Private Sector Advisory Group: Initial Recommendations on the Development of the Fund's Risk Appetite[1]

GCF/B.08/41

9 October 2014

Meeting of the Board
14-17 October 2014
Bridgetown, Barbados
Agenda item 29

[1] On document GCF/B.08/32 *Initial Risk Management Framework: Survey of Methodologies to Define and Determine Risk Appetite.*

Recommended action by the Board

The Private Sector Advisory Group recommends that the Board:

(a) Take note of the information contained in the report GCF/B.08/41 *Private Sector Advisory Group: Initial Recommendations on the Development of the Fund's Risk Appetite;* and

(b) Request the Risk Management Committee to engage with the PSAG on matters related to the determination of the Fund's Risk Appetite.

Private Sector Advisory Group: Initial Recommendations on the Development of the Fund's Risk Appetite

Introduction

The Annex of this document contains recommendations from the Private Sector Advisory Group (PSAG) on document GCF/B.08/32 *Initial Risk Management Framework: Survey of Methodologies to Define and Determine Risk Appetite.* These recommendations are included as received from the PSAG without changes or editing, including the title of the document.

Annex: Private Sector Advisory Group: Initial Recommendations on the Development of the Fund's Risk Appetite

I. Introduction

1. In its Decision B.07/05, the Board adopted the Fund's initial financial risk management framework. The Board requested the Secretariat, in consultation with the Risk Management Committee, to prepare an analysis of the Fund's potential risk appetite under different key assumptions as part of its financial risk management framework. The GCF Secretariat is expected to l provide, as a first step, a survey of methodologies used by relevant institutions to define and determine their risk appetite, for consideration by the Board at the third Board meeting of 2014.

2. The Private Sector Advisory Group is mandated to provide recommendations to the Board on Fund-wide engagement with the private sector and modalities to that end (Decision B.04/08 paragraph (i)). Furthermore, the Terms of Reference for the PSAG states that the Risk Management Committee and the Investment Committee will consider recommendations and advice provided to them by the Private Sector Advisory Group.

3. This document contains initial PSAG recommendations on the development of the Fund's Risk Appetite. These recommendations emerged from PSAG deliberation during its second meeting held from 10-12 September 2014 in Cape Town, South Africa.

II. Initial Recommendations on the Fund's Risk Appetite

(a) "Risk Appetite" is not new concept to all financial institutions and the PSAG is ready and able to assist the Board with this journey at a principal level.

(b) Risk is never looked at in isolation, but in conjunction with strategic objectives, the business plan, reputational risk and the expected level of return.

(c) Financial institutions determine their "risk appetite" by analyzing what segments (how many deals, size of trade, location and quantifiable and qualitative measures) it wants exposure given the strategic objectives and business plan and a maximum exposure to that segment and size of any one trade. Almost every financial institution assesses their "risk appetite" on a regular basis, and as a matter of managing their exposures, creating new lines of business, and/or determining how well they are meeting shareholder objectives. "Risk appetites" are also affected by external factors, such as market movements, geopolitical events and changes in counter-party risks.

(d) Risks are not bets, each piece of risk accepted and placed on the books of a financial institution must be able to be managed, hedged or exited should the need occur. Assessment of investments fundamentally incorporates the institution's ability to achieve the return profile of the objective, i.e. does the return warrant the risk and achieve the broader portfolio objective.

(e) In most cases, alternative investments of similar risk and return are compared, and benchmarked, and the one with the best overall fit with an institution's objectives will be invested.

(f) Certain investments that put the reputation or ethic of the financial institution at risk will never be done, irrelevant of the risk/ return profile.

(g) The expected level of return is then adjusted by the risk or the amount the organization is willing to loose should the risk occur.

(h) The difference between the actual loss and the potential loss is attributed to organizational risk management and ability of senior management to make quick and well informed decisions against the risk framework and the institutions objectives;

(i) As a portfolio of assets is accumulated, certain risks will be offset (natural hedges) and new items will appear (items needing to be aggregated), and these too will need to be assed and measured against returns. Financial intermediaries should have the competency to manage various risks towards the strategic objective of the GCF.

(j) Risk results in both losses and profits. The GCF Board and its shareholders need to be comfortable it can deal with both. Given the role of GCF funding to catalyze investments that are not otherwise occurring in mitigation and adaptation, GCF funding may naturally be exposed to higher risks, and possible losses. This does not mean it will be acceptable to not enforce accountability or to not attempt to recover against losses. All partner intermediaries should deploy GCF funds with the highest standard of care, including in structuring default and recovery mechanisms wherever possible to minimize the possibility of loss.

(k) The GCF will operate in its initial phases through accredited partners, and will rely heavily on those partners' risk management functions to assess and understand the riskiness of the underlying portfolio. Thus GCF should ensure its partners are competent to manage risks, and have well-functioning risk management practices.

(l) As the GCF develops capacity to make direct investments, it will also in parallel need to develop the capacity to directly manage the risks of those direct investments. Over time, this will mean the GCF portfolio and the associated risk management framework is a combination of both:

(i) Direct investments; and

(ii) Investments made on its behalf by partner intermediaries.

(m) The GCF Board should understand that the "risk appetite" is not static, and thus it should undertake an assessment of its portfolio risk on a regular basis, and through the information it receives from accredited partner intermediaries. With such assessment it may wish to adjust from time to time the "risk appetite" of the overall Fund.

(n) The GCF Board should consider the resources necessary for risk management and asset management as they address staffing and operations. The PSAG recommends consultation with industry experts to employ best practices."