

Annex IV: Investment risk policy

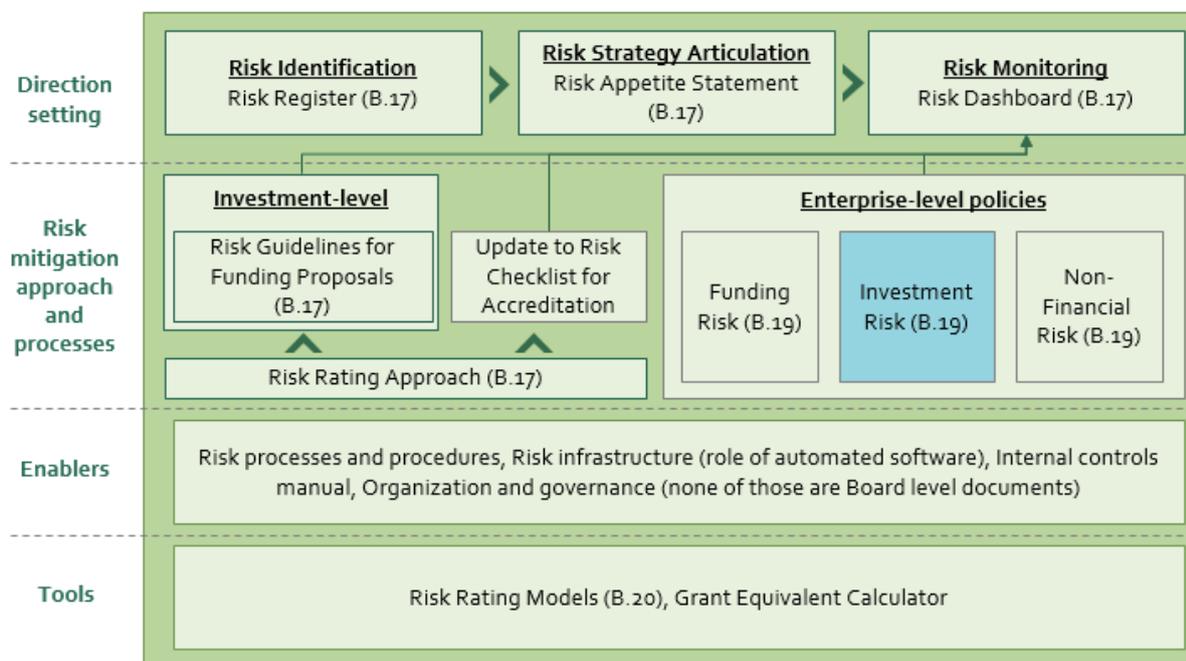
I. Introduction

1. This document presents a critical element of the Risk Management Framework (“RMF”), the policy governing investment risk management for the Green Climate Fund (“GCF”).

II. Objectives and scope

2. This document is a part of the comprehensive RMF – the components of the framework are presented below in Figure 1.

Figure 1: RMF components



3. The Investment Risk Policy (“Policy”) defines investment risk management requirements related to the risk of failure of a Funded Activity¹ or Readiness / Project Preparation Facility (“PPF”) Proposal to deliver the expected impact, or the risk of delay or shortfall of reflows² from these activities. This Policy is not intended to detail the operational processes in relation to Funded Activities or Readiness / PPF, as the operational processes will be specified in the GCF Operations Manual for the Funded Project Lifecycle.³

4. This Policy is based on the following core principles:

- (a) Ensuring sustainable financial viability for the Fund and enabling the Fund to meet its mission of promoting paradigm shift towards low-emission and climate-resilient development pathways;
- (b) Adherence to the GCF’s Risk Appetite Statement (part of the RMF) for investment risk;

¹ A Funded Activity is defined as a GCF-funded investment or payment for a climate project/programme.

