

Annex IX: Risk management framework component V – risk rating approach

I. Introduction

1. The Board, through decision B.13/36, requested the Secretariat, in consultation with the Risk Management Committee (“RMC”), to develop the necessary methodologies to enhance the Secretariat’s risk management capacity.

2. This document is a component of the Risk Management Framework (“RMF”), and it describes the set of ratings recommended for the Green Climate Fund (“GCF”, “the Fund”) to maintain for prudent risk management purposes.

3. There are two risk ratings recommended for the GCF:

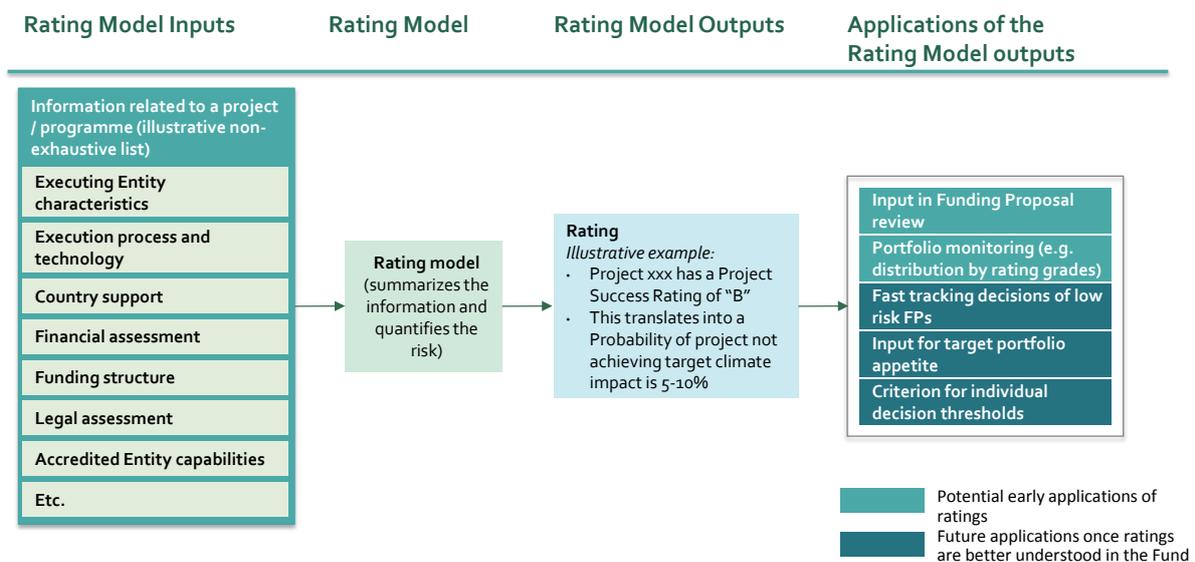
(i) Project / Programme Success Rating (“PSR”): a project / programme level rating that enables quantification of the likelihood of project / programme achieving the target climate impact.

(ii) Credit Risk Rating (“CRR”): a project / programme level rating that enables quantification of the likelihood of project / programme defaulting.

4. Once developed, these ratings can immediately be applied by the GCF in a range of applications including – supporting Funding Proposal (“FP”, “proposal”) decisions and managing GCF’s portfolio mix.

5. Risk ratings form a critical component of the overall RMF proposed for the GCF. Risk ratings are forward looking estimates of the risk associated with a specific entity / funding contract, mapped to a scale for easy and consistent communication across the organization. Underlying a risk rating is usually a rating model, which defines the quantitative relationship between the risk of a specific entity / funding contract and its various risk drivers. Figure 1 below illustrates a rating model aimed at estimating the risk of project’s failure to achieve its target impact, some example inputs to the rating models and some example applications where the output of the rating model can be used.

FIGURE 1. ILLUSTRATIVE RISK RATINGS (PROJECT SUCCESS RATING EXAMPLE)



6. Risk Ratings are commonly used by most financial institutions (including most Multilateral Development Banks) in order to quantify risks associated with their clients or

funding contracts. These risk ratings are key inputs to several portfolio and individual client / funding contract level decisions at the institution. However, depending on the institution’s mandate and operating model, there is a variety of practices with regards to the specific risk type the ratings aim to quantify (credit risk vs. equity risk etc.) and the entity for which the risk is being assessed (client vs. affiliate vs. project etc.).

7. This risk rating approach document recommends a set of risk ratings appropriate for the GCF, given its mandate and operating model (including describing which risks should be quantified at the individual entity / project / programme level in the form of ratings, and what should be the target of those ratings).

8. Upon the Board taking note of this document, it is expected that the GCF will develop the set of rating models required to generate the risk ratings described in this document, and commence applying the risk ratings in day-to-day decision making.

