Green Climate Fund

Investment Framework

GCF/B.07/06

9 May 2014

Meeting of the Board
18-21 May 2014
Songdo, Republic of Korea
Agenda item 9

Recommended action by the Board

It is recommended that the Board:

(a) Take note of the information presented in document GCF/B.07/06 *Investment Framework*; and

(b) Adopt the draft decision presented in Annex I to this document.

Investment Framework

I. Introduction

1. By decisions taken at the June and October 2013 meetings, the Board established the Investment Committee and the Risk Management Committee (decisions B.04/08 and B.05/13, respectively). At its February 2014 meeting, the Board informally discussed progress reports on the initial investment framework and the initial financial risk management framework (documents GCF/B.06/11 and GCF/B.06/10, respectively). The informal Board discussions and subsequent feedback received from the Investment Committee and the Risk Management Committee, as well as documents submitted to the Board at prior meetings, were utilized for the preparation of this document.

II. Linkages with other documents and prior Board decisions

2. This document has linkages with and addresses matters that cut across the following documents:

(a) Initial Proposal Approval Process, Including the Criteria for Programme and Project Funding (GCF/B.07/03);

(b) Financial Risk Management Framework (GCF/B.07/05);

(c) 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 (GCF/B.07/02);

(d) Initial Results Management Framework of the Fund (GCF/B.07/04); and

(e) Initial Modalities for the Operation of the Fund's Mitigation and Adaptation Windows and the Private Sector Facility (GCF/B.07/08).

3. The recommendations in this document will operationalize decisions B.04/08, paragraph (k), B.05/04, paragraph (e), B.05/05, paragraph (g), B.05/07 and B.05/17. It will support the Investment Committee, as well as the Risk Management Committee to a different degree, in the performance of their duties.

III. Initial investment framework

4. The initial investment framework was prepared under the oversight of the Investment Committee.

5. By its decision B.05/05, the Board decided to adopt a theme/activity-based approach to the allocation of resources in order to meet the Fund's objectives. Resources will be allocated for mitigation and adaptation via a theme-based approach in accordance with the initial parameters and guidelines in decision B.06/06. These relate to adaptation funding in particularly vulnerable countries, funding through the Private Sector Facility (PSF), ensuring a geographic balance for overall funding, and via an activity-based allocation approach to individual projects and programmes. The initial investment framework comprises the Fund's investment policies and operationalizes the theme/activity-based approach mentioned above.

3.1 Purpose of the initial investment framework

6. The Board plays a key role in the governing structure of the Fund, as emphasized by paragraph 5 of the Governing Instrument:[1]

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

7. The purpose of the initial investment framework is to translate the Fund's overall objectives into clear guidelines for investment decisions. The funding targets and allocation guidelines for the approval of projects and programmes will be reassessed by the Board from time to time, based on the Fund's resource base and existing investment portfolio. The process by which such approvals will take place is outlined in document GCF/B.07/03.

8. The intention of this document is to present the components of the initial investment framework, including the key building blocks and a timeline for the development of a full set of activity-specific decision criteria, sub-criteria and indicators to inform future funding decisions.

3.2 Role of the Investment Committee in the initial investment framework

9. Annex XVII to document GCF/B.05/23, 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 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 (PSAG) and the Risk Management Committee.

3.3 Linkage to the initial financial risk management framework and the Risk Management Committee

12. As outlined in document GCF/B.07/05, the overarching purpose of the Fund's initial financial risk management framework is to:

[1] Annex to decision 3/CP.17 of the Conference of the Parties to the United Nations Framework Convention on Climate Change.

(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;

(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 initial investment framework will have a direct impact on the initial financial risk management framework and vice versa. The levels of funding allocated through the theme/activity-based approach to mitigation and adaptation and to activities will affect the overall risk profile of the Fund.

IV. Components of the initial investment framework

14. The Fund's initial investment framework consists of three components:

(a) **Investment policies**;

(b) **Investment strategy and portfolio targets,** which will initially be those set by the Board in its decision B.06/06; and

(c) **Investment guidelines** composed of activity-specific decision criteria to be utilized in the initial proposal approval process.

