Risk appetite statement *(Component II)*

This document is as adopted by the Board and contained in annex VI to decision B.17/11, paragraph (a) (ii).

I. Introduction

1. Through decision B.13/36, the Board requested the Secretariat, in consultation with the RMC, to develop the necessary methodologies to enhance the Secretariat's risk management capacity. This document presents the initial risk appetite statement to guide the level of risk taking by the Green Climate Fund ("GCF", "the Fund") and, where required, steer mitigation of such risks. This document is part of the broader Risk Management Framework ("RMF").

2. In order to achieve its mission to promote paradigm shift towards low-emission and climate-resilient development pathways, the GCF will be required to take various forms of risks. The definition of these risks is included in the risk register (part of the RMF).

3. This document[1] provides a statement of the levels of risk that the GCF is willing to take (the Fund's "appetite" for risk). The risks are differentiated across the types defined in the risk register (part of the RMF), and are further differentiated between risks inherent with running a large fund, and risks specific to the considered funding proposals.

4. The risk appetite statement is the desired risk profile for the GCF as a whole across the full spectrum of risk-types defined in the risk register (another component of the RMF).

5. The purpose of the risk appetite statement is to provide guidance on:

(a) Overall level of risk that GCF is willing to take to achieve its objectives;

(b) Types of risks to be monitored; and

(c) Qualitative appetite statements and quantitative metrics that can be cascaded to specific business units to guide their day-to-day operations.

6. The risks faced by the GCF range from those for which the GCF has no appetite (e.g. compliance risks) to those that the GCF has a relatively high risk appetite, e.g. certain Funding Proposal ("FPs", "proposals") risks. Overall, the GCF has zero-tolerance for illegal practices and integrity or policy breaches, relatively moderate risk tolerance for activities that arise as a result of operating a global investment fund, and considerable risk tolerance for activities necessary to realize GCF's mandate.

II. Linkages with previous decisions and other documents

7. At its seventh meeting, the Board requested the Secretariat, in consultation with the RMC, to prepare an analysis of the Fund's potential risk appetite under different key assumptions as part of its financial risk management framework (decision B.07/05).

8. Furthermore, the Board took note of document, B.09/13 "Initial Risk Management Framework: Survey of methodologies to define and determine risk appetite" (decision B.09/06).

9. The Board requested the Secretariat, in consultation with the RMC, to present an initial risk appetite statement for the GCF as per decision B.10/08.

10. This document is part of a staged evolution of the RMF at the GCF, as the Fund seeks to refine its vision around risk taking and risk culture. This document builds on previous decisions undertaken by the Board:

(a) Paragraph 2 of the Governing Instrument established GCF's mission to "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," taking into consideration the

[1] This document does not specify the process of risk assessment, the investment criteria for the GCF, or methods of mitigating breaches. Such specific details are discussed in other policy documents.

needs of developing countries particularly vulnerable to the adverse effects of climate change.

(b) Decision B.06/06 requested the GCF to strive to balance the portfolio based on a 50:50 theme-based allocation between mitigation and adaptation, and within adaptation, at least 50% allocation for particularly vulnerable countries (including Least Developed Countries ("LDCs"), Small Island Developing States ("SIDS"), and African States).

(c) Decision B.07/05 established the initial financial risk management framework of the GCF, consisting of financial risk policies, a financial risk monitoring and reporting management system and financial risk governance arrangements. The financial risk policies were further elaborated through decision B.08/13 as part of the policies for contributions. Elements of the financial risk monitoring and reporting management system were defined through decision B.08/18 (financial reporting and the external auditing process) and decision B.BM-2015/06 (internal control framework).

(d) Decision B.07/05 also requested the Secretariat to start the process of analysis to determine the risk appetite of the GCF. Through decision B.09/06, the Board took note of a survey of methodologies to define and determine the risk appetite and through decision B.10/08 it adopted the risk dashboard, its related risk categories and subcategories, and the methodology to be followed by the GCF to set its risk appetite.

