Portfolio risk management

GREEN CLIMATE FUND

Portfolio risk management

Background

GCF's mandate is to promote a paradigm shift towards low-emission and climate-resilient development pathways in developing countries. GCF helps countries design, finance, and implement innovative climate initiatives that can be replicated, scaled up, and sustained after completion to achieve transformational change.

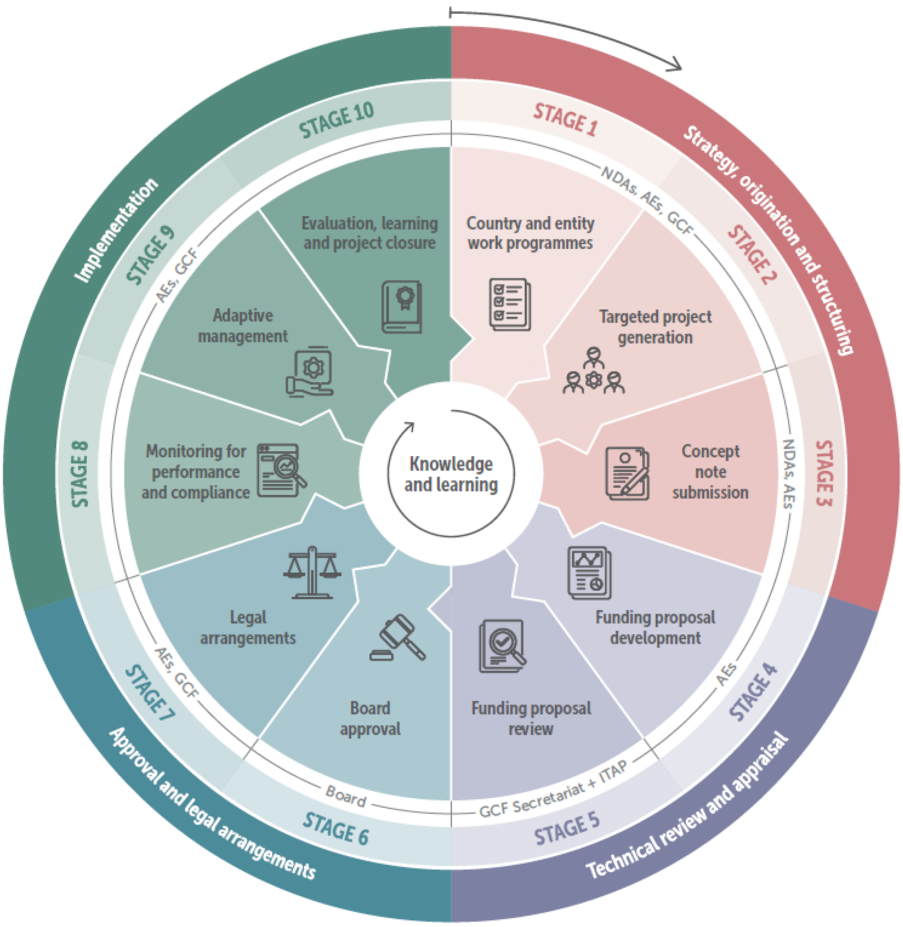
GCF is a partnership institution which operates through a network of accredited entities (AEs) that work directly with developing countries to propose projects and programmes for GCF funding, and implement them once approved. These entities span a wide range of bodies, including multilateral and national development finance institutions, international and national commercial banks, United Nations agencies, equity funds, government agencies, and regional institutions.

GCF has a unique business model in which large funding investments are made, through AEs, across a range of diverse result areas and financial instruments with a mandate explicitly and solely to support the efforts of developing countries as they implement commitments under the Paris Agreement.

GCF Programming Cycle and Risk Assessment

The origination, appraisal, and implementation of GCF investments follow an established ten-stage programming cycle from origination to closure, as detailed in **Figure 1** below (additional details on the GCF's cycle for full size projects and programmes can be found in its Programming Manual).

Figure 1: Stages of the GCF Programming Cycle



The project review, implementation, and performance risk management is guided by the relevant policies and frameworks including the Investment Framework, Monitoring and Accountability Framework (MAF), the Risk Management Framework (RMF) as well as the Integrated Results Management Framework (IRMF).