4.1 Component 1: Investment policies

15. The Fund's set of financial policies will consist of investment policies and financial risk management policies. Investment policies will be set by the Board on the basis of recommendations by the Investment Committee. They will comprise the overall investment guiding principles from a financial point of view and be based on the overall objectives of the Fund as set out in the Governing Instrument. They will need to take into account and be aligned with the initial allocation guidelines (decision B.06/06), the guiding principles for determining terms of financial instruments (to be determined), and the financial risk management framework (document GCF/B.07/05), all of which are also established by the Board.

16. The initial set of investment policies are as follows:

(a) The Fund will finance projects and programmes that demonstrate the maximum potential for a paradigm shift towards low-carbon and climate-resilient sustainable development, in accordance with its agreed results areas and consistent with a country-driven approach;

(b) Funding received and extended by the Fund will be accounted for in grant-equivalent terms based on a standard methodology[2], to be developed by the Fund based on best international practices, to provide an accurate comparison of funding amounts between financial instruments;

(c) The Fund will provide the minimum concessional funding (i.e. a grant-equivalent subsidy element) necessary to make a project or programme viable. Concessional

[2] For example, the methodology developed by the International Monetary Fund: see IMF, "Concessionality and the design of debt limits in IMF-supported programs in low-income countries", October 2013. Available from <http://www.imf.org/external/np/pdr/conc/>. The IMF also hosts a concessionality calculator on its website at <http://www.imf.org/external/np/pdr/conc/calculator/default.aspx>.

funding is understood as funding with below-market terms and conditions. Consistent with the Governing Instrument, the minimum amount of concessional funding needed can be up to and including the full cost of the project or programme[3];

(d) Financing provided by the Fund to intermediaries may be used by the latter to blend with their own financial resources in order to increase the level of concessionality of the financing they extend to projects and programmes;

(e) The Fund will not "crowd out" potential financing from other public and private sources; and

(f) Only revenue-generating activities that are intrinsically sound from a financial point of view will be supported through loans by the Fund.

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

4.2 Component 2: Investment strategy and portfolio targets

18. The theme-based approach to allocation is composed of the Fund's investment strategy and portfolio targets. These represent the funding objectives for the Fund's overall investment portfolio that the Board will seek to achieve through its funding decisions. Initially, these objectives are contained in decision B.06/06.

Table 1: Investment strategy and portfolio targets (as per decision B.06/06)

Strategy	**Portfolio target**
Balance between mitigation and adaptation	50/:50 (over time)
Adaptation allocation for particularly vulnerable countries (including least developed countries, small island developing States and African States)	Floor of 50 per cent
Geographic balance	Reasonable and fair allocation across a broad range of countries
Engagement with the private sector	Maximize engagement with the private sector, including through a significant allocation to the Private Sector Facility

4.3 Component 3: Investment guidelines

19. The initial investment guidelines, consisting of initial activity-specific decision criteria, will operationalize the Fund's investment policies and strategies, and will constitute the activity-based approach to allocation that guides the day-to-day funding decisions to be taken by the Board. The activity-specific decision criteria form the basis of the approval process that enables the Board to make funding decisions regarding project and programme funding proposals, as defined in document GCF/B.07/03.

20. This document proposes 6 initial activity-specific decision criteria and 15 initial sub-criteria, as outlined in Table 2.

[3] Governing Instrument, paragraph 35.

