

# CLIMATE INVESTMENT FUNDS

August 22, 2013

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**UPDATES TO THE ELABORATION OF AN ENTERPRISE RISK MANAGEMENT PROGRAM  
FOR THE CLIMATE INVESTMENT FUNDS (DRAFT)**

## **PROPOSED DECISION**

The CTF and SCF Trust Fund Committees, having reviewed the document entitled, *Updates to the Elaboration of an Enterprise Risk Management Program for the Climate Investment Funds*, dated August 22, 2013, and the *Proposed Duties and Responsibilities of a Senior Risk Management Officer*, dated August 22, 2013,

- a) approve the revised Tier 1 risks and associated risk mitigation measures to be incorporated in the Enterprise Risk Management Framework for the Clean Technology Fund and the Strategic Climate Fund;
- b) request the CIF Administrative Unit, the Trustee and the MDBs to undertake the next steps identified in the document to ensure the continued implementation of the ERM;
- c) approve the duties and responsibilities of a senior risk management officer and request the CIF Administrative Unit to recruit a senior risk management officer to be responsible for the duties outlined in the proposal; and
- d) approve the inclusion of additional funds necessary to cover the costs of a Grade G specialist, as proposed in the document, in the FY 14 administrative budget of the CIF Administrative Unit.

## I. INTRODUCTION

1. At the joint meeting of the CTF and SCF Trust Fund Committees on April 29-30, 2013, the following decision on the elaboration of an Enterprise Risk Management Framework (ERM) was adopted:

- a) The joint meeting of the CTF and SCF Trust Fund Committees welcomes document CTF-SCF/TFC.10/5, *Elaboration of an Enterprise Risk Management Program for the Climate Investment Funds*, and the proposals presented therein related to manage priority risks and implement the CIF ERM program. The joint meeting agrees to the Tier 1 risks presented therein, subject to revisions to be made on the basis of written comments from Committee members (see paragraph 8 below), and decides to integrate the risk of timely implementation of pledges to the CIF into the existing Tier 1 risks.
- b) The joint meeting invites the members of the CTF and SCF Trust Fund Committees to submit their written comments on the Tier 1 risks proposed in the document to the CIF Administrative Unit by May 20, 2013. The Trustee and the CIF Administrative Unit are requested to work with the working group that elaborated the ERM program to revise the Tier 1 risks, taking into account the comments received and to circulate a revised text to the members of the Committees for approval by mail.
- c) The joint meeting further requests the working group to propose for comment by the end of June 2013, together with the revised Tier 1 risks, options and possible modalities to assist the Trust Fund Committees to identify the Committees' tolerance for the Tier 1 risks. Taking into account the comments received the head of the Administrative Unit and the co-chairs of the joint meeting should propose to the members the next steps to be followed in implementing the ERM program, including whether it would be useful to convene an intersessional joint meeting of the Committees.
- d) The joint meeting encourages members to consider their risk in preparation for participation in any future meeting.
- e) The joint meeting further requests the CIF Administrative Unit and the Trustee to prepare proposed terms of reference for a Senior Risk Management Officer and to circulate to the Trust Fund Committee by the end of June 2013 the terms of reference and a breakdown of the respective budgetary requirements for review and approval by mail by the members of the joint meeting.

2. As requested by the joint meeting, the ERM Working Group met on June 5 and 6, 2013 to: (a) revise the Tier 1 risks incorporating comments received from the members of the CIF Committees; (b) consider how to clarify the Committee's tolerances for the Tier 1 risks; (c) discuss next steps for implementation of the ERM (Enterprise Risk Management) Program; and (d) prepare proposed terms of reference for a Senior Risk Management Officer.