II. Linkages with previous decisions and other documents

9. The risk rating approach is part of the broader Risk Management Framework (“RMF”) (discussed in more detail in Section III). Relevant components of the RMF are submitted to the Board in parallel to this document. Those components and previous decisions, and other documents relevant to this document are listed in Table 1.

Table 1. Linkages to previous decisions and other documents.

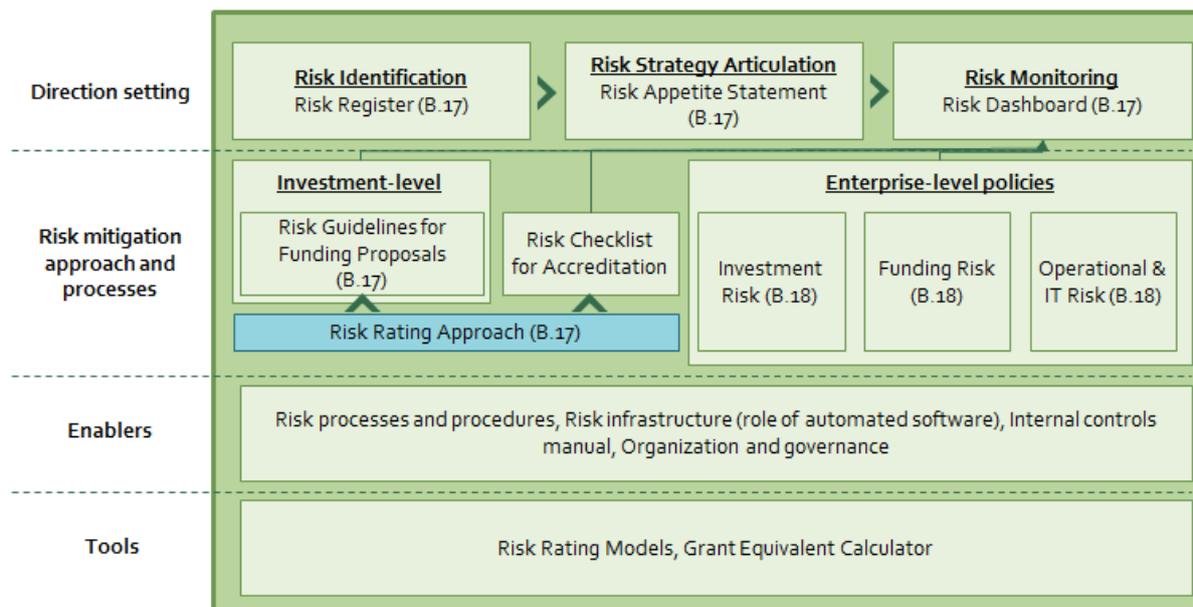
Document	Relevance
Risk Appetite Statement (part of the RMF, to be considered at B.17)	This document provides guidance on: <ul style="list-style-type: none"> • Overall level of risk that GCF is willing to take to achieve its objectives. • Types of risks to be monitored. • Qualitative appetite statements and quantitative metrics that can be cascaded to specific business units to guide their day-to-day operations.
Risk Guidelines for Funding Proposals (part of the RMF, to be considered at B.17)	This document provides guidelines to ensure that the risks relevant to the GCF are appropriately understood and addressed in a standardized manner.
Risk Checklist for Accreditation (part of the RMF, to be considered at B.18)	This document provides guidelines to ensure a consistent assessment of Accredited Entity (“AE”) in the accreditation process.
GCF/B.07/02 “Guiding Framework and Procedures for Accrediting National, Regional and International Implementing Entities and Intermediaries, Including the Fund’s Fiduciary Principles and Standards and Environmental and Social Safeguards”	This document provides an initial guiding framework for the Fund’s accreditation process.
GCF/B.12/17 “Initial Risk Management Framework”	Defined the initial Risk Register, Risk Appetite, and Risk Guidelines for Credit and Investment.

Decision B.13/36	The Board’s request to develop the necessary risk management methodologies.
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III. Objective

10. This document is a part of the comprehensive RMF – the components of the framework are presented below in Figure 2.

Figure 2. RMF components



11. The objective of this document is to recommend a set of risk ratings appropriate for the GCF, given its mandate and operating model.

12. This document also provides an overview of how the proposed set of ratings can be incorporated in various applications across the Fund. Finally, the document describes the roles and responsibilities of various parties in the Fund in developing the underlying rating models, and in the ongoing risk rating process.