To ensure seamless and timely tracking and exchange of information and data across the Secretariat and with the AEs/Delivery Partners, the monitoring of performance and risks in the portfolio by the Secretariat during implementation is supported by an integrated Portfolio Performance Management System (PPMS) which will continuously be improved and updated in response to the evolving needs of the Fund and operational realities.

The sections below provide details of the various elements of portfolio risk management at GCF.

GCF risk assessment: Overview of due diligence and appraisal processes

GCF’s overall **due diligence** and **appraisal processes** are tailored to ensure that all its investments contribute to its mandate, and at the same time align with the applicable policies and frameworks (prudent standards of care, probity, and investigation, etc.) at GCF and all institutions involved in the business model.

GCF’s **due diligence** is a risk management process, wherein fact-based screening is applied to potential counterparties such as AEs and Executing Entities (EEs), in order to ensure minimum standards of practice are carried out. The output of due diligence is a determination of the level of compliance with minimum standards.

GCF’s **appraisal** (or assessment of the viability of a project) process entails:

- An analysis of the purpose and approach of a project and its intended impact, and alignment to the GCF strategy as stipulated in the Investment Framework.
- A determination of the risks that may impact on the effectiveness, efficiency, and sustainability of the project results, and the measures necessary to mitigate those risks.

The output of the appraisal process is an assessment of the extent to which a project can reasonably be expected to deliver the intended results within a determined level of risk tolerance. The appraisal is completed with the engagement of the Secretariat’s First and Second Lines of Defence (LOD) for risk.

GCF’s levels of due diligence and appraisal

GCF portfolio risk management comprises two distinct levels of due diligence and appraisal:

1. **Primary due diligence (1DD) and appraisal** is an extensive process undertaken by the originating organisations, in particular the AEs, to document, assess, and verify the details of the investment or financing opportunity being proposed.

   The main output of primary due diligence and appraisal is a concept note or funding proposal package including relevant annexes upon which the GCF Secretariat conducts secondary due diligence and appraisal as outlined below.

   These tasks can be divided within AEs across different units organised in independent LOD to provide quality control and oversight.

2. **Secondary due diligence (2DD) and appraisal** is undertaken by the GCF Secretariat, Independent Units, and Panels to assess the details of counterparties and proposed funding opportunities as well as to ascertain and identify any relevant risks— including technical, financial, environment, and social risks— and to ensure consistency with fiduciary standards of

care, relevant GCF policies and procedures, and GCF's mandate. These duties are fulfilled by three LOD with distinct GCF governing bodies.

As a result of this assessment, GCF may request specific additional clarification, information, and documentation from AEs.

Figure 2 provides an overview of the two different levels of due diligence and appraisal as well as the various actors within each level. Further details are elaborated in Section II.

Figure 2: Levels of due diligence and appraisal

I. The GCF accreditation risk assessment process

AEs are accredited to GCF for a five-year period and are re-assessed against GCF accreditation standards after each period, if they seek to continue as a GCF AE. The GCF's (re-) accreditation process is led by an independent Accreditation Panel which assesses the applicant organisations' institutional capacities related to:

- Basic fiduciary standards on key administrative and financial matters and systems, and transparency and accountability including financial management and accounting systems; audit systems; control frameworks and procurement; disclosure of conflicts of interest; code of ethics; capacity to prevent or deal with financial mismanagement and other forms of malpractice, prohibited practices, money laundering, and financing of terrorism.
- Project management including project preparation and appraisal from concept to full funding proposal; project oversight and control; monitoring and evaluation; and project-at-risk systems and related project risk management capabilities.
- Funding instruments abilities including:
  - Grant award and/or funding allocation mechanisms e.g., grant award procedures; transparent allocation of financial resources; public access to information on beneficiaries and results; and good standing with regard to multilateral funding.
  - On-lending and/or blending for loans, equity and/or guarantees appropriate registration/licensing for such activities; creditworthiness; due diligence and investment management policies, processes, and procedures; financial resource management; public access to information on beneficiaries and results; financial risk management (including asset liability management).

The independent Accreditation Panel also assesses the Accredited Entities' institutional structure, capacities, and competencies to implement the requirements under GCF's environmental and social safeguards and gender policy.