11. This document also has linkages with the following documents:

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

(b) Investment Framework (GCF/B.07/06);

(c) Further development of the Initial Results Management Framework (GCF/B.08/07);

(d) Policies for Contributions to the Green Climate Fund (GCF/B.08/16);

(e) Initial Risk Management Framework: Survey of methodologies to determine and define risk appetite (GCF/B.09/13);

(f) Further development of the Initial Investment Framework: Sub-criteria and Methodology (GCF/B.09/07);

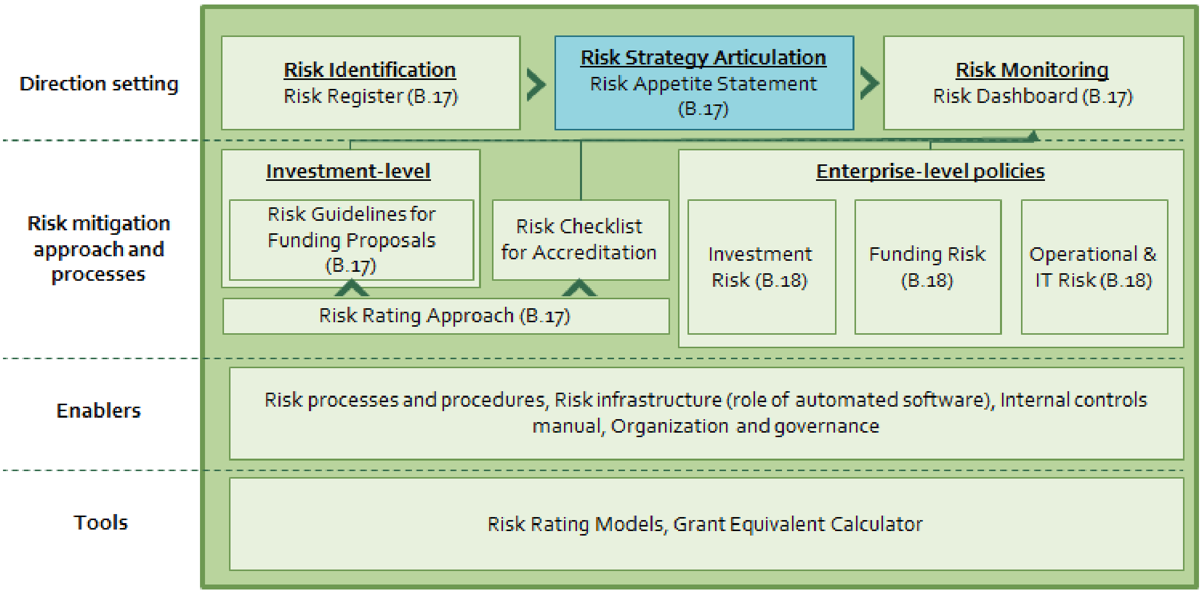
(g) Initial Risk Management Framework: risk register, risk appetite update and initial risk guidelines for credit and investment (GCF/B.12/17); and

(h) Initial Strategic Plan for the GCF: the need for improved and coherent guidance on the Fund's investment criteria and risk appetite (GCF B.12/32 Annex I).

III. Objective

12. This document is a part of the comprehensive GCF RMF with the objective of setting the appropriate level of risk taken by the GCF. The components of the framework are presented below in Figure 1.

Figure 1. RMF components (in brackets for each component: the Board meeting when it is planned to be discussed).



13. The objective of this document is to propose an initial risk appetite statement for the Fund. The risk appetite describes the overall level of risk that the GCF is willing to take in order to achieve its objectives. This statement will encompass:

(a) A set of top-down, Board level directions to steer level of risk taking.

(b) An interpretation of the Governing Instrument into practical risks faced in day-to-day operations.

(c) An emphasis on key risks that could compromise the ability to achieve GCF's strategic mandate.

(d) Quantitative metrics and qualitative statements describing acceptable risk levels.

