Green Climate Fund

Investment Framework (Progress Report)

GCF/B.06/11

11 February 2014

Meeting of the Board
19-21 February 2014
Bali, Indonesia
Agenda item 12 (c)

Recommended action by the Board

It is recommended that the Board:

(a) Takes note of the information presented in document GCF/B.06/11 *Investment Framework (Progress Report)*; and

(b) Provides guidance to the Secretariat concerning the Fund's investment framework.

Investment Framework (Progress Report)

I. Introduction

1. At its June and October 2013 meetings, the Board decided to establish the Investment Committee and the Risk Management Committee (decisions B.04/08 and B.05/13, respectively). The Board also requested that progress reports be prepared on the development of the investment framework and the risk management framework for its consideration (decision B.BM-2013/04).

2. This progress report on the investment framework lays out the essential elements that will constitute a framework for the Fund's investment policy, strategy and guidelines. It constitutes an initial undertaking at outlining the purpose, processes and parameters for the Fund's investment framework. The framework itself will need to be a living instrument under regular review and adjustment to be recommended by the Investment Committee and endorsed by the Board, to align it with the Fund's needs and the external economic environment. It is therefore proposed that the investment framework continues to receive regular updates and adjustments over time, as required by the Investment Committee.

II. Linkages with other documents

3. This document has linkages and cross-cutting matters with the following documents (each focusing as closely as possible on its own topic to avoid redundancy and repetition):

(a) *Financial Risk Management Framework (Progress Report)* (GCF/B.06/10);

(b) *Initial Proposal Approval Process, Including the Criteria for Programme and Project Funding* (GCF /B.06/08);

(c) *Policies and Procedures for the Initial Allocation of Fund Resources* (GCF/B.06/05);

(d) *Financial Terms and Conditions of Grants and Concessional Loans* (GCF/B.06/16);

(e) *Initial Results Management Framework of the Fund (Progress Report)* (GCF/B.06/04); and

(f) *Initial Modalities for the Operation of the Fund's Mitigation and Adaptation Windows and the Private Sector Facility* (GCF/B.06/02).

III. Prior Board decisions

4. The recommendations of this document will operationalize Board decisions B.04/08, paragraph (k), B.05/04, paragraph (e) and B.05/17 and support the Investment Committee, as well as the Risk Management Committee to a different degree, in the performance of their duties.

IV. Investment framework

5. The investment framework is prepared under the oversight of the Investment Committee and would comprise the Fund's investment policy, investment strategy and targets, and investment guidelines.

4.1 Purpose of the investment framework

6. The Board has a key role in the governing structure of the Fund, as emphasized by paragraph 5 of the Governing Instrument:

> *"The Fund will be governed and supervised by a Board that will have full responsibility for funding decisions."*

7. The purpose of the investment framework is to operationalize the objective of the Fund into clear guidelines for investment decisions.

8. As outlined in document GCF/B.06/05, the Board is considering to commence operations with a two-tier allocation process, with a first tier allocating available resources to the themes mitigation and adaptation, and a second tier to activities. The investment framework will, therefore, be the mechanism by which the specific levels of these allocations will be agreed by the Board from time to time, based on the Fund's available resource base and existing investment portfolio. It will also constitute other funding targets (see below).

4.2 Role of the Investment Committee in the investment framework

9. Annex XVII to document GCF/B.05/23, referred to in decision B.05/13, states that the role of the Investment Committee is to develop and review investment strategies and instruments and recommend their approval to the Board, in particular relating to the Private Sector Facility (PSF) and in accordance with the Fund's objectives and result areas, social and environmental safeguards and risk management framework.

10. In fulfilling this role, the Investment Committee will:

(a) Oversee the development by the Secretariat of the Fund's investment framework, consistent with decision B.05/17, for consideration by the Board;

(b) Review and make recommendations to the Board on implementing the investment strategy and financial instruments, including with regard to their economic viability and alignment and compliance with the Fund's objectives, social and environmental safeguards and risk management framework;

(c) Oversee and review periodic assessments by the Secretariat of the Fund's portfolios to ensure consistency with the Fund's investment strategy;

(d) Review and recommend for Board consideration proposed amendments to the Fund's investment-related policies and the use of various financial instruments; and

(e) Consider any other investment-related matters that the Board deems appropriate.

11. The Investment Committee will consider recommendations and advice provided to it by the Private Sector Advisory Group.

4.3 Linkage to the financial risk management framework and the Risk Management Committee

12. As outlined in document GCF/B.06/10, the overarching purpose of the Fund's financial risk management framework is to:

(a) Establish the overall level of financial risk the Board is willing to assume for the Fund in the pursuit of its objectives (the Fund's risk appetite or risk limit) to be reflected in the Fund's investment framework that sets out the criteria for the process of funding approval for projects and programmes;

(b) Ensure that the risks assumed by the Fund lie within the Board-approved ceiling for the risk appetite at any given time, by monitoring, assessing and reporting the actual level of financial risk; and

(c) Set the framework for portfolio management and approval of funding proposals on the basis of the Board-determined risk appetite and the level of actual risk assumed by the Fund.