## II. CTF TIER 1 RISKS

3. Based on comments from members of the CIF Trust Fund Committees, the Working Group revised the list of CTF Tier 1 risks including (a) incorporating the risk related to the timely implementation of pledges, and (b) disaggregating the financial risks. The following is the revised list of CTF Tier 1 risks:

### Financial

- a) Risk 1: *Financial Management Portfolio risk*—Lack of integrated financial portfolio and consolidated cash flow management may increase the likelihood of losses and disruption, and diminish effectiveness of decisions and the overall efficiency of the use of funds.
- b) Risk 2: *Financial model risk*—Actual credit default (sovereign/private) as well as other financial indicators may exceed CTF Cash Flow model projections.
- c) Risk 3: *Credit Risk*—Portfolio loan losses due to defaults or non-payments may exceed the CTF's ability to absorb such losses.
- d) Risk 4: *Market Interest rate and Foreign Exchange risk*—CTF interest rate available to borrowers may not have the appropriate level of concessionality; adverse exchange rate movements may create a significant negative impact on CTF's ability to fund project/program portfolio.
- e) Risk 5: *Asset Liability Management risk*—Liquidity may not be sufficient to meet the CTF's obligations to repay loan contributors and/or obligations to MDBs; excessive cash reserves may result in disruptions to pipeline management.

### Operational/Strategic

- a) Risk 6: *Pledge risk*—Funding pledged by contributors may not materialize in a timely manner.
- b) Risk 7: *Misuse of funds risk*— Recognizing that each MDB has robust procedures in place to mitigate misuse of funds, MDB reporting on actual misuse of funds to the Committee may not be timely. This may result in the Committee's inability to effectively respond to such an event.

- c) Risk 8: *Impact risk*—Inability to deliver the expected programmatic impact as defined by CTF objectives, investment criteria, and the results framework.

## **Operational**

- a) Risk 9: *Operational Portfolio risk*—Insufficient or untimely information hinders the Committee’s ability to make risk informed decisions.
- b) Risk 10: *Pipeline management risk*—Optimistic forecasts and uncertainties of project forecasting may lead to suboptimal use of CTF funds.
- c) Risk 11: *Financing Terms risk*—Lack of active management and tracking of the financing terms for projects may result in a situation where the level of concessionality is inappropriate and/or the distribution of terms within the portfolio does not comply with the Principles Regarding Contributions to the CTF.

## **III. INITIAL ACTIONS TO MITIGATE CTF TIER 1 RISKS**

### **Financial**

4. Risk 1: Financial Management Portfolio risk—Lack of integrated financial portfolio and consolidated cash flow management may increase the likelihood of losses and disruption, and diminish effectiveness of decisions and the overall efficiency of the use of funds.

5. Description: Currently, financial reports to the Committee are disparate; little work has been concluded to aggregate (a) individual financial information at the project level with (b) outputs of the CTF Cash Flow model to create a consolidated financial portfolio view. This information gap may hamper the Committee’s ability to make harmonized and cohesive decisions on project financing. MDBs are required to provide financial information to both the Committee and the Trustee, but the information is reported on separately. Therefore, it is difficult for the Committee to consider all the relevant and related information in their decision making.

6. Actions to Mitigate Risk:

#### *Existing Risk Mitigation Actions and Reporting Protocols*

- a) No mitigation actions or reporting protocols are in place.

#### *New Risk Mitigation Actions and Reporting Protocols*

- a) The Trustee and the CIF Administration Unit are developing a CTF Portfolio Risk Dashboard to enable an integrated view of financial statistics and indicators with outputs from the CTF Cash Flow model.

7. Risk 2: Financial model risk—actual credit default (sovereign/private) as well as other financial indicators may differ significantly from model projections.

8. Description: The assumptions and the actual information used for the CTF Cash Flow model may not be updated with sufficient frequency; the sources of such assumptions may not be appropriate for the CTF, resulting in flawed risk and/or cash flow information. To maintain the CTF Cash Flow model, the Trustee receives information (projections and actuals) from several sources: MDBs, the Global Emerging Markets database (GEMs)<sup>1</sup>, and financial market data provided by World Bank Treasury Operations.

9. Actions to Mitigate Risk and Reporting Protocols:

*Existing Risk Mitigation Actions and Reporting Protocols*

- a) MDBs are required to report quarterly to the Trustee on the terms and amounts of on-lending and guarantees as well as actual repayments, defaults or non-payment of loans and calls on guarantees; information provided by the MDBs is included in the CTF Cash Flow model.
- b) The Trustee uses the GEMs database as a reference for calculating the loan loss rate (public/private) for the CTF portfolio.
- c) An analysis of the output is performed quarterly to review cash flow projections and financial sustainability of CTF commitments (including liabilities to loan contributors).