² The risk of delay or shortfalls in reflows may originate from various sources – including loss in the counterparty’s willingness or ability to repay, convertibility and transfer risk, and foreign exchange losses from non-holding currency investments.

³ The GCF Operations Manual for the Funded Project Lifecycle is being drafted by the Secretariat.

- (c) Establishing fit for purpose controls and ensuring efficiency in risk management; and
- (d) Roles and responsibilities allocated:
- (i) **First Level of Responsibility (“First Level”)**: The first responsibility of risk management and control is with the accountable units who are the primary owners and managers of risk; there may also be multiple units within the Secretariat that form the First Level;
 - (ii) **Second Level of Responsibility (“Second Level”)**: For each risk, there is a Second Level of Responsibility, or a control function independent of the First Level, to ensure risks are managed given asymmetric incentives, short-termism, and optimism of risk takers; there may also be multiple units within the Secretariat that form the Second Level; and
 - (iii) **Third Level of Responsibility (“Third Level”)**: The Third Level of Responsibility focuses on review of the actions and interactions of the risk taker and risk controller, and assurance that the RMF is operating as intended.
- (e) Recognizing the role of the Accredited Entity (“AE”) in risk management given GCF’s business model of investing through AEs. The presence of the AE has the following key implications:
- (i) The AEs form a key part of the First Level of Responsibility within the scope of this policy;
 - (ii) The role of the First Level within the Secretariat (“Secretariat First Level”) is lighter, as part of the First Level responsibilities are with the AEs; and
 - (iii) An AE’s lack of ability or willingness to meet GCF’s expectations is a key source of investment risk. However, the management approach for this risk inherent to the AE is not described by this policy. This management approach is addressed in the Risk Checklist for Accreditation, Guiding Framework and Procedures for Accrediting National, Regional, and International Implementing Entities and Intermediaries, individual Accreditation Master Agreements (“AMAs”) and Funded Activity Agreements (“FAAs”).
5. The detailed roles and responsibilities of the First and Second Levels are set out in Sections III and IV below. The Third Level will develop and perform scheduled and ad-hoc audits, reviews, and assurance engagements, in order to gain assurance that the design and implementation of policies and procedures by the First and Second Levels are managing the GCF’s risks appropriately.
6. For roles and responsibilities defined in Sections III and IV of this policy, the Secretariat deems most appropriate that:
- (a) Secretariat First Level responsibilities should lie with Private Sector Facility (“PSF”), Division of Mitigation and Adaptation (“DMA”), or the Division of Country Programming (“DCP”) depending on which division originates the funding outlay. Some of these responsibilities may be given to the Portfolio Management Unit (“PMU”). The specific roles and responsibilities will be outlined in procedural documents developed by the Secretariat;
 - (b) Second Level responsibilities should lie with the Office of Risk Management and Compliance (“ORMC”) and the Office of the General Counsel (“OGC”). Some of these responsibilities may be given to PMU where they play a review or control role over First Level activities performed by the AE or Delivery Partner (“DP”);

- (c) Third Level responsibilities should lie with the Office of the Internal Auditor (“OIA”); and
 - (d) In order to ensure independence of the First and the Second Levels, the PMU may either be given some Secretariat First Level responsibilities or some Second Level responsibilities, but not both.
7. The Secretariat may re-allocate responsibilities to other divisions over time.

III. Investment risk management – Funded Activity

3.1 Initial approval of Funding Proposal

3.1.2. Risk assessment

8. The AE is responsible for conducting due diligence on the Funding Proposal (“FP”, “proposal”) prior to submitting it to the Secretariat. The AE must meet the standard of care, as defined in its AMA, when conducting its due diligence, and later through the life of the project.