Table 2: Initial criteria for programme and project funding decisions

Criterion	Definition	Sub-criteria
Impact/result potential	Potential of the programme/project to contribute to the achievement of the Fund's objectives and results areas	– Climate-related impact – Sustainable development impact
Paradigm shift potential	Degree to which the Fund can achieve sustainable development impact beyond a one-off project or programme investment through replicability and scalability	– Potential for scaling-up and replication – Knowledge and learning potential – Contribution to the creation of an enabling environment (i.e. achieving systemic change) and to sustainable development, including social, economic and environmental co-benefits for a paradigm shift
	Systemic change towards low-carbon and climate-resilient development pathways	- Ability of a proposed activity to demonstrate its potential to adapt to the impacts of climate change and/or to limit and reduce greenhouse gas emissions in the context of promoting sustainable development and a paradigm shift
Needs of the beneficiary country/ alternative funding sources	Financing needs of the beneficiary country, or fewer available funding sources	– Absence of alternative sources of financing – Income levels of affected population
Country ownership and institutional capacity	Beneficiary country ownership of and capacity to implement a funded project or programme (policies, climate strategies and institutions)	– Existence of a national climate strategy – Coherence with existing policies – Capacity of implementing entities or executing entities to deliver
Economic efficiency	Benefit-cost ratio of activity: impact per US dollar[4] delivered by the Fund	– Cost-effectiveness – Amount of co-financing – Industry best practices
Financial viability (for revenue-generating activities)	Financial soundness of activity	– Project or programme financial return (net of subsidy element) and other financial indicators (e.g. debt service coverage ratio) exceed predefined benchmarks

21. The definitions of the sub-criteria and a set of activity-specific indicators will be decided by the Board based on advice from the Investment Committee, with technical support provided by the Secretariat and stakeholders. These will take into account the Fund's investment framework (included in this document), the Fund's initial results management framework (document GCF/B.07/04), the Fund's initial results areas (document GCF/B.05/23, Annex I), additional adaptation results areas that are to be defined, and gender considerations (decision B.06/07). The definitions of the sub-criteria and set of activity-specific indicators will furthermore be established with a view to ensuring that the guidelines facilitate cross-cutting funding proposals, a results-based approach, a country-driven approach, a geographically

[4] As the Fund uses the US dollar as its currency.

balanced approach, and private sector mitigation and adaptation activities at the national, regional and international levels (decision B.05/05).

22. In order to ensure high quality funding proposals, the Board may decide as necessary to assess funding proposals against minimum benchmarks for each criterion. The Board may wish to request the Investment Committee to advise the Board with regard to these minimum benchmarks, with support from the Secretariat and other stakeholders, taking into account the best practices of other institutions.

23. The PSAG would be consulted during the development of the sub-criteria definitions and set of indicators in order to take into account any differences for private sector funding proposals and the PSF. Furthermore, potential differences in sub-criteria between projects and programmes would be considered, including activities with several phases. Potential differences between adaptation and mitigation funding proposals that go beyond the adaptation and mitigation results areas would also be considered, including for cross-cutting funding proposals.

24. The Board may decide, however, to request the Secretariat to assess the financial viability of the funding proposal as part of its due diligence rather than including it as an activity-specific decision criterion that informs the Board's decision on whether or not to proceed with funding. This is because, as stated in the investment policies (see chapter 4.1 above), financial viability is a precondition for financing revenue-generating projects.

25. Illustrative examples of potential indicators are included in Annex III to this document.

26. Over time, the activity-specific decision criteria will evolve along with the Fund's results management framework to ensure that those project and programme funding proposals that are most likely to achieve the Fund's objectives are retained for funding.

V. Overall portfolio management

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

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

(a) Quarterly by means of a risk management dashboard (see document GCF/B.07/05); and

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

29. The Investment Committee will review the annual portfolio review before it is presented to the Board.

30. Consistent with decision B.06/06, the Secretariat will report annually on the status of resources in respect of the Fund's investment strategy and portfolio target (i.e. allocation parameters). These will be reviewed by the Board no later than two years from the start of the allocation of resources.