*New Risk Mitigation Actions and Reporting Protocols*

- a) Trustee will perform an analysis of actual defaults and guarantee calls and other financial indicators compared with projections (including the assumptions based on GEMs' data) used in the CTF Cash Flow model to determine whether assumptions need to be adjusted.
- b) Trustee will include such analysis of the financial model as part of the quarterly update on Available Assets and report through the CTF Portfolio Risk Dashboard to ensure appropriate oversight.
- c) The Trustee will provide in the CTF Portfolio Risk Dashboard the (i) actual default rates by sector and region and the impact on cash flows, if any; and (ii) allocation of actual losses to each contributor.

10. Risk 3— Credit Risk—Portfolio loan losses due to defaults or non-payments may exceed the CTF's ability to absorb such losses.

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<sup>1</sup> GEMs is a comprehensive database of credit risk information related to emerging market operations. Its primary purpose is to provide pooled MDB and IFI data on credit default rates from the projects funded by the participating organizations and the recovery rates of defaulted projects. It is a superior representation of the entire market than any individual institution alone.

11. Description: Credit risk is the potential loss incurred by the CTF when a borrowing client becomes unable or unwilling to meet its financial obligations to the MDBs on the CTF loans. The Trustee aggregates default or non-payment information on the CTF loans, guarantees and other financial products provided by the MDBs and monitors the ability of the CTF to absorb such losses. Any amount of loan losses that the CTF is unable to absorb would have to be shared by CTF contributors.

12. Actions to Mitigate Risk:

*Existing Risk Mitigation Actions and Reporting Protocols*

- a) The MDBs administer CTF loans in accordance with its policies and procedures (including, for the avoidance of doubt, its policies and procedures for the CTF operations, if any), subject to the understanding that the MDB's measures regarding non-payments on CTF loans will be based on the principles and procedures set out in the papers entitled "Financing Products, Terms, and Review Procedures for Public Sector Operations" dated December 15, 2011 and "Financing Products, Terms, and Review Procedures for Private Sector Operations" dated October 24, 2012. MDBs' standard appraisal criteria will address credit risk through their assessments of borrower creditworthiness, financial viability, corporate governance, and safeguards against irresponsible borrowing. If a CTF loan is made to a sub-national entity, the member country will be required to guarantee the loan, where MDB sub-sovereign lending requires such guarantees.
- b) The MDBs use rigorous lending criteria and policies which are approved by their respective Executive Boards. The MDBs periodically review these lending criteria and policies to ensure compliance and assess the need for any revisions.
- c) The MDBs notify the Trustee if any defaults or non-payments have occurred. The Trustee aggregates default or non-payment information provided by the MDBs, updates the CTF Cash Flow model and assesses the CTF's ability to absorb actual losses.
- d) If any defaults or non-payments are reported, (i) the Trustee will promptly report to the Trust Fund Committee and include the assessment of the impact of such defaults on contributors' shares, and (ii) the relevant MDB will consult the Trust Fund Committee and all relevant contributors to the Trust Fund on the proposed course of action in respect of the CTF loan and seek agreement with the relevant contributors on the course of action to be taken.

### *New Risk Mitigation Actions and Reporting Protocols*

- a) The Trustee will provide in the CTF Portfolio Risk Dashboard the (i) actual default rates and the impact on cash flows, if any; and (ii) allocation of actual losses to each contributor.

13. Risk 4: Market Interest rate and Foreign Exchange risk—CTF interest rate available to borrowers may not have the appropriate level of concessionality (see Risk 11); adverse exchange rate movements may create a significant negative impact on CTF’s ability to fund project/program portfolio.

14. Description: Overuse of concessional terms or lack of flexibility in the terms offered to the borrower may significantly hamper overall efficiency and effectiveness of the CTF while leading to unwanted market distortions and crowding out of other public and private investors; adverse foreign exchange movements on donor pledges and contributions may (a) slow down the funding of projects in the pipeline or (b) delay disbursements on approved and committed projects. Consistent with the objective of simplified loan administration procedures and streamline project processing, the CTF has uniform financing terms (two levels of concessional loan terms that may be proposed by projects regardless of country credit ratings) rather than terms varying by country and /or projects, or each MDB applying different terms. Increasing or decreasing the proportion of CTF concessional financing blended in the overall financing plan would calibrate the grant element to the country, sector, and project contexts. For private sector loans, the loan terms are negotiated on a case by case basis using existing MDB processes and the rules and procedures established for the CTF.