9. The Secretariat First Level is responsible for co-drafting a risk assessment of the Funded Activity in the Secretariat Review with the Second Level as well as other relevant units/divisions, based on the Risk Guidelines for Funding Proposals (GCF/B.17/21, annex VIII) for investment risk. After reaching consensus, this assessment is shared with the SMT and, if recommended by the Secretariat and the Independent Technical Advisory Panel, to the Board. In addition, the Secretariat First Level is responsible for liaising with the AE, or with the Executing Entity (“EE”) via the AE, for necessary documents and information (including those requested by the Second Level, SMT, and the Board) required to complete the risk assessment⁴ of an FP.

3.1.3. Generating the risk ratings⁵ (including rating refresh)

10. The Second Level is responsible for generating a rating as defined in the Risk Rating Approach (part of the RMF)⁶ to be included in the Secretariat Review to the SMT and the Board. The rating is to be refreshed every year.

11. The Secretariat First Level is expected to collect the required information from the AE, and provide inputs for non-financial assessment required for generating the rating. Different First Level teams may be responsible for this activity before and after the first disbursement.

12. The Second Level is also responsible for tracking any delays in rating refreshes and reporting to the SMT. The SMT may approve a delay in rating generation of up to six months past its due date.

13. The rating may be considered by the SMT in its recommendation to the Board, and may be considered by the Board in taking a decision on an FP.

3.2 FAA administration

⁴ Including term sheets.

⁵ Refer to Risk Rating Approach. The delineation of responsibilities will become effective after the rating models are adopted and implemented by the Secretariat.

⁶ Further development of appropriate risk rating models will be brought to the Board for consideration as requested in Decision B.17/11

3.2.1. Activities leading up to FAA signing

14. The First Level, in collaboration with the Second Level, is responsible for reviewing and approving the FAA and the set of documents received for completeness from a risk perspective and ensuring that all risk conditions have been met.

- (a) The AE is responsible for promptly collecting necessary documents for Funded Activities in a timely fashion and ensuring adequate maintenance of all documents related to individual Funded Activities.
- (b) The Secretariat First Level is responsible for collecting required documents and other information from the AE regarding the FAA.

3.2.2. Disbursements to the AE

15. The First Level, in collaboration with the Second Level, clears any conditions required to be met for disbursements to the AE. The Second Level is also responsible for providing legal advice on disbursements as requested by the Secretariat and taking safe custody of all legal documents.

16. The First Level initiates the checks for conditions tied to the disbursement of Funds.

3.3 Funded Activity monitoring

3.3.1. Individual Funded Activity monitoring

17. The AE is responsible for monitoring each Funded Activity in line with the AE's own internal rules, policies and procedures, and responsibilities set forth in the relevant FP and AMA/FAA with the standard of care as defined in the AMA. It also provides interim and final evaluation reports and other ad hoc reports for each Funded Activity to the Secretariat First Level as specified in applicable legal agreements.

18. The Secretariat First Level is responsible for the following activities:

- (a) Providing necessary inputs to the Second Level to populate the GCF Risk Dashboard, which the Second Level will share with the SMT, RMC and the Board on a quarterly basis; and
- (b) Reviewing interim and final evaluation reports and other ad hoc reports provided by the AE on the Funded Activity and monitoring compliance with the FP, AMA/FAA, and the GCF's own internal policies and guidelines.

19. The Second Level is responsible for the following activity:

- (a) Developing a recommendation, independent of the First Level, on any action required for improving the GCF's investment risk management for the project/programme and strengthening its adherence to the Risk Appetite Statement. This recommendation will be discussed with the First Level, reviewed and finalized with the Office of the Executive Director ("OED").

3.3.2. Portfolio monitoring

20. The Second Level is responsible for developing a recommendation, independent of the First Level, on any action required for improving the GCF's investment risk management at a portfolio level and strengthening its adherence to the GCF Risk Appetite Statement (GCF/B.17/21, annex VI). This recommendation will be discussed with the First Level, reviewed and finalized with the OED.

