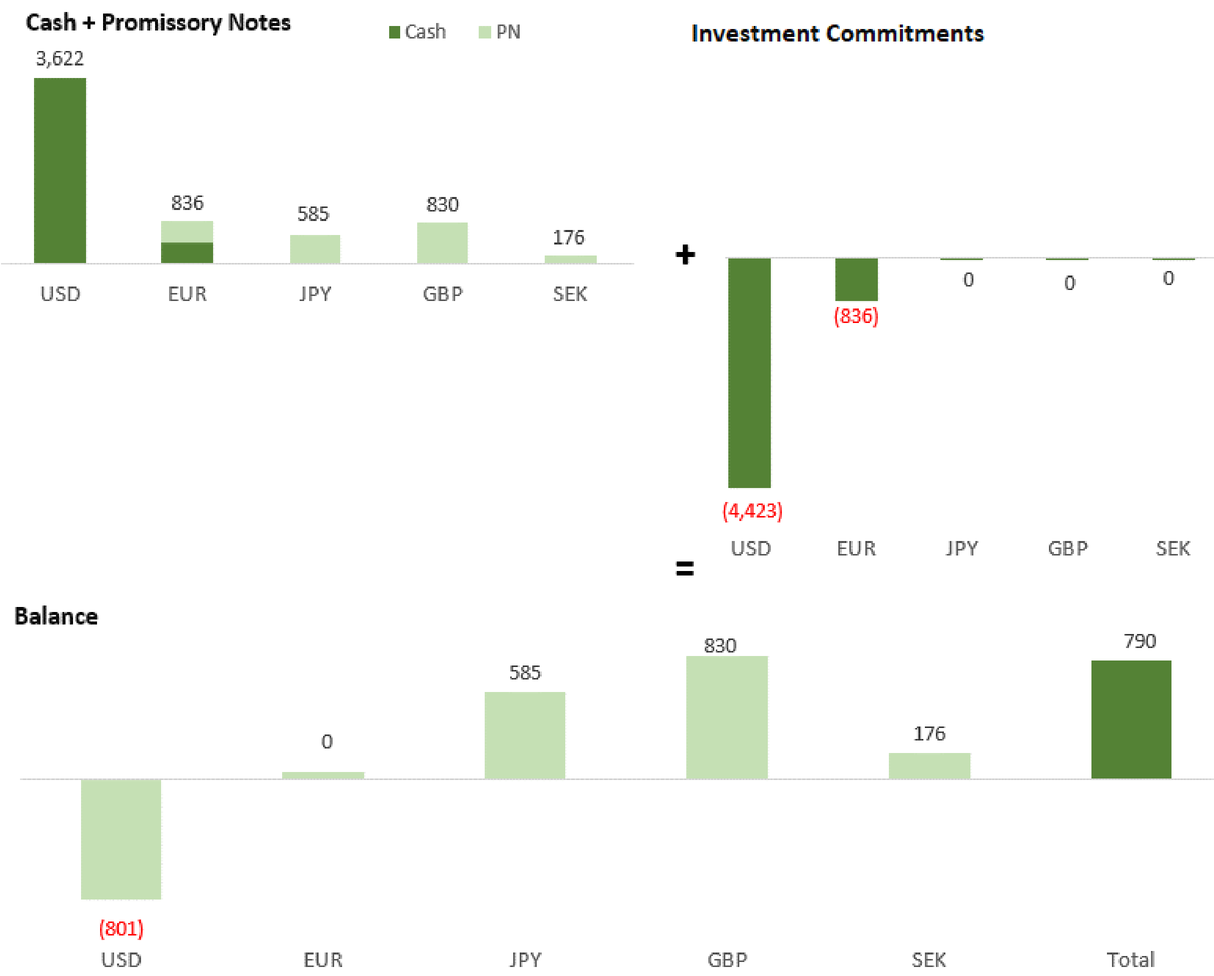
(b) In 2019, USD 0.5 billion will be disbursed for the approved funding projects;

[2] In line with decision B.21/14.

(c) Additional commitment authority of USD 0.16 billion will be received in 2019; and

(d) Additional investment income of USD 70 million will be generated in 2019.

Figure 2: Projected availability of the cash and promissory notes in the Trust Fund in different currencies (in USD equivalent) and the funding commitments until December 2019



Abbreviations: GBP = Great British pounds, JPY = Japanese yen, PN = promissory note, SEK = Swedish kroner.

3.3 Consideration of the amounts to be set aside for the foreign exchange commitment risk buffer

(a) The risk management framework states that GCF will set aside a foreign exchange commitment risk buffer at an initial target amount of 20 per cent of the nominal investment commitment amount of GCF for which the matched source of funds is not in the investment currency;

(b) Figure 2 shows the projected availability of the cash and promissory notes in the Trust Fund in different currencies and the funding commitments until December 2019;

(c) As GCF encashes the promissory notes and converts them into the required currencies, it will then actually realize the foreign exchange gains and losses, and the amounts required for the foreign exchange risk buffer to reduce;

(d) It is important to note that the Trust Fund resources generated cumulative investment income of USD 123 million by the end of 2018. Investment income of USD 70 million is projected for 2019 in the estimates above, thus bringing the total projected investment income to USD 193 million by the end of 2019;

(e) Due to the large number assumptions, more precise estimates will be available each quarter as more confirmed data becomes available throughout 2019; and

(f) Of note, the estimated foreign exchange hedging cost (currency swap) for hedging the future promissory notes to United States dollars will be minimal (i.e. in the range of USD 1–3 million). If done, currency hedging would likely reduce the need to reserve a foreign currency commitment risk buffer. Though it should be noted that once the currency swap is done, then one cannot benefit from the favourable currency movement, should that happen.