IV. Structure of the risk appetite statement

14. The GCF defines three levels of appetite for risk taking, from zero tolerance to considerable tolerance, that differ across risk types:

(a) Prohibited risk taking ("zero risk tolerance"): Activities that the GCF will not engage in and for which the GCF will have zero risk tolerance.

(b) Risks to be carefully managed and where practicable minimized ("moderate risk tolerance"): Risk taking based on activities that are a by-product of operating a materially significant fund.

(c) Risks taken to achieve strategic impact ("considerable risk tolerance"): Risks required to be taken to fulfil the GCF mandate, to be compensated through climate change impact.

V. Risk appetite statement

5.1 Overall statement of risk appetite

15. The GCF is required to take risks in order to fulfil its mandate, however such risks will be carefully managed:

(a) The Fund will uphold the highest level of integrity in conducting its operations and hence has zero-tolerance towards partaking in prohibited practices, breaches of international sanctions / embargoes, by staff, Board members, counterparties and partners (especially Accredited and Executing Entities ("AEs" and "EEs"). The Fund will also have zero tolerance for violations of applicable internal policies by staff or Board members.

(b) The GCF seeks a stable and moderate enterprise risk profile which will enable the Fund to ensure adequacy and predictability of financial resources, maintain a well-balanced portfolio of projects/programmes consistent with the principles of country ownership and the Conference of the Parties' guidance, and operate in a transparent, accountable, and efficient manner.

(c) In order to realize significant impact and promote paradigm shift to meet the Fund's strategic objectives, the Fund is willing to accept considerable uncertainties around investment risks in return for impact potential, to be evaluated on a case-by-case basis recognizing specifics of each proposal. The Fund will strive to mitigate programme risks to provide reasonable assurance that investments can fulfil their stated objectives.

5.2 Tolerance level 1: zero risk tolerance

5.2.1. Compliance risk

Regulation and sanction/embargo breach and engagement in prohibited practices

16. The GCF will have zero tolerance towards its staff, Board members, counterparties and partners (especially AEs and EEs) breaching the Fund's prohibited practices requirements, and Anti-Money Laundering, Countering the Financing of Terrorism Policy (as appropriate), etc.

17. The GCF will also have zero tolerance for working with parties subject to sanctions, embargoes, or similar measures issued by reputable international organizations such as the United Nations ("UN").

5.2.2. Internal compliance breach

18. The GCF will have zero tolerance towards its staff and Board members breaching the following policies:

(a) Policies on Ethics and Conflicts of Interest (for the Executive Director and external members of the GCF panels and groups) (B.10/13/Rev.01).

(b) Information Disclosure Policy (B.12/35).

(c) Administrative Policies of the Fund (BM-2014/01).

(d) Financial Risk Management Framework (B.07/05): cross-subsidization between providers of grants and providers of loans.

(e) Gender Policy and Action Plan (B.09/10).

(f) 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 (B.07/02).

19. The above lists of policies should be updated on a quarterly basis.

5.3 Tolerance level 2: moderate risk tolerance

5.3.1. Concentration risk

20. To ensure that the GCF maintains a diverse portfolio to optimize deployment of its financial resources, the Fund will maintain prudential risk appetite levels on the amount of funding allocated to result areas, countries, and projects. The GCF will monitor its exposure levels (in nominal amount of cumulative GCF cash transfers and funding approvals for ongoing projects at a Fund level, i.e. for PSF and DMA combined) for the following:

(a) The GCF will target no more than [50%] of total investible amount into a single results area.[2]

(b) The GCF will target no more than [10%] of total investible amount into a single proposal.[3]

21. The total investible amount is defined as the sum of the GCF's liquid asset portfolio size, the nominal amount of GCF's unencashed promissory notes with fixed encashment dates deposited with the Trustee, and the total nominal amount disbursed to live projects / programmes. The liquid asset portfolio is defined as securities, cash or cash equivalents held in Trust or in GCF's bank accounts.

