



**GREEN  
CLIMATE  
FUND**

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Provisional Agenda Item 21

**GCF/B.13/27/Rev.02**

**28 June 2016**

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# Interim risk and investment guidelines

## Risk Management Committee Proposal

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### **Summary**

At its twelfth meeting, the Board requested the Secretariat, in consultation with the Risk Management Committee, to present a revised proposal for the Interim risk and investment guidelines at the thirteenth meeting of the Board. This document presents the Risk Management Committee's proposal on the interim risk and investment guidelines for consideration by the Board.

## I. Introduction

1. The Board, through decision B.12/34, requested the Secretariat, in consultation with the Risk Management Committee, to present a revised proposal for the Interim risk and investment guidelines at the thirteenth meeting of the Board.
2. Furthermore, the Board decided that the Interim risk and investment guidelines will expire the earlier of (a) the fifteenth meeting of the Board, or (b) at the adoption of an updated set of risk policies and guidelines.<sup>1</sup>
3. This document presents the Risk Management Committee’s proposal on the interim risk and investment guidelines for consideration by the Board.

## II. Linkages with other documents

4. This document has linkages to the following documents:
  - (a) Document GCF/B.12/17 titled “Initial risk management framework: risk register, risk appetite update and initial risk guidelines for credit and investment”; and
  - (b) Document GCF/B.07/06 titled “Investment framework”.

## III. Linkages with previous decisions

5. Decision B.04/08 defined the principles guiding the operation of the Private Sector Facility. Decision B.05/07 established guiding principles and factors for determining the terms of financial instruments. Decision B.07/06 defined the initial investment framework of the GCF and decision B.08/12 noted that the use of a broad range of financial instruments is consistent with the investment framework of the GCF. Document GCF/B.10/Inf.10 titled “Brief guideline on the application of the case-by-case provisions in the financial terms and conditions of the Fund’s Instruments” indicated that the terms and conditions of financial instruments shall be determined on a case-by-case basis. Table 1 provides a summary of some of the previous documents related to GCF investment.

**Table 1. Summary of GCF business operation-related documents**

Document	Relevant clause
Governing instrument for the GCF	Eligibility (para. 35): The Fund will finance agreed full and agreed incremental costs for activities to enable and support enhanced action on adaptation, mitigation (including REDD-plus), technology development and transfer (including carbon capture and storage), capacity-building and the preparation of national reports by developing countries. Access modality and accreditation (para. 45) : Access to Fund resources will be through national, regional and international implementing entities accredited by the Board
GCF/B.05/07 “Business model framework: terms and criteria for grants and concessional loans”	Guiding principles (annex II, para. (b)): Guiding principles applicable to private sector operations: (i) Structure terms on a case-by-case basis to address specific barriers; (ii) Minimize concessional terms by assessing needs, market conditions and other factors; (iii) Avoid distortion and crowding out commercial financing;

<sup>1</sup> Decision B.12/34, paragraph (f).

	(iv) Maximize leveraging of other financing, including public and private financing; (v) Promote long-term financial sustainability; and (vi) Apply due diligence to assess the risk to the investment
Annex III to decision B.05/07 (annex III to document GCF/B.05/23):	Guiding principles and factors for determining terms of financial instrument (para. (b) (iii)): Concessional forms of finance will be designed to minimize market distortions and potential disincentives to private investment
GCF/B.08/12 “Use of other financial instruments”	Principles for deployment of financial instrument with the private sector (para. 13): In introducing additional financial instruments to work with the private sector, it will be important for the Fund to ensure it provides additionality, avoids crowding out other sources of finance and minimizes distortion to financial markets
GCF/B.10/inf. 10 “Brief guideline on the application of the case-by-case provisions in the financial terms and conditions of the Fund’s instruments”	Level and structuring of concessionality (para. 26): (...) the Fund will structure terms on a case-by-case basis to address specific barriers, where the grant element of concessional finance is tailored to provide the appropriate incentive to facilitate the implementation of mitigation and adaptation activities

#### **IV. Objective**

6. The purpose of this document is to provide a set of proposed interim risk and investment guidelines in order to help the GCF to fulfil its mission. Until the Secretariat develops an updated set of risk policies and guidelines that include internal risk ratings methodologies, risk limits/tolerances/targets which is scheduled for completion by no later than the sixteenth meeting of the Board, these interim guidelines will help the GCF to manage the risk in the absence of requisite infrastructure and capability at this juncture.

#### **V. Interim risk and investments guidelines**

7. The objective of an organization’s risk management is to ensure that the level of risk it faces is controlled within its risk appetite. The main driver of an organization’s risk appetite is its strategic objective. In the case of the GCF, paragraph 2 of the Governing Instrument for the GCF defines the purpose of the fund as follows; “In the context of sustainable development, the Fund will 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”.

8. In order to fulfil the above-mentioned objectives, [according to the strategic plan for the GCF endorsed by the Board through decision B.12/20,] the GCF should be able to take on risks that other funds/institutions are not able or are willing to take, and so wants to set a high level of risk appetite. Moreover, the GCF recognizes that a high level of risk appetite needs to be supported by solid risk culture and internal capability to manage and report the risk.

9. The GCF needs to develop and establish robust procedures and infrastructure, including internal risk rating methodology for mitigation and adaptation activities. At the moment, the Secretariat is working toward this end, but significant gaps remain.