Based on its assessment of the AE's capacities denoted above, the Accreditation Panel recommends the scope of AE accreditation for Board approval. Once approved, AEs can then submit funding proposals to GCF within the scope of their accreditation.

II. Due diligence and appraisal process for funding proposals

This section further details GCF's primary and secondary due diligence and appraisal processes.

1. Primary due diligence and appraisal

Primary due diligence and appraisal can be divided between due diligence on counterparties and appraisal of investment/financing opportunities.

a) Due diligence on counterparties

The AEs conduct due diligence on the EEs which will implement the projects or programmes, as well as on other responsible parties or implementing partners which are the subject of procurement by the AEs.

AEs and National Designated Authorities (NDAs) conduct their own primary due diligence and appraisal based on their individual frameworks and/or government regulations. The assessment of these frameworks, and of the capacity of the AE to carry out its primary due diligence responsibilities effectively, is done during the GCF accreditation process outlined in section I above.

b) Appraisal of investment/financing opportunities

Appraisal of investments and financing opportunities at primary level is done by AEs and NDAs:

The role of AEs in Appraisal: As set out in the GCF Programming Manual, AEs are responsible for developing and initially appraising the concept note or funding proposal, as part of their primary due diligence responsibility. These obligations which are set out in the legal agreements including the Accreditation Master Agreement (AMA) signed between an AE and the GCF. These agreements require each AE to conduct the necessary appraisal of potential GCF investments and apply the same rigor that it would apply to its own portfolio or investing its own funds, or funds for which it has management or investment responsibility, pursuant to its policies and procedures. Based on this appraisal, the AE elaborate on the investment criteria and sub-criteria relevant to its funding proposal and clearly documents the conclusions and recommendations of primary due diligence within the funding proposal. The AE also consults NDAs and requests no-objection letters (NOLs) from NDAs to ensure country ownership.

The role of NDAs in Appraisal: The NDAs role in primary appraisal goes beyond the provision of NOLs. In particular, NDAs, on behalf of the government of the recipient country, ensure that funding proposals to be submitted to the GCF are selected and prioritised in line with national development needs, policies, regulations, and plans, including Nationally Determined Contributions (NDCs) to the Paris Agreement, and other national plans related to climate change, including GCF Country Work Programmes.

2. Secondary due diligence and appraisal.

GCF's secondary due diligence and appraisal process is anchored in its Board approved **initial**

Investment Framework and Risk Management Framework (RMF) and builds on the work of the AEs and NDAs in the funding proposal appraisal process.

The Risk Management Framework (RMF) establishes three lines of defence (LOD) for GCF's second level of due diligence:

a) **First Line of Defence (LOD1)**: comprises owners and managers of risk from many units within the Secretariat.

b) **Second Line of Defence (LOD2)**: comprises a control and oversight function which is independent of the first to ensure that funding proposals comply with GCF strategic priorities, investment policies, environmental and social safeguards, and risk management framework. It centres on an inter-divisional Climate Investment Committee (CIC) and is supported by the Office for Risk Management and Compliance.

c) **Third Line of Defence (LOD3)**: independently verifies and validates the effectiveness of the first two in fulfilling their mandates and managing risk.

This comprehensive framework also sets the risk appetite for GCF, and establishes a risk register and risk dashboard, which are used by the Secretariat in its decision-making. The LOD within GCF's secondary due diligence and appraisal function are elaborated in **Figure 3** below and further in Annex 1.

Figure 3: Second Level Due Diligence and Appraisal: Roles of GCF Secretariat, Independent Audit function, Panels, and Units

		Lines of Defence (LOD)		
		First LOD	Second LOD	Third LOD
Reporting to ED of GCF Secretariat	Function	Proposal Origination and initial risk analysis	Risk Control, policy and legal compliance	Internal Audit
	Responsible Units	Origination & IPT	ORMC	OIA
		IPT (all units) to Climate Investment Committee		
Reporting to GCF Board	Function	Assesses the applicant organizations' (AEs) institutional capacities	Assesses project quality	Ensure adherence to Standards and Practice & assurance of results
	Responsible Panels and Units	Accreditation Panel	Independent Technical Advisory Panel (ITAP)	Independent Units

Key elements of the appraisal process

The GCF Secretariat appraisal process is initiated by the origination teams (DMA, PSF, and DCP) who conduct an initial review of each funding proposal (FP) and/or concept note (CN) to ensure that it meets the basic conditions/requirements (see key questions in **Figure 4**). If these are met, the origination teams then work with the GCF Secretariat's Interdivisional Project Team (IPT)[1] to undertake an in-depth review of FPs, including a risk analysis by units working directly with AEs on funding proposal origination and implementation.