22. In addition, the GCF will monitor its exposure by country, AE and EE[4] and the impact of this exposure on other risk dimensions (e.g. credit risk, equity risk, impact risk). The Fund will also balance its deployment of funding instruments (i.e. grant, equity, loan, and guarantees) in accordance with its investment policies and guidelines.

5.3.2. Foreign Exchange ("FX") risk

23. The GCF faces two major sources of FX Risk:

(a) FX risk on the Asset side. The GCF operates with financial instruments in holding currencies that could be repaid in currencies other than holding currencies to meet the Fund's mandate.

(b) FX risk on the Liability side. Receiving contributions from countries in currencies that do not match the currency in which future funding proposals will be denominated. This can further be distinguished between:

 (i) Contributions through cash received and promissory notes encashed, held in the Trustee account;

 (ii) Contributions through promissory notes received but not yet encashed;

 (iii) Contributions through cash not yet received and promissory notes not yet deposited or encashed.

24. While the overall FX risk appetite for FX risk is moderate, the fund has markedly different appetite across the above categories.

25. Investments of the GCF that implement funding proposals with local currencies are subject to a risk of repayment in holding currencies. The asset side FX risk can be of considerable risk tolerance providing the Board a broader set of investment options, in line with

---

[2] Results area is defined as one of: Energy access and power generation; Low emission transport; Building, cities, and industries and appliances; Forestry and land use; Most vulnerable people and communities; Health and well-being, and food and water security; Infrastructure and built environment; Ecosystem and ecosystem services.
[3] Refer to risk dashboard for examples.
[4] The GCF will review annually whether to include an appetite level for concentration by country, AE and EE.

the Fund's mission to promote paradigm shift towards low-emission and climate-resilient development pathways.

26. Contributions already received and encashed will be held in holding currencies, converted on receipt of funds, at a proportion determined by the Secretariat based on their expectation of future cash outflows (referred to in paragraph 23 (b) (i)).

27. Contributions through promissory notes received but not yet encashed (referred to in paragraph 23 (b) (ii)), and contributions through cash not yet received and promissory notes not yet deposited and unencashed (referred to in paragraph 23 (b) (iii)) are not required to be hedged, however the Secretariat may decide to implement a hedging strategy for additional conservatism. Any such hedging must be guided by a clear policy to be approved by the Board. Further, the Secretariat must ensure that the GCF has all necessary arrangements (models, agreements etc.) in place before it engages in any hedging.

5.3.3. Funds held in trust risk

28. The GCF will also actively manage its liquid asset portfolio through the Trustee in accordance with the Fund's investment policy or, should the Fund not have an investment policy, by the Trustee's default investment strategy. The eligibility criteria for the liquid asset portfolio securities will also be guided in the same manner. The GCF will be prudent in establishing liquid asset portfolio investment policies and guidelines to maintain a conservative risk profile with the following appetites:

(a) The Fund will only invest in investment grade securities;

(b) The Fund will target average credit rating of [AA] equivalent by international rating agencies, or an equivalent risk metric approved by the Board, for its liquid asset portfolio;

(c) The funds earmarked for the Fund's liquidity reserve will only be invested in securities with duration no longer than one year. All other funds in the liquid asset portfolio (representing the Fund's excess liquidity) will only be invested in securities with duration no longer than five years and average duration no longer than two years; and

(d) In its liquid asset portfolio, the GCF will refrain from making investments that go against the Fund's mission to promote paradigm shift towards low-emission and climate-resilient development pathways. The Trustee will monitor the asset allocation of the liquid asset portfolio in this regard and report to the GCF on it.

(e) If the Interim Trustee is unable to implement these requirements, they will become applicable after the selection of the Permanent Trustee. Until that time, the GCF should monitor the Fund's adherence to these requirements to the extent possible under the current agreement.

