Annex VIII: Risk management framework component IV – "Risk guidelines for funding proposals"

I. Introduction

1. Through decision B.13/36, the Board requested the Secretariat, in consultation with the Risk Management Committee ("RMC"), to develop the necessary methodologies to enhance the Secretariat's risk management capacity. This document presents the "Risk guidelines for funding proposals" – one of the developed methodologies.

2. Paragraph 2 of the Governing Instrument for the Green Climate Fund ("GCF, "the Fund") defines the purpose of the Fund as follows: "In the context of sustainable development, the Fund will promote the paradigm shift towards low-emission and climate-resilient development pathways by providing support to developing countries to limit or reduce their greenhouse gas emissions and to adapt to the impacts of climate change".

3. The GCF will have to take on certain risks to meet this purpose. When deploying its financial resources towards projects with positive climate change impact potential, the Fund will assess the investment risks and enforce appropriate controls. "Risk guidelines for funding proposals" describe the approach to such risk assessment.

4. This document[1] provides guidelines for the risk assessment of Funding Proposals ("FPs", "proposals") and Concept Notes ("CNs") by the GCF. The goal of these guidelines is to ensure that the risks relevant to the GCF are appropriately understood and addressed in a standardized manner. This document divides guidelines into four types:

(a) Guidelines for assessing the risk of the project / programme failing to deliver its target impact.

(b) Risk guidelines for setting funding terms and conditions.

(c) Guidelines for assessing alignment with GCF's portfolio level risk limits.

(d) Guidelines for assessing compliance with GCF's policies and legal requirements.

5. All proposals under review should be assessed using these guidelines. This assessment will be included as a part of the Secretariat Review to be reviewed by the Board when considering the proposal for approval.

II. Linkages with previous decisions and other documents

6. The "Risk guidelines for funding proposals" are a part of a broader Risk Management Framework ("RMF") (discussed in more detail in Section III). The Funding Risk, Investment Risk, and Operational and IT Risk Policies documents formalize measurement and mitigation of the risks. The risk rating approach document describes the methodology of applying ratings to assess particular risks. Previous decisions and documents relevant to "Risk guidelines for funding proposals" are listed in Table 1.

[1] The guidelines contained in this document do not specify appropriate risk levels or investment criteria for the GCF. The opinion on whether the risks are acceptable is delivered as an expert assessment in the Secretariat Review - these guidelines define the required assessment dimensions and process.

Table 1. Linkages to previous decisions and documents.