VI. Recommendations and next steps

31. The Board may wish to adopt the decision as contained in Annex I.

Annex I: Draft decision of the Board

The Board, having reviewed document GCF/B.07/06 *Investment Framework*:

(a) Adopts the initial investment framework of the Fund, as contained in Annex II;

(b) Decides that the Fund's initial investment framework will reflect the Fund's theme/activity-based resource allocation system as laid out in decision B.05/05;

(c) Requests the Investment Committee to present the following to the Board, with technical support from the Secretariat and other stakeholders and taking into consideration recommendations by the Private Sector Advisory Group, before the Fund approves funding proposals:

(i) Definitions for the activity-specific sub-criteria and a set of activity-specific indicators, taking into account the Fund's initial investment framework, the Fund's initial results management framework, and decisions B.05/03, B.05/05 and B.06/07;

(ii) Minimum benchmarks for each criterion, taking into account the best practices of other institutions;

(d) Also requests the Secretariat to prepare a document for the second Board meeting in 2015 that considers the additional support, expert advice and/or additional structures that are required to facilitate the work of the Investment Committee and the Secretariat relating to development of and assessment against the activity-specific decision criteria;

(e) Decides to undertake a review of the initial investment framework no later than three years from the initial resource mobilization of the Fund, taking into account the results from the Fund's results management framework.

Annex II: Initial investment Framework

1. The Fund's initial Investment Framework consists of the following components:

(a) Investment policies;

(b) Investment strategy and portfolio targets; and

(c) Investment guidelines.

I. Investment policies

2. The Fund's initial set of investment policies are as follows:

(a) The Fund will finance projects and programmes that demonstrate the maximum potential for a paradigm shift towards low-carbon and climate-resilient sustainable development, in accordance with its agreed results areas and consistent with a country-driven approach;

(b) Funding received and extended by the Fund will be accounted for in grant-equivalent terms based on a standard methodology, to be developed by the Fund based on best international practices, to provide an accurate comparison of funding amounts between financial instruments;

(c) The Fund will provide the minimum concessional funding (i.e. a grant-equivalent subsidy element) necessary to make a project or programme viable. Concessional funding is understood as funding with below-market terms and conditions. Consistent with the Governing Instrument, the minimum amount of concessional funding needed can be up to and including the full cost of the project or programme[5];

(d) Financing provided by the Fund to intermediaries may be used by the latter to blend with their own financial resources in order to increase the level of concessionality of the financing they extend to projects and programmes;

(e) The Fund will not "crowd out" potential financing from other public and private sources; and

(f) Only revenue-generating activities that are intrinsically sound from a financial point of view will be supported through loans by the Fund.

II. Investment strategy and portfolio targets

3. The Fund's initial investment strategy and portfolio targets will represent the theme-based allocation mechanism and will be composed of the initial allocation of the Fund's resources, as laid out in decision B.06/06 (see table 1).

[5] Governing Instrument, paragraph 35

Table 1: Investment strategy and portfolio targets (as per decision B.06/06)

Strategy	Portfolio target
Balance between mitigation and adaptation	50/50 (over time)
Adaptation allocation for vulnerable countries (including the least developed countries (LDCs), small island developing States (SIDS) and African States)	Floor of fifty per cent of adaptation allocation
Geographic balance	Reasonable and fair allocation across a broad range of countries
Engagement with the private sector	Maximize fund-wide engagement with the private sector, including through significant allocation to the PSF

III. Investment guidelines

4. The Fund's initial investment guidelines will represent the activity-based allocation mechanism and will be composed of the 6 criteria and 15 initial sub-criteria shown in table 2:

Table 2: Initial criteria for programme and project funding

Criterion	Definition	Sub-criteria
Impact/result potential	Potential of the programme/project to contribute to the achievement of the Fund's objectives and results areas	– Climate-related impact – Sustainable development impact
Paradigm shift potential	Degree to which the Fund can achieve sustainable development impact beyond a one-off project or programme investment through replicability and scalability	– Potential for scaling-up and replication – Knowledge and learning potential – Contribution to the creation of an enabling environment (i.e. achieving systemic change) and to sustainable development, including social, economic and environmental co-benefits for a paradigm shift
	Systemic change towards low-carbon and climate-resilient development pathways	- Ability of a proposed activity to demonstrate its potential to adapt to the impacts of climate change and/or to limit and reduce greenhouse gas emissions in the context of promoting sustainable development and a paradigm shift
Needs of the beneficiary country/ alternative funding sources	Financing needs of the beneficiary country, or fewer available funding sources	– Absence of alternative sources of financing – Income levels of affected population
Country ownership and institutional capacity	Beneficiary country ownership of and capacity to implement a funded project or programme (policies, climate strategies and institutions)	– Existence of a national climate strategy – Coherence with existing policies – Capacity of implementing entities or executing entities to deliver