15. Actions to Mitigate Risk:

### *Existing Risk Mitigation Actions and Reporting Protocols*

#### Market Interest rate risk:

- a) To ensure appropriate levels of concessionality in a project, the Committee assesses the level of CTF financing against co-financing at the time of endorsement of the Investment Plan. This is also considered at the time of project appraisal by the MDB.
- b) For private sector operations, MDBs are using their own procedures to ensure the appropriate level of concessionality.

#### Foreign exchange risk:

- a) The Trustee reserves a portion of promissory note balances from commitments. The reserve is released once the foreign currency is received and converted to USDs.



## *New Risk Mitigation Actions and Reporting Protocols*

### Market Interest rate risk:

- a) The CTF Trust Fund Committee will annually review CTF public loan terms vis-à-vis comparable terms of MDBs to determine if the loan terms need to be adjusted.

### Foreign exchange risk:

- a) The working group concluded that existing mitigation actions and reporting protocols are satisfactory.

16. Risk 5: Asset Liability Management risk—liquidity may not be sufficient to meet the CTF’s obligations to repay loan contributors and/or obligations to MDBs; excessive cash reserves may result in disruptions to pipeline management.

17. Description: Inadequate liquidity management may (a) hinder the ability of the CTF to repay loan contributors, triggering guarantee event for a loan contributor, and (b) delay disbursements by the MDBs to projects, i.e. impact execution of the project. On the other hand, overuse of cash reserves in the liquidity management will withhold funding from projects ready for implementation.

18. Actions to Mitigate Risk:

### *Existing Risk Mitigation Actions and Reporting Protocols*

- a) On a quarterly basis, the Trustee updates the CTF Cash Flow model with information provided by the MDBs and the World Bank treasury department and develops projections for liquidity levels.
- b) The Trustee reviews the liquidity level to assess the CTF’s ability to make the next interest and repayment obligations to the loan contributors. The Trustee reports the outcome to the loan contributors through the Available Assets Report.
- c) MDBs agreements with recipients include provisions that disbursements are conditional to availability of funds in the CTF.
- d) The Trustee notifies MDBs if projections show that current liquidity levels are insufficient funds to meet their disbursement for projects.

*New Risk Mitigation Actions and Reporting Protocols*

- a) The Trustee will develop a system to monitor and test compliance of the projected liquidity levels with the minimum liquidity requirement. The Trustee will report on the results through the CTF Portfolio Risk Dashboard.

**Operational/Strategic**

19. Risk 6: Pledge risk—Funding pledged by contributors may not materialize in a timely manner.

20. Description: Pledges that do not materialize in a timely fashion may create delays in project approvals and execution.

21. Actions to Mitigate Risk:

*Existing Risk Mitigation Actions and Reporting Protocols*

- a) Trustee reports semi-annually on status of pledges.
- b) CIF Administrative Unit incorporates pledge status into semi-annual Operational Report and identifies any impacts to the pipeline.
- c) The CIF Administrative Unit analyzes potential impact on projects, based on reduced funding availability, and informs the CTF Trust Fund Committee.

*New Risk Mitigation Actions and Reporting Protocols*

- a) Reporting on the status of pledges will be included in the CTF Portfolio Risk Dashboard.
- b) The CTF Trust Fund Committee will review the status of the CTF pledges and determine if action is needed.
- c) If required, the pipeline schedule will be adjusted according to actual and projected funding availability.

22. Risk 7: Misuse of funds risk— Recognizing that each MDB has robust procedures in place to mitigate misuse of funds, MDB reporting on actual misuse of funds to the Committee may not be timely. This may result in the Committee’s inability to effectively respond to such an event.

23. Description: While the MDBs have robust policies and procedures in place to mitigate the risk of misuse of funds and report on any incidences to donor(s), a systematic, common framework for reporting such incidences is not in place for the CTF. MDBs rely on their own

policies and procedures in monitoring and handling suspected and actual cases of fraud and corruption.