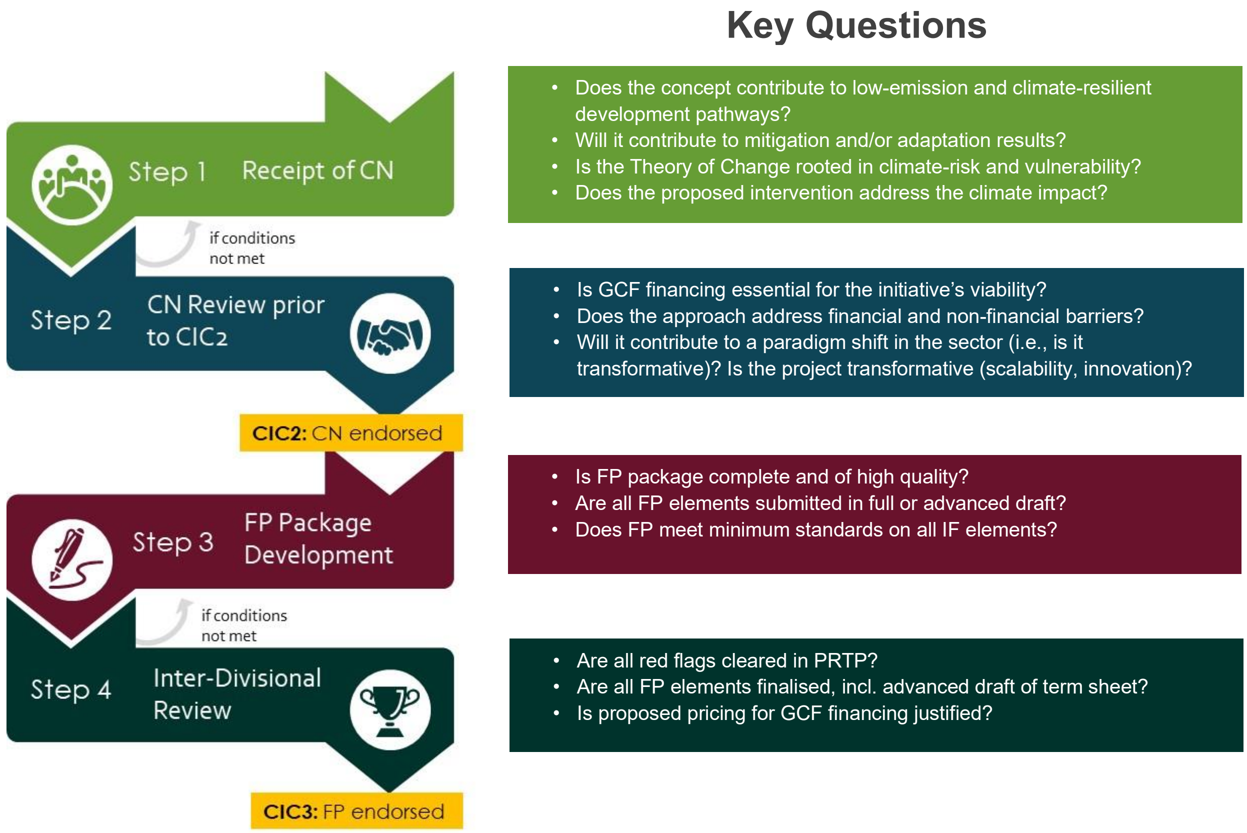
The IPT is responsible for conducting a thorough assessment of all elements of the FP package, including technical soundness and best practices in the areas of investment risk, compliance, Environmental and Social Safeguards (ESS), greenhouse gas (GHG) calculations, economic and financial analysis, detailed budget and sources of co-finance, and other sources of secured or potential mobilised finance. The IPT also reviews whether the project or programme has been designed in accordance with the logic elaborated in the Theory of Change (ToC).