Economic efficiency	Benefit-cost ratio of activity: impact per US dollar[6] delivered by the Fund	– Cost-effectiveness – Amount of co-financing – Industry best practices
Financial viability (for revenue-generating activities)	Financial soundness of activity	– Project or programme financial return (net of subsidy element) and other financial indicators exceed predefined benchmarks

[6] As the Fund uses the US dollar as its currency.

Annex III: Examples of illustrative indicators for the Fund's activity-specific decision criteria

I. Criterion 1: Impact/result potential[7]

Indicator type	Mitigation
Impact/result potential	(a) tCO_2-eq reduced through improved governance and planning systems for sustainable cities; (b) Reduced emissions from buildings and appliances (tCO_2-eq/m^2); (c) Increased access to transportation with low-carbon transportation options (tCO_2/passenger km); (d) Reduced emission intensity of industrial production (tCO_2-eq/year); (e) Households with access to low-carbon modern technologies (Number of households served by off-grid or clearly identifiable on-grid renewable technologies); (f) Deployment of low-carbon power generation technologies (tCO_2/kWh); (g) Reduced emissions from sustainable land use management (tCO_2-eq/year); and (h) Support to development of negative emission technologies (Number of carbon capture and storage projects, tCO_2 sequestered).
	Adaptation
	(a) Environmental effectiveness: including units of human health (disability-adjusted life years (DALYs)) and units of wealth (US$) saved and enhanced; (b) Cost-effectiveness: US$/DALY and US$ saved; (c) Co-benefits: US$/unit of co-benefit; (d) Institutional feasibility: level of acceptance.

[7] See Annex II, document GCF/B.05/23.

II. Criterion 2: Paradigm-shift potential[8]

Paradigm shift potential	Mitigation
	(a) Carbon intensity of nationally determined sectors (tCO_2/gross domestic product); (b) Facilitating the design of sustainable cities (tCO_2/capita).
	Adaptation
	(a) Environmental effectiveness: including units of human health (DALYs) and units of wealth (US$) saved and enhanced; (b) Cost-effectiveness: US$/DALY and $ saved; (c) Co-benefits: US$/unit of co-benefit; and (d) Institutional feasibility: level of acceptance.

III. Criterion 3: Needs of the beneficiary country/alternative funding sources

Needs of the beneficiary country/alternative funding sources	Mitigation and adaptation
Absence of alternative sources of financing	Share of official development assistance and other official flows in total capital flows (source: International Monetary Fund (IMF))
Income level of affected population	Per capita Gross National Income at purchasing power parity (USD in 2010) (source: IMF) by gender

[8] See Annex II, document GCF/B.05/23

IV. Criterion 4: Country ownership and institutional capacity

Country ownership and institutional capacity	Mitigation and adaptation
Existence of a national climate strategy	Existence of nationally appropriate mitigation actions (NAMA), national allocation plan (NAP), national adaptation programme of action (NAPA), or other national strategy less than five years old
Coherence with existing national policies	Alignment with existing climate policies (as assessed by the Secretariat)
Capacity of implementing entities or executing entities to deliver	Existence of a national designated authority (NDA) Capacity of NDA (as assessed by the Secretariat)

V. Criterion 5: Economic efficiency

Economic efficiency	Mitigation and adaptation
Cost-effectiveness	Alignment with existing climate policies (as assessed by the Secretariat)
Amount of co-financing	Total financing mobilized per USD of GCF financing provided
Industry best practices	Alignment with industry best practices (as assessed during review by external experts)

VI. Criterion 6: Financial viability (for revenue-generating activities)

Financial viability	Mitigation and adaptation
Project or programme financial return (net of subsidy element) and other financial indicators exceed predefined benchmarks	Financial rate of return (net of subsidy element) exceeds the 5 per cent hurdle rate