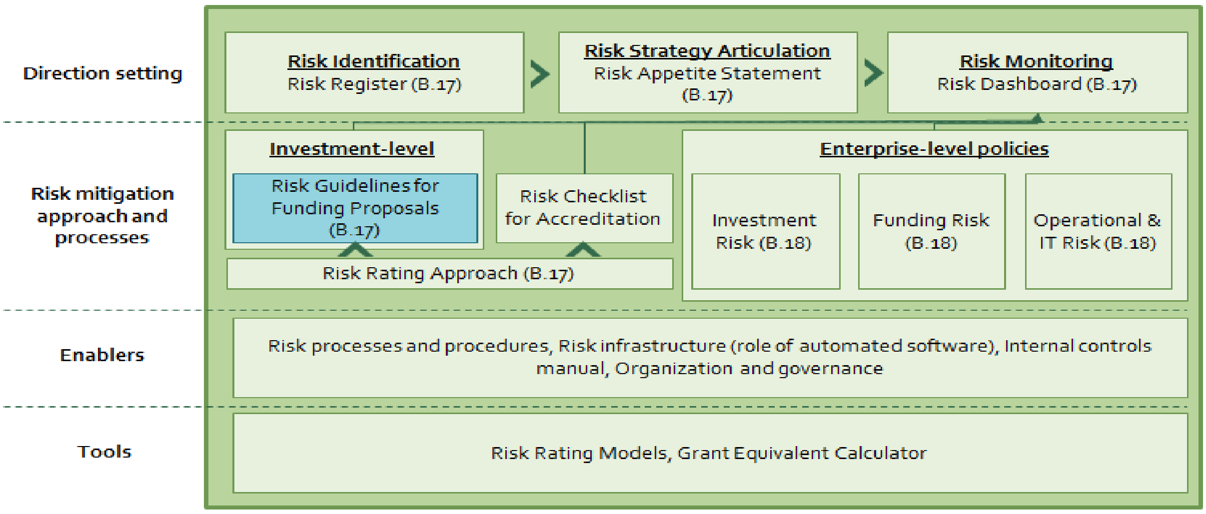
Document	Relevance
GCF/B.13/27/Rev.02 "Interim Risk and Investment Guidelines"	Previous document including proposal level guidelines for risk assessment (superseded by this document).
Governing instrument for the GCF	Access modality and accreditation (para. 45): "Access to Fund resources will be through national, regional and international Implementing Entities accredited by the Board" Financial instruments (para. 54): "The Fund will provide financing in the form of grants and concessional lending, and through other modalities, instruments or facilities as may be approved by the Board. Financing will be tailored to cover the identifiable additional costs of the investment necessary to make the project viable. The Fund will seek to catalyse additional public and private finance through its activities at the national and international levels."
GCF/B.05/07 "Business model framework: terms and criteria for grants and concessional loans"	Guiding principles (annex II, para. (b)): Guiding principles applicable to public sector operations: 1. "Grant elements should be tailored to incremental cost or the risk premium required to make the investment viable; 2. Concessional terms should not displace investments that would otherwise have occurred, including for private sector investment; 3. Overall levels of public debt in the recipient country should be taken into account so as not to encourage excessive indebtedness." Guiding principles applicable to private sector operations: 1. "Structure terms on a case-by-case basis to address specific barriers; 2. Minimize concessional terms by assessing needs, market conditions and other factors; 3. Avoid distortion and crowding out commercial financing; 4. Maximize leveraging of other financing, including public and private financing; 5. Promote long-term financial sustainability; and 6. Apply due diligence to assess the risk to the investment"
GCF/B.07/05 "Financial Risk Management Framework"	Definition of the initial financial risk principles, e.g. para. 6: "By their nature, these activities and technologies would at times assume a higher level of risk than conventional investments undertaken on the market."
GCF/B.10/inf. 10 "Brief guideline on the application of the case-by-case provisions in the financial terms and conditions of the Fund's instruments"	Level and structuring of concessionality (para. 26): "(...) the Fund will structure terms on a case-by-case basis to address specific barriers, where the grant element of concessional finance is tailored to provide the appropriate incentive to facilitate the implementation of mitigation and adaptation activities."
GCF/B.12/32 Annex I: Initial Strategic Plan for the GCF	Enhancing Accessibility and Predictability: "Signal more clearly what kinds of projects and programmes it is looking to finance. This requires providing improved and coherent guidance on the Fund's investment criteria, risk

	appetite, standards and processes to be published on the website and communicated through the Fund's communication channels and the Readiness Programme.“ Regarding Funding Proposals credit and project / programme risk approach, the GCF has the ability to: • Programme and manage financing at scale; • Engage in partnerships with both public and private actors at various levels; • Take on risks that other funds/institutions are not able or willing to take including risks associated with deploying innovative climate technologies; • Pilot and potentially scale-up and replicate innovative approaches; • Deploy the full range of financial instruments at its disposal; • Leverage additional financing inputs from innovative and alternative sources; and • Leverage its status as an operating entity of the financial mechanism of the UNFCCC to set new standards with regard to country ownership, direct access and level of ambition impacting the global practice of climate finance beyond its immediate engagement.
GCF/B.12/17 “Initial Risk Management Framework”	Defined the initial Risk Register, Risk Appetite, and Risk Guidelines for Credit and Investment

III. Objective

7. This document is a part of the comprehensive GCF RMF, which has the objective of setting the appropriate level of risk taken by the GCF, and establishing the risk management and mitigation approach and processes. The guidelines support the notion that the GCF will actively take credit risk to meet its strategic mandate of promoting paradigm shift towards low-emission and climate-resilient development pathways, and that the GCF is willing to take on risks that other investors will not take. The components of the framework are presented in Figure 1.

Figure 1. RMF components (in brackets for each component: the Board meeting when it is planned to be discussed).



8. The objective of this document is to serve as a guideline for the risk analysis required as a part of the review of FPs. The Secretariat can leverage this document as a guide for risk factors to be included in the proposal assessment process, ensuring a consistent view on risk assessment to support Board decisions.

9. These guidelines are applicable at an individual FP level. Assessment of a particular proposal should also be performed in conjunction with a broader portfolio and enterprise-level risk management, e.g. managing concentration risks, foreign exchange risks, etc., which are outlined separately in Funding Risk, Investments Risk, and Operational and IT Risk Policies. While part of the assessment may be operationally done by the Accredited Entity ("AE"), internal responsibility for the application of these guidelines lies with:

(a) Private Sector Facility ("PSF") – for private proposals;

(b) Division of Mitigation and Adaptation ("DMA") – for public proposals

10. Office of Risk Management and Compliance ("ORMC") should examine and independently review the PSF and DMA's assessment.

11. The GCF can seek external independent support in the assessment process. The GCF may especially consider such support in specific scenarios (e.g., a large funding request where GCF has been requested to take a junior position relative to other co-investors).