The assessments and appraisal produced by the IPT are reviewed and validated by the Climate Investment Committee (CIC) of the Secretariat. The CIC reviews the results of the secondary due diligence (2DD) conducted by the first line of defence (LOD1) of the Secretariat and performs the 'challenge function' (i.e., the CIC critically assesses the quality and sufficiency of the first line's appraisal of proposals) and takes decisions on the readiness of FPs to progress to subsequent appraisal stages towards submission for Board consideration and the final funding decision.

Figure 4 illustrates the proposal review and appraisal decision flow process within the Secretariat, from receipt of a CN to the endorsement of an FP package, prior to submission of the package to the independent TAP.

[1] The Interdivisional Project Team (IPT) is composed of the Division of Mitigation and Adaptation (DMA), the Division of Private Sector Facility (DPSF), as well as the Division of Country Programming (DCP), the Division of Portfolio Management (DPM), the Division of Support Services (DSS-Fin), the Climate Impact Assessment Network (C-NET) and the Office of Risk Management & Compliance (ORMC).

Figure 4: Appraisal process decision flow within GCF Secretariat



III. Risk assessment during implementation: Risk-based monitoring and management

Guided by the MAF and RMF, the Secretariat takes a risk-based monitoring approach which uses an early warning system to provide information and flag risks on performance and compliance. There are two monitoring components to this approach:

1. AE compliance with GCF accreditation standards; and
2. Performance of funded activities (projects/programmes).

AE compliance with accreditation standards is monitored through self-assessment reporting, mid-term reviews, review and analysis of AE portfolio performance, as well as information from the independent units.

Monitoring of performance and risks related to funded activities during the implementation phase is done through reports, evaluations, and ad-hoc information gathering. **Table 1** below provides details on the types of risks that are monitored, in addition to monitoring performance on result delivery of the portfolio according to its recently adopted Integrated Results Management Framework (IRMF).

Table 1: Implementation risks by type

RISK TYPE	EXAMPLES
Operational risks	Start-up delays, inadequate or failed internal processes, systems, people, or external events, restructuring
Political risks	Election and change in government, humanitarian crisis, war, civil disorder, terrorism, sanctions and embargoes, criminal activities, other

	country-specific risks
Procurement risks	Procurement Integrity risks, disruption/lapse in supply chain, conflict with suppliers, market failure
Legal risks	Contractual breach, legal disputes, insurance issues, change in law and regulations on the ground, third-party liabilities
Sanction-related risks	UN sanctions
Compliance risks	Non-compliance with any GCF policies and procedures and external requirements such as procurement contracts, country laws, and international agreements
Risks related ESS, Gender, and Indigenous Peoples	Any activities against GCF policies on ESS, Gender, IPs
Financial risks	Financial integrity risk, Potential default on loan repayment, asset-liability management issues
Other	Natural uncertainties (e.g., COVID-19), cyber security risks

As with the due diligence and appraisal processes that take place during Stages 3,4, and 5 of the GCF's ten-stage programming cycle during project/programme implementation, risk assessment and appraisal are also conducted across three LOD:

a) **First Line of Defence (LOD1): IPT with DPM in the lead conduct risk** assessments based on monitoring tools (Annual Performance Reports, Annual AE self-assessment, midterms review of AE compliance performance, financial reports, interim evaluation reports) to identify and flag underlying issues impacting implementation. Analyses of whether project/programmes are being implemented in line with GCF policies such as financial management, RMF, anti-money laundering (AML), countering the financing of terrorism (CFT), Prohibited Practices Policy, ESS, Gender are also conducted.

b) **Second Line of Defence (LOD2)**: The Operations Committee (OC), within the authority conferred on the Secretariat by the Board and the Governing Instrument, oversees the implementation of funded activities. With particular respect to projects under implementation, the OC reviews and provides guidance and advice (in line with the Policy on Restructuring and Cancellation) on deviations from the initial approved proposal and related terms and conditions, or from the GCF policies and guidelines. Its recommendations include referring issues to the GCF Board for consideration and decision (e.g., in case of deviations from terms and conditions that were approved by the Board). Additionally, the OC reviews and advises on actions related to portfolio implementation challenges, non-performing projects/programmes, and any other issues arising during implementation for management action.

c) Third Line of Defence (LOD3): The Independent Units, the Independent Audit function as well as Independent Evaluators in the case of project/programme evaluations required of AEs during implementation (interim and final evaluations) independently verify and validate the effectiveness of the first two lines in fulfilling their mandates and managing risk.