21. The Secretariat First Level is responsible for monitoring delinquent, non-performing loans and losses of Funded Activities, and providing necessary inputs to the Second Level to populate the Risk Dashboard (the Second Level will share the Risk Dashboard with the SMT, RMC and the Board on a quarterly basis).

3.4 Annual review of Funded Activity

22. The AE is responsible for providing the Annual Performance Report for each Funded Activity to the Secretariat First Level, as specified in the AMA/FAA. It is also responsible for liaising with the EE for any information requests or issues raised during the review process.

23. The Secretariat First Level is responsible for reviewing the Annual Performance Report and other annual reports of Funded Activities provided by the AE, and raising identified issues in its annual Portfolio Performance Review (“PPR”). It is also responsible for liaising with the AE for any information requests or issues raised during the review process and working collaboratively with the Second Level in reviewing the PPR.

3.5 Funded Activity default situation

24. A Funded Activity is considered to be in a default situation if the “event of default” or equivalent as defined in the AMA/FAA has occurred.

3.5.1 AMA/FAA default or non-compliance situation⁷

25. The Secretariat First Level works collaboratively with the Second Level in reviewing the default situation, the remedial action plan, the step-in decision, the step-in plan and the implementation of the plans.

IV. Investment risk management – Readiness/PPF Project

4.1 Readiness/PPF Proposal Review

26. The GCF is taking a programmatic approach to Readiness/PPF Proposals. Given this programmatic approach, the Second Level need not approve every single proposal. However, the Second Level will review key parameters of the programme. The Second Level is also responsible for developing and maintaining the Risk Guidelines for Readiness/PPF.

27. The Secretariat First Level is responsible for leading the review of the Readiness/PPF Proposals. The proposals will be approved by the delegated authority levels for the Readiness/PPF projects (currently the Readiness Working Group (“RWG”) or the OED).

4.2 New Grant Agreement and Readiness Framework Agreement⁸ administration

28. The Second Level is responsible for ensuring the adequacy of all documents from a legal perspective.

⁷ This section should be reviewed after the development of the Restructuring/Cancellation Policies by the Secretariat.

⁸ Refers to any legal agreement pertaining to the funding of Readiness and PPF projects, including Readiness Framework Agreements and Readiness Grant Agreements

29. The Secretariat First Level is responsible for collecting required documents and other information from the National Designated Authority (“NDA”)/DP/AE regarding Grant Agreement or Readiness Framework Agreement administration.

4.3 Readiness/PPF portfolio monitoring

30. The Second Level is responsible for conducting a check of monitoring results at a portfolio level and reviewing any issues or recommended actions by the Secretariat First Level, in consensus with the authority which originally approved the project based on the Endorsement and Approval Authority and Thresholds.

31. The Secretariat First Level is responsible for conducting monitoring activities (including collection of necessary information from the NDA/DP/AE).

4.4 Readiness/PPF Disbursement

32. The Second Level is responsible for providing legal advice on disbursements as requested.

33. The Secretariat First Level is responsible for initiating each disbursement, taking into account the latest monitoring results and holding back disbursements when deemed appropriate. The Secretariat First Level works collaboratively with the Second Level to clear the disbursements before the instructions are sent to Finance.

V. Foreign Exchange (“FX”) risk in reflows⁹

34. Non-holding currency reflows expose the GCF to FX risk. Recalling its ability to take on risks that other funds/institutions are not able or willing to take, the GCF will on occasions take such FX risks to meet its mandate. Otherwise, it will either pass on this risk to the counterparties through the FAA, or account for such FX risks in structuring the deal terms within the relevant FPs.

VI. Administrative provisions

35. This Policy will take effect on 2 April 2018.

36. This policy shall be reviewed every two years, but earlier reviews and consequential revisions may occur upon recommendation by the Secretariat or following a request from the RMC or the Board. Any resulting revisions to this policy which are of a material and/or substantive nature shall be presented to the Board for its consideration and approval.

⁹ The FX risk on the liability side is covered by the Funding Risk policy.