12. Where material information is lacking against the guidelines and a risk assessment cannot be conclusive, further due diligence and examination may be required.

13. The output of the analysis should be included in the Secretariat Review on the proposal presented to the Board.

14. This document is maintained by the ORMC who should review it once every two years or upon a Board request.

15. "Risk guidelines for funding proposals" are submitted to the Board for approval upon prior review and approval by the RMC.

IV. Guidelines

16. The guidelines are divided into four types:

(a) Guidelines for assessing the risk of a project / programme failing to deliver its target impact: While the GCF is only indirectly involved in project / programme execution, it must consider risk of their failure. Consequences of failed projects / programmes may not be limited to the disbursed funding, but might also mean additional costs to cover the liabilities, or damage to GCF's reputation.

(b) Risk guidelines for setting funding terms and conditions: The GCF may accept a range of deal structures varying in level of complexity, participation of co-investors, blending of funding instruments and modalities, control and ownership structures, and financial terms and conditions. The guidelines in this section seek to establish a comparable standard in understanding and considering risks across diverse funding structures.

(c) Guidelines for assessing alignment with GCF's portfolio level risk limits: The GCF must assess the risk of a proposal in the context of its current portfolio. A new proposal is not a standalone risk, as it also influences GCF's risks at the portfolio level.

(d) Guidelines for assessing compliance with GCF's policies and legal requirements[2]: As per the risk appetite (part of the RMF), there is zero risk tolerance for illegal practices and policy / integrity breaches.

17. All the above four types of guidelines should be applied at the FP stage.

18. At the CN stage, guidelines of the types c) and d) should be applied. Additionally, the Fund should apply guidelines of the types a) and b) at the CN stage to the extent possible.

4.1 Guidelines for assessing the risk of a project / programme failing to deliver its target impact

19. Overall assessment

(a) The proposal should clearly demonstrate that each funding request is directly connected with the Fund's objectives.

(b) A broader programme proposal should either provide a clear description of each project to be undertaken, or provide clear parameters for making delegated funding decisions.

(c) The proposal should have adequate policy and regulatory support from the relevant country. The GCF should assess the actual level of country support beyond the no-objection letter (e.g. stabilization clauses or governmental assurances).

20. AE / EE[3] capability

(a) The proposal's size, focus, Environmental and Social Safeguards ("ESS") standard, fiduciary standard and gender approach must be within the parameters of the Accreditation Master Agreement ("AMA"). The AE must have a project monitoring process and must deliver updates to the Fund at least as frequently as stated in the AMA. The AE should also monitor and report to the GCF the impact of the project upon successful execution.

(b) The AEs and EEs should have adequate technical and institutional capabilities to execute the project. They should especially provide adequate assurances about the ability to ramp up the necessary staff and ability to manage third parties involved in the execution (if the AE has specific limitations in the AMA, the proposal must not breach them). They should also provide a clear description of their track record in delivering similar projects. The AE and EEs should present their history of cooperation; the GCF should review the performance of the AE and the EE on previous projects / programmes. The GCF should consider the impact of the proposal on other projects managed by the AE in GCF's portfolio.

(c) The EEs should have a stable internal management. The proposal should include an assessment of the qualifications of the key management personnel.

(d) The EEs should provide information about their business and strategic objectives in the proposal. The EEs' objectives should be tied to the successful execution of the project.

(e) The AE and EEs should allow the GCF to request and audit documents and data related to funded activities execution upon request to the extent as defined in the AMA. Should certain risks related to funded activities arise and the GCF considers it is necessary to do further due diligence, then the GCF should be allowed to verify the details at a later stage.

[2] This category covers GCF's policies not included under other types of guidelines, i.e. specific to project execution, funding structure or portfolio level risk limits.
[3] Where EE has been finalized at the time of CN / FP preparation.

21. Project specific execution risks

(a) The GCF should take execution risks into account. These risks include: staff movement restrictions; construction risk (including permitting and siting); operating risk; and supply risk.

(b) The GCF should take country-specific execution risks into account. These risks include: political risks; trade embargoes; stability of legal and regulatory environment; and natural catastrophes.

(c) The proposal should include a plan to mitigate risks of environmental and community impact, and demonstrate adequate community engagement. The issues especially covered are: limited awareness, preparation, and/or commitment of affected communities, and tackling lack of motivation by the beneficiaries to adopt new technologies.

22. Financial viability

(a) The proposal should be assessed against the Fund's investment policies and guidelines.