GCF Portfolio Performance Management System (PPMS)

The GCF utilises its PPMS as a centralising platform to codify processes of managing project risks and performance as well as associated data in a comprehensive manner. The PPMS also facilitates information management and exchanges on project risk and performance across the GCF project life cycle. Upstream risk assessment processes (i.e., accreditation and funding proposal appraisal as outlined above) inform and feed into the PPMS about early warning signals or low performance that may occur in project implementation. Based on the signals, GCF takes precautionary measures on potential risks and provides targeted support to relevant AEs during project implementation. Once projects start implementation, GCF tracks and monitors project risks and implementation performance within the PPMS.

The identified risks and low performance are analysed to facilitate the timely execution of corrective action on projects at risk and bring the projects back on track, thereby improving the overall portfolio health. For instance, based on findings from the analyses, GCF determines where and when to conduct site visits and ad hoc checks on projects under implementation and makes decisions on taking remedial measures and providing capacity building support to AEs. The findings are also used to feed into the next accreditation and funding proposal appraisal, creating a feedback loop.

To identify and analyse risks and low performance, the following parameters are considered during the project implementation or after the project completion:

1. Slow implementation progress or delays against key milestones in implementation plans, and slow paces of disbursement and expenditure processes;
2. Poor reporting quality and frequency of untimeliness against timeframes set out in legal agreements;
3. High deviations of result delivery from mid-term and final targets (e.g., GHG) emissions reduced or the number of beneficiaries);
4. Low built capacity of entities for managing knowledge on lessons learned and good practices from project implementation; and,
5. Any types of implementation risks as outlined in **Table 1**.

The PPMS also supports the collection and tracking of risks identified by GCF's Independent Units (IUs) and from internal audits and media monitoring on an as-needed basis.

IV. Third level: Independent Risk Assurance

The third line focuses on the independent review, assurance, and accountability of the actions and interactions between AEs and the Secretariat, as well as between second line units within the Secretariat. GCF's third line of defence includes the Office of the Internal Auditor (OIA) and the three independent units (IUs): the Independent Evaluation Unit (IEU), the Independent Integrity Unit (IIU), and the Independent Redress Mechanism (IRM).

1. **Office of the Internal Auditor (OIA)**

   As set out in Board decision B.BM2015/06, the OIA's mandate is to determine whether the GCF's risk management, controls, and governance processes provide reasonable assurance of the following:

   a) Effective and economic use of resources;
   b) Accuracy and reliability of the Fund's financial and operational information;
   c) Safeguarding of Fund assets;
   d) Compliance with the Fund's decisions, policies, and guidelines; and
   e) Achievement of the Fund's programmes, plans, and business objectives.

   The OIA independently undertakes various audits including that of the funding proposal review and portfolio monitoring processes, GCF's risk management approaches as well as ad hoc audits and reviews.

2. Independent Evaluation Unit (IEU)

In line with paragraphs 59-62 of the Governing Instrument, the objectives of the IEU are to:

a) Inform the decision-making by the Board and identify and disseminate lessons learned, contribute to guiding the Fund and stakeholders as a learning institution, providing strategic guidance.
b) Conduct periodic independent evaluations of the Fund's performance in order to provide an objective assessment of its investments and results and the effectiveness and efficiency of its activities.

The purpose of these independent evaluations is to inform decision-making by the Board and to identify and disseminate lessons learned. Findings of evaluations also inform measures that are taken to mitigate impact risk. Lastly, evaluation results should feedback into the development, update, and design of strategies, polices and operations, thus contributing to enhancing the quality of overall performance of the GCF.

