# Comments and analysis:

## Risk Management Framework

## GCF paper: GCF/B.07/05

### Review Note for the 7th meeting of the Green Climate Fund

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## Contents



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# Introduction

Risk management framework of the Green Climate Fund (GCF) provides guidance on the fund's "risk appetite" which will be considered for investment decisions made under the Fund. This essentially sets out the overall level of financial risk the Board is willing to assume for the Fund in pursuit of its objectives and that will be reflected in the Fund's investment framework. The proposed document (GCF/B.07/05) provides a conceptual outline of the framework, how the risks can be categorised and various instruments to measure them. This brief analyses the recent version of the risk management framework against lessons drawn from the IIED Climate Change Group's in country assessments of other global funds. The information presented within this note is specifically designed to present perspectives held by the Least Developed Countries' group.

# 1.0 What is the right level of risk appetite needed to fund transformative actions in LDCs?

The risk management framework document proposes that GCF should identify the right balance of risk while funding investments. This right level implies striking a balance between having on one hand a high level of risk appetite within the GCF to encourage climate change responses that are unconventional, novel, and risky and will not be funded through existing markets. On the other hand, the fund needs to be self-sustainable and viable in the long run and therefore the risk appetite should be bearable and not undermine long-term viability. This will mean that the Fund must make a trade off between 'excessive risk' (i.e. climate-related investments, which, by funding an excessive amount of non-viable projects, would endanger the long-term viability and sustainability of the Fund), and 'insufficient risk' (i.e. climate-related investments, that would not lead the Fund to achieve its stated objective of promoting a paradigm shift in developing countries).

## 1.1 Comment and Considerations

The paper suggests that determining this right balance of risk and sustainability will be done iteratively overtime using regular monitoring. The experience of the Clean Technology Fund (CTF) is suggested as a possible reference point for the GCF. Nevertheless, the experience of the CTF still suggests there is a challenge of balance to be struck to achieve the overarching objective of supporting transformative change in developing countries[1].

The Board members should also consider having a higher risk appetite for investments in least developed countries. For example, while setting the initial values for key risk parameters (e.g. ceilings for Non-Performing Loans (NPLs)) the delay risks, stakeholder risks, country risks could be higher in some countries over others, and therefore country-needs factored in to performance. If country need and performance are linked, the tolerance level for the proportion of NPLs should be accepted as higher in Least Developed Countries, where return on investments will take longer.

[1] The effectiveness of climate finance: a review of the Clean Technology Fund, Working Paper, ODI, 2013, page 17

# 2.0 Risk governance of asset-side risks

The fund assumes financial risks at three levels :(a) asset-side risk; (b) liability-side risk; (c) asset-liability mismatch risk. The asset portfolio of the Fund comprises of financial instruments such as grants and loans which will be allocated based on board approvals and finally through accredited Implementing Entities (IE) and Intermediaries. Liability-side risk constitutes risks when contributing countries could fail to honour the pledges or when countries experience currency risk. Asset-liability mismatch risk means a mismatch between assets and liabilities or grants offered vs grants received from contributing countries. The latter will be managed by the Secretariat.

As the asset-side risk will be managed through IEs and Intermediaries, as stated within the point 5.1 (para 10a (ii) of the proposed framework,

> '*Initially, as the Fund will not operate directly and rather relies on other entities for project implementation, the appraisal, management and mitigation of risks at the project level will be the responsibility of intermediaries and IEs/EEs. Therefore, the Fund will need to monitor and manage financial risk at the portfolio level. The Fund will also have to ensure that intermediaries and IEs/EEs are adequately monitoring and managing the risks of the projects for which they are responsible.'*

This approach requires that the respective IEs and intermediaries have sufficient risk controls in place and also institutionalised covenants communicated to the secretariat and the executing entities.

## 2.1 Comment and Considerations

At present, multilateral agencies such as IFC, WB, etc. are some key institutions which have their own risk controls in place. Apart from that, national institutions, particularly in least developed countries, may not have sufficient mechanisms in place. In cases where controls are not in place, technical assistance for readiness support would be needed to enhance capacities for risk measurement. The guiding framework on accreditation of NIEs, etc., lists these aspects in the specialised fiduciary standards needed for the NIEs where project risk management capabilities will be important to acquire accreditation that meets specialised fiduciary standards. However, some countries are taking some initial steps to enable national MDAs (Ministries, Departments and Agencies) to integrate financial, environmental and climate risks within their national project approval processes. The Climate Fiscal Framework[2] is one such initiative in Bangladesh and Nepal, whereby implementing entities are expected to consider financial and climate risks within at their project proposal stage. An analysis of such innovations will offer interesting lessons to draw from.