13. The investment framework will have a direct impact on the financial risk management framework and vice versa. The levels of funding allocated through the two-tier allocation process to mitigation and adaptation and to activities; the nature of this funding (grants, concessional loans, and subsequently other financial instruments); and the specific countries and institutions funded, will affect the overall risk profile of the Fund.

V. Components of the investment framework

14. The Fund's investment framework will be reviewed by the Investment Committee before it is recommended to the Board for approval. The Investment Committee would need to determine what elements it would wish to see in the investment framework. Typical components of such a framework are:

(a) Investment policy;

(b) Investment strategy, including portfolio targets and limits; and

(c) Investment guidelines and activity-specific decision criteria.

15. The investment policy will set out the overall investment goals and guiding principles of the Fund. The investment strategy, including portfolio targets and limits, will set out funding objectives for each different class that the Board may wish to distinguish, e.g. between mitigation and adaptation, or between public and private sector activities. Investment guidelines relate to the specific criteria that will be applied by the Board for the selection of activities to be financed under the proposal approval process (see document GCF/B.06/08). These three components of the investment framework are laid out in Table 1 and in subsequent sections.

Table 1: Typical components of an investment framework

Investment framework components		Purpose
1.	**Investment policy**	Overall investment goals, objectives and guiding principles of the Fund
2.	**Investment strategy and portfolio targets**	Funding objectives for each class: • Climate change objective (mitigation; adaptation; readiness and preparatory support) • Financial class (revenue-generating, non-revenue generating) • Borrower/recipient (public sector, private sector, public-private partnership) • Instrument (grant, concessional loan, equity, subordinated debt, guarantees) • Country category (middle income, low income) • Sector or industry category Strategy will not set rigid ceilings but targets to inform investment decisions
3.	**Investment guidelines and activity-specific decision criteria**	Specific criteria for the selection of activities to be financed (If the Board decides to delegate a subset of activities to be approved by the Secretariat under the streamlined or delegated approval, these criteria would be included in the investment guidelines.)

5.1 Investment policy

16. The Fund's investment policy would be set by the Board on the basis of recommendations by the Investment Committee and would comprise the overall investment guiding principles from a financial point of view. They would need to take into account and be aligned with the initial allocation guidelines, guiding principles for determining terms and financial instruments and the financial risk management framework, set by the Board as well.

17. For example, the policy could, inter alia, set out the following:

(a) The Fund should seek to finance climate-related activities (projects and programmes) that demonstrate an ex-ante positive benefit-to-cost balance,[1] once climate-related externalities have been taken into account;

(b) For certain climate-related activities, for which it will not be possible to accurately estimate the benefit-to-cost balance (e.g. financing climate mitigation and adaptation strategies, or certain adaptation activities), the Board will decide on a qualitative basis whether the activity merits support from the Fund;

(c) Funding received and extended by the Fund will be accounted for in economic terms as grant-equivalent financing[2] to provide an accurate and equitable comparison of funding amounts between grants and loans;

(d) The Fund may differentiate the pricing (if any) of its funding between recipient groups (in the sense of differentiating the risk-adjusted cost of its loans and credits between middle-income and low-income countries), and between different activities depending on the risk-return profile, in order to be able to deliver more concessional financing to low-income countries and extend the Fund's reach;[3]

(e) The Fund may decide not to cross-subsidize between contributors and partners, such that providers of grants are subsidizing debt service payments to providers of loans. (The matter of cross-subsidization between contributor groups, depending on the nature of their contribution, is considered in greater detail in document GCF/B.06/10);

(f) In order to maximize its climate impact, the Fund will seek to minimize the subsidy it delivers for each activity funded to the minimum required to achieve the impact;

(g) The Fund should not "crowd out" potential public or private sector, or other funding sources by underpricing when alternative financing is available;

(h) The investment framework will establish hurdle financial rates of return for revenue generating activities (e.g. investments in renewable energy, public transport, etc.) that have an impact sufficient to justify support from the Fund from a climate change mitigation or adaptation point of view, to ensure the financial viability of the activity funded; and

(i) The investment policy will need to be adjusted from time to time to take account of the Fund's evolving portfolio and experience. Notably, as portfolio reviews undertaken as part of the financial risk management framework bring to light systemic portfolio risks, new investment policies might need to be adopted by the Board.

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[1] Benefits and costs, including externalities, discounted at social discount rate. If the Board decides to include a benefit-to-cost balance assessment for proposals seeking funding from the Fund, it will need to discuss the methodology utilized.

[2] Based on an agreed discount rate and the term of the loan.