IV. Proposed set of ratings for the GCF

13. The Governing Instrument defines GCF’s mandate as to “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 (...). The Fund will strive to maximize the impact of its funding for adaptation and mitigation, and seek a balance between the two, while promoting environmental, social, economic and development co-benefits and taking a gender-sensitive approach.” Further, the Governing Instrument states that GCF’s strategy is to achieve these goals through investments made in projects / programmes, which are supervised by AEs: “Access to Fund resources will be through national, regional and international implementing entities accredited by the Board.”

14. Given the above mandate and strategy, GCF’s success or failure is most closely linked to the success or failure of its projects, and financial sustainability of the Fund. Thus, an assessment of the likelihood of success of a project / programme and an assessment of the credit risk for credit funded projects / programmes can be extremely useful for the GCF. These

assessments can support various critical decisions at the Fund, including decisions on FPs as well as overall portfolio management.

15. As a result, the following two risk ratings are proposed for the GCF:
 - (a) Project / programme Success Rating (“PSR”): This will be a project / programme level rating, quantifying the likelihood of project / programme achieving success defined as the target climate change impact⁵. Example risk drivers expected to be seen in the underlying risk model include – level of local government and community support for the project, construction risk, financial viability (including stress analysis), etc.
 - (b) Credit Risk Rating (“CRR”): This will be a project / programme level rating, quantifying the likelihood of a project / programme entering a Default Event⁶, resulting in reflow delays or losses. Example risk drivers expected to be seen in the underlying risk model include – financial guarantees, reliability of control of the project / programme assets by the GCF in case of a default, probability of project success etc.
16. The lists of risk drivers in the rating models for PSR and CRR are expected to have fair amount of overlap, and some correlation is expected between the PSR and CRR. However, it is recommended that the Fund develops both risk ratings as:
 - (a) The PSR is most directly linked to the Fund’s mandate and is required to assess risk for projects / programmes.
 - (b) The CRR is closely tied to the Fund’s financial viability and because funding via credit instruments is expected to grow significantly at the Fund, especially within Private Sector Facility (“PSF”).
17. Upon the Board taking note of this document, it is expected that the GCF will develop the set of rating models required to generate the risk ratings described above. Rating model development would require analysis of a much longer list of potential risk drivers, of which a few examples have been cited above.
18. Additionally, an AE Capabilities Rating was considered for the GCF. An AE Capabilities Rating is an AE level rating, reflecting its capability in ensuring success of the projects / programmes executed through it. The current recommendation for the GCF is to deprioritize the AE Capabilities Rating as:
 - (a) There is already an implicit categorization of the AEs as a result of the accreditation process.
 - (b) This rating can be developed in the future once the recommended two risk ratings are well understood and embedded.
19. The proposed set of ratings is expected to bring the following benefits to the GCF:
 - (a) The ratings will bring a common language within the Fund to communicate about and to compare the risk of various projects / programmes. The ratings will bring further structure and consistency to the evaluation process for FPs.
 - (b) The ratings will enable gradation of risk and improved financial analysis.
 - (c) The ratings will support improving several decisions taken by the Fund (See further elaboration in Section V).

⁵ Covering both mitigation and adaptation targets.

⁶ Precise definition of a Default Event is set for each Funding Proposal individually in its FAA.

V. Application of the ratings

20. Once developed, the ratings can immediately be used by the GCF in the following applications:
- (a) Supporting FP Review: The risk rating of a project / programme can be one of the key inputs that the Board can consider while taking a decision on an FP. It should be noted that based on the Risk Appetite Statement (part of the RMF), the Fund is willing to accept considerable uncertainties around investment risks in return for impact potential, to be evaluated on a case-by-case basis recognizing specifics of each FP. The risk ratings are one of several factors that can influence this evaluation.
 - (b) Portfolio monitoring: The distribution of GCF's portfolio by PSR and CRR can be monitored over time, to assess the Fund level risk profile.
21. As the Fund's understanding of the ratings and their implications deepens with time, their application can be expanded into other areas including – fast tracking decisions on low risk proposals; setting target portfolio appetite level based on the ratings; setting individual decision thresholds linked to the ratings; project reflows classification by ratings.

VI. Roles and responsibilities

22. Office of Risk Management and Compliance (“ORMC”) will be responsible for developing and maintaining the rating models. The Secretariat may seek the help of external expertise to develop these models, or to customize off-the-shelf models available in the market.
23. The Secretariat will be responsible for generating the PSR and CRR for each proposal, with strong support from the AEs in gathering the relevant data. Both Ratings will be generated at first during the proposal review process, and then refreshed at least annually, usually together with the project / programme review process.
24. In order to optimize the use of resources engaged in the rating process, rating refresh is expected to follow a simpler process, focusing on updating key rating model inputs.