24. Actions to Mitigate Risk:

*Existing Risk Mitigation Actions and Reporting Protocols*

- a) MDBs rely on their own policies and procedures in monitoring and handling suspected and actual cases of fraud and corruption.
- b) The MDBs are required to use CTF funds only for the purpose for which they have been provided, under the terms of the CTF Governance Framework Document and applicable decisions of the CTF Trust Fund Committee, including relevant Proposals approved by the CTF Trust Fund Committee for individual allocations of CTF funds.
- c) MDBs shall use reasonable efforts, in accordance with the Implementing Entity's policies and procedures, to ensure that the funds provided to the Implementing Entity by the Trustee are used for their intended purposes and are not diverted to terrorists or their agents.

*New Risk Mitigation Actions and Reporting Protocols*

- a) Develop a reporting protocol to report to the Committee on misuse of funds identified by any MDB. If an MDB concludes there was misuse of CTF funds, the MDB will consult with the CTF Committee on next steps. The Committee may recommend any appropriate additional actions.

25. Risk 8: Impact risk—Inability to deliver the expected programmatic impact as defined by CTF objectives, investment criteria, and the results framework.

26. Description: This risk may arise if there is no continued oversight of an investment plan after it is approved and there are no requirements to monitor and measure the programmatic achievements of the investment plan. As a consequence, an investment plan could fail to achieve its programmatic objective.

27. Actions to Mitigate Risk:

*Existing Risk Mitigation Actions and Reporting Protocols*

- a) No mitigation actions or reporting protocols are in place.

*New Risk Mitigation Actions and Reporting Protocols*

- a) For each investment plan, a lead MDB should be agreed on by the country and the MDBs. The lead MDB will consult with the country and other MDBs on an

annual basis to monitor and report the progress at the program level based on the revised results framework.

- b) The lead MDB will actively collect information on progress at the program level, in consultation with other MDBs (as needed). Targets derived from results framework are to be monitored and evaluated annually.
- c) The lead MDB will report progress on the programs in each country on an annual basis to the CIF Administrative Unit.
- d) The CIF Administrative Unit will include information from the country program reports in the first semi-annual operational report of the calendar year.

## **Operational**

28. Risk 9: Operational Portfolio risk—Insufficient or untimely information hinders the Committee’s ability to make risk informed decisions.

29. Description: Lack of an integrated portfolio overview of the strategic, financial and operational indicators and status diminishes the Committee’s ability to make effective decisions and provide oversight to the CTF.

30. Actions to Mitigate Risk:

### *Existing Risk Mitigation Actions and Reporting Protocols*

- a) CIF Administrative Unit monitors and reports on timeliness of project delays, using a “traffic light system”. When delays are identified, the Trust Fund Committee can request additional information on the cause of delay and if any additional actions are necessary.

### *New Risk Mitigation Actions and Reporting Protocols*

- a) An enhanced operational reporting and pipeline analysis process will be developed by the CIF Administrative Unit and the MDB Committee (note that this process has already been initiated by the CIF Administrative Unit). Enhanced reporting in the semi-annual operational reports will be focused on the strategic outlook and analysis on a program level. Portfolio view will allow analysis of sector trends and information/lessons learned shared across portfolio.

31. Risk 10: Pipeline management risk—Optimistic forecasts and uncertainties of project forecasting may lead to suboptimal use of CTF funds.

32. Description: Lack of active management of the pipeline may result in a situation where CTF funds are tied up in underperforming projects. As a result, resources are reserved for projects that are delayed, which could be used instead for projects ready for implementation.

33. Actions to Mitigate Risk:

*Existing Risk Mitigation Actions and Reporting Protocols*

- a) CTF Trust Fund Committee has agreed to 30% over-programming as part of pipeline management.
- b) CIF Administrative Unit will continue to report on traffic light indicators and give further consideration to the action(s) to be taken if the milestones are missed.

*New Risk Mitigation Actions and Reporting Protocols*

- a) As agreed by MDB Vice Presidents in September 2013, each MDB will provide semi-annual reports to its senior management (VP level) to keep them informed of operational progress in CIF-funded projects.
- b) Each MDB will present projects to be included in the calendar of approvals based on project readiness. The CIF Administrative Unit and MDB Committee will update the calendar of approvals on a quarterly basis and monitor actual approvals. This will aid in informing decisions regarding appropriate allocation of funds to implementation ready projects/programs. Comparison of actual approvals vs. projections is reported in semi-annual operational reports by the CIF Administrative Unit.