24. Based on all the above factors and requirements expected under the risk management framework, it is proposed to keep a risk buffer in the amount of USD 0.1 billion and revisit it again as more data becomes available.

Annex I: Draft decision of the Board

The Board, having reviewed document GCF/B.22/15/Rev.01 titled "Review of the amounts to be set aside for the operating costs of the Green Climate Fund and the foreign exchange commitment risk buffer for solvency risks":

(a) *Decides* to set aside the amount of USD 45 million towards the operating expenses of GCF for 2020;

(b) *Also decides* to set aside an initial amount of USD 100 million towards the risk buffer; and

(c) *Requests* the Budget Committee to review the risk buffer requirement and update the Board on the adequacy of the amount at its twenty-fourth meeting.

Annex II: Solvency concerns in funding risk policy (Section V of annex VI to decision B.19/04)

V. Solvency concerns

23. Solvency risk refers to the Fund's inability to meet its financial commitments due to a shortfall in its available funds relative to its commitments. The Fund will take all necessary measures to avoid any solvency events during its operations.

24. The Fund only makes investment commitments when a matching source of funding is available (in the form of unmatched cash, cash equivalents, securities or promissory notes). Such matching of source of funds for each investment commitment helps reduce the Fund's exposure to solvency risk.

25. Investment commitments made where the matched funding sources are not in the same currencies as the investment commitment expose the Fund to solvency risk in case the investment currency appreciates against the currencies of the matched funding sources.[1]

26. Such solvency risk exposure arises in two kinds of situations – when the investment commitment is made in a holding currency, but the matched funding sources are in different currencies (partially, or wholly);[2] or when the investment commitment is made in a non-holding currency.[3]

27. To mitigate this solvency risk arising from currency differences between investment commitments and the matched funding sources, for investment commitments due in the immediate 12 months, the GCF will match the source of funds in the same currency as the investment commitments (through actions such as currency exchanges etc.).[4] This approach will help manage the fund's exposure to solvency risk in the near term (the immediate 12 months).[5]

28. Beyond the immediate 12 months, where the matched source of funds is not in the investment currency but are available in cash or cash equivalents in another currency, the Fund will convert the matched source of funds to the investment currency.[6]

29. For the remaining matched source of funds that are not available in cash or cash equivalents and which are not in the investment currency (e.g., matched source of funds in the form of promissory notes in another currency), the Fund will set aside an FX commitment risk buffer at an initial target amount of 20% of the Fund's nominal investment commitment amount for which the matched source of funds is not in the investment currency. This buffer is not intended to support individual projects from FX fluctuation losses that they may suffer, but to protect the GCF from solvency risk. Further, holding this buffer will result in a reduction in the GCF's commitment authority (which will then adjust as the size of the buffer is recalculated over time).

30. The Secretariat can review and modify the FX buffer amount over time as necessary. Furthermore, the Secretariat will report the status of the FX positions together with the FX buffer and amount of currency mismatch to the Second Level, the RMC, and the Board on a quarterly basis.

31. The GCF will monitor the sufficiency of the buffer versus the target level on a quarterly basis. If the buffer falls below the designated target level due to appreciation in some investment currencies, the Secretariat First Level will develop a plan to replenish the buffer back above the target level no later than one month from the day the breach of the target level was first identified.

32. The First Level will be responsible for maintaining the proposed FX commitment risk buffer and reporting on size of the buffers versus the target levels, and recommending any actions required (to replenish the buffer). The action will be finalized collaboratively, taking

inputs from the Second Level. The actions should consider recommendations from the RMC and will need to be agreed with the SMT and, where appropriate, the Board.

33. The Second Level will develop a recommendation, independent of the First Level, on any action required for improving the Fund's solvency management. This recommendation will be discussed with the First Level, reviewed and finalized with the OED.

[1] FX depreciation of GCF investment commitments would not create solvency issues as defined in this Policy.

[2] Either in other holding currencies, or in promissory notes in non-holding currencies from a contributor country.

[3] It should be noted that extent of solvency risk exposure arising from investment commitments in non-holding currencies is limited by the diverse set of currencies the GCF may invest in, which provides a natural hedge to the GCF against investment currency appreciation.

[4] Conversion of funds to non-holding currencies may not be feasible within the Trustee account given the Interim Trustee Agreement.
Hence either the GCF will hold non-holding currency assets in an alternative account, and if that is not feasible, then the strategy of immediate conversion will not be applicable for non-holding currency investment commitments until the Secretariat establishes appropriate currency-holding arrangements.

[5] 12 months has been chosen consistent with the GCF's liquidity reserve definition. As a result, this full currency matching will be relevant for sources of funds which are a part of the GCF's Liquid Asset Portfolio.

[6] Conversion of funds to non-holding currencies may not be feasible within the Trustee account given the Interim Trustee Agreement. Hence either the GCF will hold non-holding currency assets in an alternative account, and if that is not feasible, then the strategy of immediate conversion will not be applicable for non-holding currency investment commitments until the Secretariat establishes appropriate currency-holding arrangements.