[3] If differentiation between country groupings is adopted as a policy by the Board, it would be useful also to consider the opportunity costs of using deeply concessional finance versus other instruments which may provide greater leverage of non-Fund resources.

5.2 Investment strategy and portfolio targets

18. From a financial point of view, specific projects and programmes supported by the Fund can be categorized according to a set of different criteria:

(a) Broad climate change objective of the project or programme: either mitigation or adaptation;

(b) Financial class of project or programme funded: revenue-generating (such as a renewable energy project or public transport system), or non-revenue generating, (such as a climate change strategy);

(c) Borrower/recipient class of the implementing entity undertaking the project or programme, i.e. public sector financing, private sector financing and public-private partnership financing. Support for private sector activities and for public-private partnerships to be undertaken through the PSF;[4]

(d) Country category in which the proposed project or programme is located: the Governing Instrument makes a particular mention of small island developing States (SIDS), least developed countries (LDC) and African States; and

(e) Sector or industry category of the project or programme (such as power, transport, forestry, agriculture, etc.).

19. The investment strategy and portfolio targets will include objectives for some of the categories to inform investment decisions, with flexibility of outcome around the specific targets and limits set by the Board. These targets could also contain a band (lower and upper-bound) around a central value for each of these categories. A review of funding outcomes compared to set investment targets would be undertaken periodically (e.g. annually) to allow course corrections in funding decisions to be taken.

Table 2: Examples of portfolio targets and limits[5]

Investment class	**Example of target[6] (at the level of the Fund portfolio)**
Objective • Mitigation • Adaptation	Balance of annual funding volume between two Fund objectives • Gross cumulative commitment of [50 per cent] for mitigation and a further [50 per cent] for adaptation (see document GCF/B.06/05) • Upper and lower bound of [20 per cent] of gross cumulative commitment around central target
Financial class • Revenue-generating • Non-revenue generating	• Sufficient revenue-generating activities at the portfolio level to ensure maximum impact for the Fund, e.g. revenue-generating activities to exceed [50 per cent] of gross cumulative commitment volume • Grants and the grant element of loans should be set at the minimum needed for financial viability of the project or programme • For revenue-generating activities, a hurdle rate of financial including grant received [e.g. 8 per cent]* to ensure activity-level viability

* Hurdle rate of return might be differentiated by sector, borrower or country group.

4 Projects and programmes will be categorized as private sector if one or more non-sovereign entity(ies) hold a controlling stake in the capital structure (typically more than 50 per cent). They would be accounted for the pro rata private share of the project. Public-private partnerships in which the private party holds less than 50 per cent of the partnership would be accounted for the pro rata degree of private ownership.

5 If these target examples are adopted by the Board they will need to be assigned an indicator to measure their contribution to the target, or compliance with limits.

6 Values in square brackets are for indicative purposes only.

Borrower/recipient class • Public sector • Private sector • Public-private partnership	• Gross cumulative commitment for private sector projects and programmes funded through the PSF, pro rata private share in the activity, to meet [20 per cent] of total funding • Levels to be tracked
Instrument • Grant • Concessional loan If approved by the Board: • Equity • Subordinated debt • Guarantee	• Initially, grants and concessional loans only • Grants provided by the Fund should not exceed a set rate to be determined of total funding provided (e.g. [50 per cent]), in order to constitute a prudential cushion against financial risks • Loan and grant agreements for loans and grants received from partners should contain risk-sharing clauses (based on grant-equivalent accounting) to avoid the possibility of grant providers subsidizing loan providers • Aggregate cost of funding provided should be superior to aggregate cost of funding obtained plus expected non-performing loan rate
Country grouping • SIDS, LDCs, African States • Single-country limit	• A minimum of [10 per cent] of gross cumulative commitments to SIDS, LDCs and African States for adaptation • No target set for low-income and middle-income countries • Single country limit set at five per cent of total outstanding portfolio volume, in grant equivalent

5.2.1 Overall portfolio management

20. Portfolio quality and performance monitoring are key activities of the Board for it to be able to adjust the Fund's overall strategy and to provide guidance to the Secretariat. Quality and performance monitoring has two dimensions: impact monitoring, which will take place through the Fund's results measurement system; and financial monitoring, which will be carried out within both the investment framework and the financial risk management framework.

21. The financial performance of the Fund's portfolio will be tracked:

(a) On a quarterly basis by means of a risk management summary (see document GCF/B.06/10); and

(b) Annually, by means of an annual portfolio review prepared by the Secretariat for discussion together with the Fund's annual financial statements.

22. The Investment Committee will review the annual portfolio review before presentation to the Board.

VI. Recommendation

23. On the basis of this document, it is recommended that the Investment Committee and the Risk Management Committee provide early guidance (e.g. through a joint workshop, together with the Secretariat) on the key inputs to the initial investment policy; investment strategy and targets; and investment guidelines.