34. Risk 11: Financing Terms risk— Lack of active management and tracking of the financing terms for projects may result in a situation where the level of concessionality within a project is inappropriate and/or the distribution of terms within the portfolio does not comply with the Principles Regarding Contributions to the CTF.

35. Description: MDBs inform the CIF Administrative Unit of the expected financial terms of the project (Softer, Harder or Grant) at the upstream portfolio planning phase. Lack of active management and tracking of the financing terms for projects may result in (i) a breach of the Principles regarding Contributions to the CTF or (ii) project renegotiation if at the time the project is presented to the Committee for approval, the expected financing terms are not available.

36. Actions to Mitigate Risk:

*Existing Risk Mitigation Actions and Reporting Protocols*

- a) No mitigation actions or reporting protocols are in place.

### *New Risk Mitigation Actions and Reporting Protocols*

- a) The CIF Administrative Unit and the MDBs will develop a process for monitoring the level of use of concessional terms in both public and private section operations at the portfolio level.
- b) MDBs will provide, on a semi-annual basis as a component of its normal reporting, estimates of financial terms using the final project documents. Due to the sensitive nature of private sector financial information, the MDBs and the CIF Administrative Unit will need to agree on appropriate reporting requirements.
- c) As part of the semi-annual pipeline updates review, the MDB Committee will assess the funding alignment analysis conducted by the CIF Administrative Unit. In the context of that review, the MDB Committee and CIF Administrative Unit will determine whether the funds are appropriately aligned or not. If funds are misaligned, the MDB Committee and CIF Administrative Unit will take necessary actions to ensure appropriate alignment of funds.
- d) The CTF Trust Fund Committee will annually review CTF public loan terms vis-à-vis comparable terms of MDBs to determine if the loan terms need to be adjusted.

#### **IV. SCF TIER 1 RISKS**

37. The following is a list and description of nine SCF Tier 1 risks.

##### **Financial**

- a) Risk 1: *Financial Management Portfolio risk*—Lack of integrated financial portfolio and consolidated cash flow management may increase the likelihood of losses and disruption, and diminish effectiveness of decisions and the overall efficiency of the use of funds. (See CTF Tier 1 Risk No. 1)
- b) Risk 2: *Credit Risk*—Portfolio loan losses due to defaults or non-payments may exceed the SCF's ability to absorb such losses. (See CTF Tier 1 Risk No. 3)
- c) Risk 3: *Market Interest rate and Foreign Exchange risk*—SCF interest rate available to borrowers may not have the appropriate level of concessionality; adverse exchange rate movements may create a significant negative impact on SCF's ability to fund project/program portfolio. (See CTF Tier 1 Risk No. 4)

##### **Operational/Strategic**

- a) Risk 4: *Pledge risk*—Funding pledged by contributors may not materialize in a timely manner. (See CTF Tier 1 Risk No. 6)

- b) Risk 5: *Misuse of funds risk*— Recognizing that each MDB has robust procedures in place to mitigate misuse of funds, MDB reporting on actual misuse of funds to the Committee may not be timely. This may result in the Committee’s inability to effectively respond to such an event. (See CTF Tier 1 Risk No. 7)
- c) Risk 6: *Impact risk*—Inability to deliver the expected programmatic impact as defined by SCF objectives, investment criteria, and the results framework. (See CTF Tier 1 Risk No. 8)

## **Operational**

- a) Risk 7: *Operational Portfolio risk*—Insufficient or untimely information hinders the Committee’s ability to make risk informed decisions. (See CTF Tier 1 Risk No. 9)
- b) Risk 8: *Pipeline management risk*—Optimistic forecasts and uncertainties of project forecasting may lead to suboptimal use of SCF funds. (See CTF Tier 1 Risk No. 10)
- c) Risk 9: *Financing Terms risk*—Lack of active management and tracking of the financing terms for projects may result in a situation where the level of concessionality is inappropriate and/or the distribution of terms within the portfolio does not comply with the Principles Regarding Contributions to the SCF. (See CTF Tier 1 Risk No. 11)