5.3.4. Reputational risk

29. Given that the GCF will operate in new, transformational areas that may be untested, continued support from global stakeholders will be essential to the GCF's success, and the GCF will seek to actively engage stakeholders and plan and respond to reputational issues which may arise. That being said, the GCF will manage the reputational risk through stringent monitoring and oversight policies applied across all GCF operations.

30. The GCF will monitor and manage the following:

(a) Adverse publicity; and

(b) Grievances from projects.

5.3.5. Project/programme: risk of non-compliance against internal requirements

31. The GCF is heavily reliant on the intermediary entity, the AE, for all stages of operation, from project sourcing and due diligence to project execution, governance, and monitoring. The GCF has policies and documents in place, which set the standards for actions by AEs, EEs and other partners, and there is limited risk appetite to breaches of those standards:

(a) Gender Policy and Action Plan (B.09/10).

(b) 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 (B.07/02).

(c) Accreditation Master Agreement.

(d) Funded Activity Agreement.

(e) Local regulations that are not explicitly covered in the Interim Policy on Prohibited Practices.

32. In order to further mitigate this risk, the GCF will monitor the list of countries (and corresponding approved funding) in which the Fund is investing but has not secured privileges and immunities.

5.3.6. Legal risk

33. Legal risk for the GCF is the risk of loss caused by defective transactions, penalties or sanctions originating from lawsuits filed against the Fund, sanctions pronounced by a regulatory or government body, and changes to legal frameworks. The GCF will manage its legal risk by closely monitoring the number of any legal disputes that arise across the operations of the GCF.

5.3.7. Funding contribution uncertainty risk and liquidity risk

34. Predictable funding is essential for the GCF to achieve its objectives. The GCF will take necessary actions to protect the predictability of its financial resources, including diversifying sources of contributions across a range of contributor countries, managing cancellation, postponement, and other changes in encashment schedules, ensuring to convert the pledges or encashment of promissory notes in a timely manner, and preventing over-concentration of contributions to be encashed. This will effectively help the GCF manage any risks associated with cash flow mismatches, that is, mismatch that may arise between the effective duration of the contributions and commitments with regards to pledge conversions, disbursements, or reflow. Failure to manage cash flow could have an impact on the Fund's ability to undertake and fund projects/programmes.

35. The GCF will ensure sufficient liquidity at all times. The GCF will set an appetite level on the size of the GCF's liquidity reserve that will be equivalent to sufficient levels to sustain net funding requirements for 1 year. This threshold should be reviewed in the future, when GCF's cash management practices are better established. Net funding requirements over a period of time are defined as the planned outflows over the period of time (including disbursements and Board and Secretariat expenses) net of the planned contribution encashments over the same period of time. It should be noted that at present, GCF does not plan to use planned project reflows to reduce Net funding requirements. This decision should be reviewed in the future once reflows become a significant part of GCF's planned inflows.

36. Currently the GCF approves FPs only if there is a known source of funds from contributions rather than reflows. Further at present the GCF does not plan to depend on project reflows for its liquidity needs. In the future, if the GCF starts depending on project

reflows to meet liquidity needs, the Board may consider maintaining an alternate source of funding for the GCF to cover for unexpected shortfalls or delays in reflows.

37. The GCF will also monitor the following areas:

(a) Projection of expected net inflows and outflows and deviations from expected commitment schedules;

(b) Concentration of funding contributors.

5.3.8. Operational and IT risk

38. The Fund will actively manage any operational and IT risks that may arise across all stages of Fund operations, including process and execution, human resources ("HR"), systems and information, and catastrophic events, and business continuity risks that may jeopardize the Fund's day-to-day operations.

39. To do so, the GCF will closely monitor the following risk areas:

(a) Timelines for FP approval and target timelines for AE approval.

(b) Vacancy rate, employee turnover rate and internal or external complaints on employee behaviour.

(c) Number of information security breach attempts, and number of system failures.

(d) Natural catastrophe occurrences, geopolitical events, wars, and terrorism.