10. Considering the above-mentioned needs and circumstances, the Secretariat prepared the Interim risk and investment guidelines to guide the day-to-day operations of the GCF. Exceptions to the guidelines can be approved on a case-by-case basis.
11. The proposed interim guidelines are composed of:
  - (a) Guidelines for the public sector (annex II); and
  - (b) Guidelines for the private sector (annex III).
12. Annexes II and III present sets of guidelines that the Board may consider for approval as interim guidelines to be adopted while the GCF develops an updated set of risk policies and guidelines that include internal risk-rating methodologies and risk manuals for GCF financial instruments, asset and liability management, liquidity and market risk. During this period of time until the sixteenth meeting of the Board, the GCF will develop its risk policies and manuals.

## Annex I: Draft decision of the Board

The Board, having reviewed document GCF/B.13/27 titled “Interim risk and investment guidelines”:

- (a) Adopts the Interim risk and investment guidelines as contained in annex II and Annex III to this document. These guidelines will expire the earlier of: (i) the sixteenth meeting of the Board or (ii) at the adoption of an updated set of risk policies and guidelines as determined by decision B.12/34;
- (b) Reiterates that the Green Climate Fund intends to be an institution that takes risks that other institutions or funds are not willing or able to take; and
- (c) Requests the Secretariat to hire a permanent risk manager and additional staff to enhance the Secretariat’s risk management capacity as a matter of urgency.

## **Annex II: Proposed interim risk and investment guidelines for the public sector**

1. Grants: The GCF can finance up to 100 per cent of agreed full costs and agreed incremental costs as per the Governing Instrument for the GCF.
2. Loans: Co-financing is highly recommended whenever feasible.

## **Annex III: Proposed interim risk and investment guidelines for the private sector**

1. The private sector may involve more complex structures of projects/programmes than those of public sector. Considering that the Secretariat's control and monitoring capabilities and infrastructure are not yet fully developed, the GCF will set the following interim guidelines as a stopgap measure.
2. To bridge the Secretariat's temporary capacity gap in terms of risk management, the Secretariat shall seek an independent and reputable third party's opinion on a case-by-case basis.
3. The Board can approve exceptions to the guidelines with review by the Risk Management Committee on a case-by-case basis and the Secretariat is encouraged to take such high-impact/transformational projects forward.

<b>Consideration for the private sector</b>		
<b>Instrument</b>	<b>Parameters</b>	<b>Comment</b>
Grant with repayment contingency, or without repayment contingency <sup>a</sup>	<p>Component of the Private Sector Facility (PSF) project/programme consisting of 100% grants should be limited to 5% of total project cost and should benefit the end beneficiaries such as through providing technical assistance and capacity building.</p> <p>Notwithstanding the above, in some instances the 5% limit may not be appropriate in such cases as small size projects or transformational private sector projects which have large non-revenue generating components, particularly in SID's/LDC's/Africa.</p> <p>Similarly, innovative high impact use of grants beyond technical assistance and capacity building on a case-by-case basis is stimulated, but must always be properly justified and focused on mobilizing additional private sector investment.</p>	<p>In line with the spirit of prior Board decisions that the GCF will work through minimal concessionality with the private sector. Grants need to minimize market distortion and should not to give the wrong signal to the market that the GCF is grant focused in its PSF funding grant, therefore grants need to be restricted (annex III to decision B.05/07 (annex III to document GCF/B.05/23) and the need to employ them must be justified on a case-by-case basis. In addition to technical assistance and capacity building, innovative financing structures might require grants to address certain barriers. Such use of grants however must address specific barriers hindering the mobilization of private investments, which can't be addressed otherwise.</p>
Loan, equity, guarantee	<p>At this early stage, where GCF is building up its Risk Management capacity, GCF's participation in a tranche will be subject to an independent third party advice on risk, except when GCF's participation in a tranche is aligned with all terms and conditions of the AE other than pricing.</p>	<p>It is understood and recognized that the GCF needs to take on the requisite risk to make a transformational impact, provide added value and will have the necessary in house risk assessment capacity to ensure appropriate due diligence.</p> <p>While developing in house risk assessment capacity the GCF will temporarily need to rely on the expertise and experience of AEs and</p>



		<p>independent and reputable third party experts.</p> <p>Where the GCF participates in a tranche aligned with the AE on all terms and conditions other than pricing, the interests of the AE and the GCF are fully aligned and as the GCF is not exposed to more risk than the AE it can fully rely on the AE's risk analysis.</p>
	<p>At this early stage, where GCF is building up its Risk Management capacity, in case the GCF takes the position of the largest contributor (e.g. is the largest debt holder) or the largest financier in its tranche, the Secretariat shall seek an expert opinion from an independent and reputable third party on the risks of the investment decision. This advice will also include an assessment of the capacity that will be needed to manage such a position.</p> <p>In the exceptional case that an investment decision leads to a default situation and the GCF is the largest contributor/financier in its tranche, the Secretariat shall seek service from an independent and reputable third party in order to handle the workout situation.</p>	<p>The GCF does not currently have the workout team to handle a workout situation, being the single largest financier creates the risk of the GCF being the lead in the event of a workout. Before investing into a situation where this sort of capability might be needed, it must be clear how such an event will be handled.</p>

<sup>a</sup> 'Grant with repayment contingency' expects repayment based on predefined milestones and targets which are to be negotiated for each case. Grant without repayment contingency does not expect repayment.

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