## **V. INITIAL ACTIONS TO MITIGATE SCF TIER 1 RISKS**

38. The actions to mitigate the SCF Tier 1 risks are the same as those under the CTF (See Section III).

## **VI. RECOMMENDED MODALITIES TO ASSIST THE COMMITTEE’S TOLERANCE DETERMINATION**

39. The joint meeting of the CTF and SCF Trust Fund Committees requested the ERM Working Group to propose modalities to assist them in identifying tolerances for the Tier 1 risks.<sup>2</sup>

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<sup>2</sup> As a first step, the ERM Working Group discussed the purpose of identifying tolerances and re-visited ERM best practices. ISO 31000 and the COSO ERM Framework use similar approaches to risk tolerances. COSO uses two terms to define an entity’s overall risk aversion, risk appetite and risk tolerance. Appetite is defined as “the amount of risk, on a broad level, an organization is willing to accept in pursuit of stakeholder value.” In their Strengthening Enterprise Risk Management for Strategic Advantage, COSO says: “An entity should also consider its risk tolerances, which are levels of variation the entity is willing to accept around specific objectives. Frequently, the terms risk appetite and risk tolerance are used interchangeably, although they represent related, but different concepts. Risk tolerance reflects the acceptable variation in outcomes related to specific performance measures linked to objectives the entity seeks to achieve.” In addition COSO states, “To determine risk tolerances, an entity needs to look at outcome measures of its key objectives, such as revenue growth, market share, customer satisfaction, or earnings per share, and consider what range of outcomes above and below the target would be acceptable. The primary purpose of developing risk tolerances is to assist the entity in developing the detail risk mitigation actions and thresholds. (Emphasis added)

40. Recognizing that the primary purpose of identifying tolerances for Tier 1 risks is to facilitate the development of appropriate actions to mitigate or prevent risk, the ERM Working Group proposes that the CTF and SCF Trust Fund Committees focus on identifying mitigation actions and reporting protocols as a proxy for risk appetite and an appropriate means to keep their risk appetite under review.

41. The revised Tier 1 risks in this paper are ordered in such a way as to indicate the priority risks of the Committee members (e.g., 1 being the highest priority) and thereby already reflect a degree of risk tolerances of the Committees. Once agreement on the mitigation actions is reached and the reporting on those mitigation actions to the Committees is established, each Committee will be able to monitor achievement of the objectives of the program, while assessing and explicitly recognizing financial, operational and strategic risks incurred in achieving those objectives. Further, an additional proxy for reassessing priority Tier 1 risks is whether the Committee determines that additional measures are needed to address ineffective risk mitigation.

42. The ERM Working Group therefore recommends that CTF and SCF Trust Fund Committees focus on reviewing and approving the CTF and SCF Tier 1 risk mitigation measures and reporting protocols, respectively, as set out in in this paper as the most practical modality for ascertaining the risk appetite<sup>3</sup> and risk tolerance<sup>4</sup> of each Committee.

## **VII. RECOMMENDED NEXT STEPS TO IMPLEMENTING THE ERM PROGRAM FOR TIER 1 RISKS**

43. The Working Group identified the following critical next steps to ensure continuation of the ERM implementation effort over the course of FY14 following the approval of the risk mitigation measures and reporting protocols in this paper.

- a) Revise existing operational processes to include steps called for by mitigation actions.
- b) Enhance operational reporting and create additional reporting protocols as needed.
- c) Recruit Senior Risk Management Officer to manage the ongoing development and execution of an ERM Framework and the related implementation plan and prepare an annual report on the effectiveness of the ERM program.
- d) Develop prototype Risk Dashboard (Financial and Operational) for review and comment by the joint meeting of the CTF and SCF Trust Fund Committees in October/November 2013. Fully implement Risk Dashboard by May 2014.
- e) Prepare Tier 2 risk assessment for review by the joint meeting of the CTF and SCF Trust Fund Committees in May 2014.

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<sup>3</sup> COSO definition of risk appetite is “the amount of risk, on a broad level, an organization is willing to accept in pursuit of stakeholder value”.

<sup>4</sup> Risk tolerance reflects the acceptable variation in outcomes related to specific performance measures linked to objectives the entity seeks to achieve.