5.4 Tolerance level 3: considerable risk tolerance

5.4.1. Financial investments: equity investments risk

40. The GCF will utilize equity investments, accepting the fact that such investments may pose considerable financial risk. The Fund will seek to understand and manage the associated risks, such as possibility of decline in equity valuation (resulting in decline in return on equity investment below target) or illiquid equity markets that may affect the GCF's exit. The GCF will regularly monitor changes in equity valuations relative to the initial equity investment through the AE during the project lifecycle, depending on accounting requirements of the target country.

5.4.2. Financial investments: credit risk

41. The GCF will actively take credit risk to meet its strategic mandate of promoting paradigm shift towards low-emission and climate-resilient development pathways. The GCF is willing to take on risks that other investors will not take.

42. The GCF will aim to utilize its investments to crowd-in other debt, and to enhance the credit worthiness of a project. The GCF will also enter relatively high risk transactions, such as junior positions in credit structures or being the sole investor, in order to meet its strategic mandate.

43. The GCF will set an initial required cushion for loss reserves being equal to 20%[5] (in grants) of the face value of the loan contribution provided to the Fund by the loan contributors for non-performing loans, and the adequacy of the cushion will be reviewed at the end of the Initial Resource Mobilization (IRM) period. Loan cushions will not count toward grant equivalency or individual debt limit calculations. The GCF will actively monitor the credit performance of its funded portfolio.

[5] Policies for Contributions (GCF/B.08/16)

44. If the loan contributions provided to the Fund grow in the future and become a significant portion of its investible amount, the GCF might consider updating this appetite statement to further mitigate the risks of excessive credit losses, in order to ensure that the GCF is able to repay the loan contributions.

5.4.3. Project/programme programme failure: impact risk

45. The GCF will manage its project and programme risks, which include project governance, execution, impact, and monitoring, as well as country risks that may impede successful execution, to maximize the possibility of successful execution and delivery of the desired impact. This will involve ensuring sufficient technical and institutional capabilities of the AE/EEs and community readiness (awareness, preparation, commitment); monitoring of country risks, including natural disasters, climate shocks, poor infrastructure, and economic and political risks, as well as country ownership status. The GCF will closely monitor the following areas:

(a) Projects delays or slippages;

(b) Impact achievements based on the GCF results framework; and

(c) Distribution of cumulative cash transfers and funding commitments for ongoing projects by Project Success Rating and Credit Risk Rating.[6]

VI. Effective date

46. The provisions of this risk appetite statement will take effect on September 1st 2017. If the Interim Trustee is unable to implement the requirements in the risk appetite statement, they will become applicable after the selection of the Permanent Trustee. Until that time, the GCF should monitor the Fund’s adherence to these requirements to the extent possible under the current agreement.

VII. Revisions to the risk appetite statement

47. The overall risk appetite will be revised and submitted to the Board for approval; (i) whenever a new or revised Fund Strategy is formulated; or (ii) the Board or the RMC finds it relevant to review the statement due to major changes in related policies.

VIII. Reporting of risk appetite

48. The Secretariat will integrate the GCF’s risk appetite tolerance levels into the risk dashboard (part of the RMF) and risk register (part of the RMF) based on the risk monitoring and reporting management system under the RMF. The risk appetite will be reported to the Board through the risk dashboard. The risk dashboard consists of regular snapshots of the Board-agreed risk categories and subcategories that will be tracked by the Secretariat, the Risk Management Committee and the Board. This reporting will be the basis for continuous review and updating of the Fund’s risk appetite and risk management practices. The Fund would need to conduct risk control and self-assessment, a process of identification, assessment, effective internal control and action plans related to high-risk events, in a timely manner, in order to ensure the robustness of the risk framework. Such periodic reporting from the Secretariat will enable the Board to review the evolution of the risk borne by the Fund and to make any necessary adjustments.

---

[6] Risk ratings are discussed in the risk rating approach document (part of the RMF).

GREEN
CLIMATE
FUND