Although some evidence shows that even if institutions have strong risk measurement standards, compliance and implementation of risk management measures are not always at its best, especially if we look beyond financial risks (e.g. social and environmental risks). For example, the IFC is presented as an international best practise benchmark for financial risk and performance standards. However, according to a recent audit report the IFC struggles to monitor risks adequately on the ground, due to inadequate oversight of application of standards. Even if the qualities of standards are good, their oversight and application is important. An emphasis on building the capacities for monitoring and oversight could be one area for further readiness support during the accreditation process.

[2] MoF, Climate Fiscal Framework, Ministry of Finance, Bangladesh.

The issue of oversight clearly connects with the issue of establishing linkages between higher level risk assessments with portfolio level risks. For example, the paper suggests the roles and responsibilities of the Secretariat, Board and Committees vis-à-vis GCF financial risk governance (Table 2, page number 10). However, the linkages between aggregate level risk governance (Secretariat) and portfolio level risk governance needs further attention. It will make sense to provide an overview or flow diagram with risk governance responsibility at the fund level and then by NIEs and Intermediaries at the portfolio and project level. Working through these details at an early stage will allow establishing better mechanisms for monitoring and overseeing the application of risk management measures, especially at the portfolio and project level.

# 3.0 Exploring innovative risk mitigation instruments for Least Developed Countries

Besides ensuring there will be an acceptable level of risk appetite, countries require innovative risk mitigation instruments to address high risk challenges, such as those faced by least developed and small island countries. Conventional risk mitigation instruments are designed to meet conventional risks in conventional circumstances, however, these may not work in unconventional circumstances as those experienced in high risk countries.

## 3.1 Comment and Considerations

It is important that the paper gives examples of risk mitigation instruments that may work specifically in exceptional circumstances. For example, the Scaling-up Renewable Energy Programme (SREP) funded by the Climate Investment Funds (CIFs) is using specific risk hedging financial instruments to address “delay risk” and “foreign exchange risks” through SREPs foreign exchange risk support. A conventional small hydropower project in Nepal requires some time spent in project development which can extend the project for years. This could present significant foreign exchange rate risks, particularly under Nepal’s economic conditions. Risk mitigation support in the form of hedging forex risks was factored into the fund to deal with circumstances which are specific to least developed or small island countries, where the combination of project delays and currency fluctuations in currency value can affect project costs. Liability-side risks take these into consideration to some extent, but a more thorough examination could help.

Our knowledge around such instruments specifically designed for high risk countries is limited. An analysis and presentation of the comparative advantage of different instruments used by different funds in high risk countries and contexts or in different sectors other than climate change focussed areas could be one step to increase knowledge on specific risk mitigation support tools.

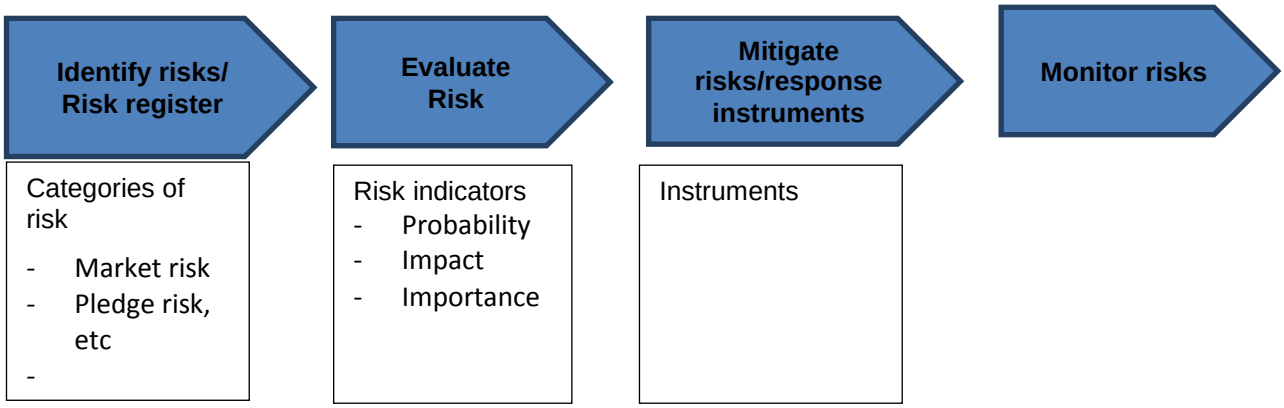
# 4.0 How risk will be measured, evaluated and managed