(b) The proposal should include financial and cash flow analyses, including stress analyses. The specific areas that should be covered include (depending on the characteristics of a particular proposal): market conditions analysis; sensitivity of the asset value and liquidity to economic cycles; debt service financial ratios; repayment schedule; off-take risk; and GCF's control over reflows (including expropriation risk).

4.2 Risk guidelines for setting funding terms and conditions

23. Funding terms

(a) Any form of funding should be granted only to acceptable and identified EEs[4]. The GCF should assess the EEs' capabilities and intent. The proposal should include a review of:

  (i) Public reports if the EE is a publicly listed company;

  (ii) Disclosed relevant documents otherwise.

For existing EEs, the previous dealings with the GCF and the AE should be taken into account.

(b) Where possible, the GCF should be a co-investor, rather than a sole investor. The participation of co-investors can provide higher confidence in the diligence process, and reveal information about the market's pricing and perception of the risks. Co-investment from the AE is encouraged where possible.

(c) The requirements and proposed terms for co-investor participation should be clearly articulated in the terms of the funding agreement.

(d) The proposal should include an outline of GCF's rights and responsibilities in case of project failure. The AE should provide clarity around subordination, workout rules and roles of each party, and the GCF should have reasonable assurance that it has the technical and institutional capacity to fulfill its role (or otherwise engage a third party).

(e) The execution liabilities should be borne by the AE and the EE (or particular subcontractors) rather than the GCF. While the GCF receives updates about the project progress, it does not actively manage the project operations, and thus shouldn't be responsible for dealing with grievances related to execution; however, the grievances should be monitored by the GCF as well.

[4] Where EE has been finalized at the time of CN / FP preparation.

24. Additional analysis specific to loan / equity / reimbursable grant investments / guarantees:

(a) Credit proposals should clearly prescribe the disbursement and repayment schedule, and terms and conditions must comply with GCF's Investment Risk Policy (a component of RMF). The GCF needs to make future cash flow projections for Asset-Liability Management. Credit should not be extended if there is strong doubt about the borrower's willingness or ability to repay from a clear, identifiable set of cash flows. The GCF should also estimate the grant equivalent value of the credit.

(b) When the structural subordination of a lending arrangement results in the GCF taking a different level of credit risk compared to the level of credit risk taken by all other co-investors, the GCF may consider an external independent risk evaluation, especially for large funding requests.

(c) When taking on an equity/mezzanine stake on different terms than the terms of all other co-investors (including a situation when the GCF is the only equity / mezzanine investor), the GCF may consider an external independent risk evaluation, especially for large funding requests.

(d) The GCF should consider reflows Foreign Exchange risk and hedging approach.

4.3 Guidelines for assessing alignment with GCF's portfolio level risk limits

(a) GCF's portfolio concentration should remain within the risk appetite after inclusion of the proposal. The concentration across a number of metrics is defined in the risk appetite statement document (part of the RMF). The GCF should calculate the incremental impact of every proposal on those metrics during the approval process (and a combined calculation for all the proposals discussed in a particular Board meeting). Note: The Board retains the authority to approve FPs which may be exceptions to the risk appetite statement. Hence if collected at the CN stage, breach of concentration limits should not result in automatic rejection of the proposal.

(b) Committing to the disbursement of funds as per the proposal should not breach GCF's liquidity tolerance. Otherwise, the Fund must take mitigating actions to ensure sufficient liquidity in accordance with the risk appetite statement document (part of the RMF). The timing of the investment must be clearly defined and there should be a prudent gap in timing between disbursement of GCF's investment and encashment of the relevant contributions.

(c) Equity proposals should provide financial projections, articulate any terms on exit (e.g. lock-in period) and exit strategies (e.g. in illiquid markets), and discuss shareholder roles and rights (e.g. potential future dilution). Similarly to the credit structures, the GCF needs to make future cash flow projections for ALM purposes and estimate the level of concessionality in equity structures. The GCF also requires that the AE update the valuation periodically and deliver it to the GCF.

4.4 Guidelines assessing compliance with GCF's policies and legal requirements

(a) The AE should demonstrate in the context of the particular proposal, that it can enforce provisions agreed to in the AMA among the project participants (especially the Prohibited Practices policy) as GCF's delegate. Specifically, the AE needs to submit its 'Procedures for controlling procurement by third parties or Executing Agencies undertaking projects financed by the entity'. The AMA and Funded Activity Agreement ("FAA") must be effective before disbursement of the funds.

(b) The AE should verify the laws/policies in relevant countries and inform the GCF of any discrepancies (especially if they are different than the AMA provisions), and propose a resolution.

(c) (Guideline applicable to loan funding, guarantees or reimbursable grants) Where there is collateral held in escrow, it must not be invested in assets that go against the GCF's climate change mandate.