3. Independent Integrity Unit (IIU) – Integrity risk assessment and mitigation

The IIU takes a proactive approach in managing integrity risks across GCF operations by developing and implementing robust preventive measures that include:

a) Conducting integrity risk assessments and subsequently proactive in-depth reviews of projects/programs to assess a project's vulnerability to integrity violations and to detect and mitigate red flags and risks at an early stage.
b) Providing guidance advisories to the GCF Secretariat and AEs regarding the implementation of GCF integrity policies on matters related to financial mismanagement, Prohibited Practices, reporting mechanisms and conflicts of interest.
c) Providing technical support to AEs to enhance their capacity in addressing integrity issues in the implementation of GCF-funded projects and establishing cooperation arrangements to facilitate joint activities and effective communication.
d) On a need-to-know basis, informing and consulting the Secretariat, in a timely manner, about existing or potential risks identified in relation to investigations.
e) Encouraging and safeguarding whistleblowing as an early warning mechanism to enable mitigation measures prior to escalation of integrity violations and consequential damages to the Fund.

Figure 5: Integrity Risk Monitoring Process Flow

4. **Independent Redress Mechanism (IRM)**
   As part of the GCF accountability mechanism, the IRM addresses the grievances and complaints of a person or a group of two or more persons or communities who have been or may be affected by adverse impacts through the failure of a project or programme funded by the GCF to comply with applicable GCF operational policies and procedures, including environmental and social safeguards. Thus, the IRM helps the GCF take appropriate measures to mitigate related risks that are brought to its attention. The IRM handles complaints from design stage and up to two years after project closure OR up to two years after the complainant becomes aware of the harm, whichever is later.

ANNEX I

In the context of the funding proposal development and review process, within the Secretariat, the roles of the three LOD as set out in **Figure 3** are summarised in the following table.

THREE LINES OF DEFENCE	ROLE AND FUNCTIONS
First Line (LOD1)	**RISK OWNER**
IDENTIFY, ANALYSE, MONITOR and ADDRESS RISK	• Own, identify, manage, measure, and monitor current and emerging risks in concept note and funding proposal development. • Design, implement, and maintain appropriate measures to mitigate risks in CN and FP development, and assess the operating effectiveness of those measures. • Assess CNs and FPs for compliance with applicable laws and regulations. • Monitor and report on risk profile so that FPs are within GCF's risk appetite and policies. • Recommend risk-based approval processes for all submissions. • Determine whether the project or programme is designed to contribute primarily to low-emissions and climate resilient development pathways, • Will the project/programme provide measurable mitigation or adaptation results? • Do the proposed interventions directly address identified climate risks and vulnerabilities? • Escalate risk issues (e.g., capacity constraints of AEs in due diligence) and develop and implement action plans in a timely manner. • Implement training, tools, and advice to address risk in FP development. • Promote a strong risk management culture.
Second Line (LOD2)	**RISK OVERSIGHT**
CONTROL FUNCTION, STANDARD SETTING	• Establish and communicate risk control strategies and frameworks within the Secretariat • Provide oversight and independent challenge to the first line through an effective, objective assessment that is evidenced and documented where material, including: • Identify and assess current and emerging risks and controls, using a risk-based approach; • Monitor the adequacy and effectiveness of internal control activities; • Review and discuss assumptions, material risk decisions and outcomes; • Aggregate and share results across business lines (e.g., DMA, PSF) and risk categories to identify similar events, patterns, or broad trends; • Identify and assess, and communicate relevant regulatory changes; • Develop and implement risk measurement tools (risk register) to ensure alignment of FP development practice with GCF's RMF; • Monitor and report on compliance with GCF's RMF and policies; and • Escalate risk issues in a timely manner. • Report on the risks of the Fund on an enterprise-wide and disaggregated level to the Board and/or senior management, independently of the business lines or operational management. • Design and deliver training, tools, and advice to support the first line in carrying out its duties. • Promote a strong risk management culture.
Third Line (LOD3)	**INDEPENDENT RISK ASSURANCE**
INDEPENDENT VERIFICATION AND VALIDATION	• Verify independently that GCF's RMF and appraisal process is designed and operating effectively. • Validate the effectiveness of the first and second lines in fulfilling their mandates and managing risk.