The current document provides a holistic overview of the categorisation of risk (Annex 3, page number 12) under the table titled, the ‘Fund’s financial risk categorization and management’. However, the table currently leaves many unanswered questions. For examples what will be the dimensions for evaluation? How will the risks be measured: by calculating probability, impact and priority? And, what kind of risk mitigation instruments can be suggested?

### 4.1 Comment and Considerations

The table would benefit from the addition of a preliminary risk register, as well as some preliminary examples of how risks will be measured. The weights given for risk assessment and the instruments suggested for risk mitigation will need to be tailored to different categories of countries (Developing, LDC, SIDs), and therefore an example sheet could provide an overview of risk evaluation and risk by different categories of countries.

An example table for each country category could be presented under following aspects:




## 5.0 Cross subsidization[3] of Non-Performing Loans (NPL)[4] risk

Irrespective of the risk appetite level set by the Board, some financial risks will be taken for Non-Performing Loans (NPL), which comprise of those loans which may have a high chance of not being able to generate returns. The question arises, how will these NPL risks be covered?

The proposed framework suggests three cross subsidisation options: (1) grant providers take on the NPL risk (However, cross subsidisation between the providers of grants and providers of loans is not favoured by grant contributing countries); (2) lenders to the fund could write down the value of their loans to cover for NPL risks; (3) establish a capital cushion by the fund to cover NPL risk.

### 5.1 Comment and Considerations

Due to the nature of climate change, a risk rate or value needs to be set to maintain a level of tolerance for non-performing loans. If NPL increases the amount of grants or loans given by contributing countries it can cause an asset-liability mismatch.

However, cross subsidisation by grants could bring the risk where the willingness of donors to provide grants will be limited. An ideal mechanism should avoid such cross subsidisation risks.

## Conclusions

The framework document represents a step forward in discussing and setting out a direction for ensuring that the GCF has the right guidance and institutions in place to ensure an adequate risk

[3] Cross-subsidization means where payment for a Non Performing Loan comes from the profits generated from the better performing ones.
[4] A Non-Performing Loan is a loan which is either in default or has a high likelihood of being defaulted.

appetite. Due to high levels of uncertainty and low levels of current capacity (especially amongst LDC countries), climate investments are inherently risky. Establishing institutions and mechanisms to both encourage adequate risk taking and manage associated implications for the long-term financial sustainability of the GCF is critical.

The current documents goes a long ways towards addressing these issues, but much more can be done to ensure risk management does not undermine the importance of investing in low income and island countries. Towards this end, any framework will need to:

- Ensure that any risk management responsibilities assigned to an organisation (e.g. IEs, etc.) are paired with adequate readiness support and technical assistance;
- Explicitly recognise that climate investment in LDC and island countries are high risk, and that these risks need to be managed rather not avoided;
- Establish higher tolerance acceptance levels for the underperformance (e.g. NPLs) of high-risk investments;
- Learn from existing financial risk management instruments (e.g. forex hedging, etc.) employed by existing funds to ensure that the mechanisms selected are based on best available knowledge;
- Avoid cross-subsidising loans using grant funding as much as possible, and recognise the appetite of donors for any risk mitigation strategy.

IIED's experience working with major climate funds and development projects, including the Climate Investment Funds (CIFs), LDCF, GEF, Adaptation Fund, etc. gives it a unique perspective on the challenges and opportunities encountered through different approaches to climate finance. Learning from the large body of existing evidence on what mechanisms work best will be important for ensuring that the GCF benefits from existing knowledge and avoids challenges faced by other funds in the past.