CLIMATE INVESTMENT FUNDS

March 7, 2019

CTF RISK APPETITE STATEMENT

PROPOSED DECISION

The CTF TFC Committee reviewed the document, *CTF Risk Appetite Statement*, and agrees:

a) that the risk appetite/tolerance levels proposed in the document accurately reflect the Committee's appetite/tolerance for each risk outlined in the document; and

b) that those parties in roles best placed to manage each risk exposure should make every effort to manage these risk exposures within the Committee's corresponding risk appetites/tolerances outlined in this document.

I. Introduction and Background

1. At the December 15, 2017 Joint meeting of the CTF and SCF Trust Fund Committees, the CIFAU included, in the Risk Report of the CTF and SCF, drafting Risk Appetite Statements (RAS) for the CTF and each of the SCF programs as a next step for enhancing risk management for the CIF.

2. An RAS is an articulation of the types and levels of risk an organization is willing to take, and serves as a reference point against which risk exposure assessments should be appraised. Risk exposure refers to the level of risk an organization is facing. With these in mind, it is not worthwhile to apply a single aggregate RAS, but rather, to focus on establishing a clear view of the level of acceptable risk for each risk type (see Annex A for a summary of the program's risk appetites). The level of risk exposure (e.g. as reported on the program's **Risk Dashboard** or via a risk report) should be examined against the corresponding appetite for each risk with the goal of avoiding or addressing situations where a risk exposure exceeds a corresponding risk appetite.

3. This document is the RAS of the Clean Technology Fund (the program). The Trust Fund Committee should be particularly focused on risks which could affect the CTF's (the program) strategy and ability to meet its objectives (e.g. implementation risk and resource availability risk), as well as risks which could damage the program's reputation (e.g. fraud and sexual exploitation and abuse).

Context

4. When assessing a program's risk appetites, it is essential to examine them in the context of the program's:

   A. Objectives
   B. External Context
   C. Internal Context

A. Objectives

5. The CTF's objectives include the following.

   - Providing scaled-up financing to developing countries to contribute to demonstration, deployment and transfer of low-carbon technologies with a significant potential for long-term GHG emissions savings, that are embedded in national plans and strategies to accelerate their implementation;
   - Providing experience and lessons in responding to the challenge of climate change through learning-by-doing;

- Utilizing skills and capabilities of the MDBs to raise and deliver new and additional resources, including official and concessional funding, at significant scale;
- Providing positive incentives, through public and private sector investments, for the demonstration of low carbon development and mitigation of greenhouse gas emissions;
- Promoting realization of environmental and social co-benefits thus demonstrating the potential for low-carbon technologies to contribute to sustainable development and the achievement of the Millennium Development Goals; and
- Promoting international cooperation on climate change and supporting agreement on the future of the climate change regime.

6. By extension, risk is defined as any threat to the achievement of the program's objectives.

7. These objectives have significant direct implications for the risk appetites of the program. Demonstrating innovative low carbon technologies and development, and providing lessons learned requires a willingness to take substantial risk under certain circumstances. Because the program was established to take risks which other stakeholders would not be willing to take, in order to make projects viable, the program's risk response[1] to some types of risk will need to be "risk acceptance."

8. These objectives also have significant indirect implications for the risk appetites of the program through the external and internal contexts mandated by the objectives.

B. External Context

9. That this program funds projects which are implemented in developing countries, has significant implications for the necessary appetites for certain risk exposures (e.g. credit risk and implementation risk) which the program must have to achieve its objectives.

C. Internal Context

10. This program's governance and organizational structure involves four primary parties with varying roles for carrying out the four integral tasks to the risk management function (1. Risk Identification; 2. Risk Assessment; 3. Risk Monitoring/Reporting; and 4. Risk Mitigation/Control).

    1) **CTF Trust Fund Committee (TFC)** – is the key decision-making body for the program and sets the priorities, and oversees the strategy, operations and activities (including risk management) of the program. The TFC leverages the

[1] The four risk responses are 1) Accept, 2) Mitigate, 3) Transfer, and 4) Avoid.

information, reports and advice it receives from the CIFAU and the Trustee to engage in risk-based decision-making.

2) **CIF Administrative Unit (CIFAU)** – supports the work of the program, and supports and makes recommendations to the TFC. The CIFAU uses the information it receives from the MDBs and Trustee to assess and monitor/report risk exposures to the TFC.

3) **MDBs** – serve as the implementing entities for the program. They receive the program's funds from the Trustee to originate and implement the projects which are resonant to the objectives of the program. As implementing entities, the MDBs are best placed to identify, assess, monitor/report and (especially) mitigate/control the program's risk exposures on an ongoing basis.

4) **Trustee** – receives contributions, commits and transfers the program's resources to the MDBs, and receives reflows generated by the program's projects from the MDBs. The Trustee is best placed to identify, assess, monitor/report and mitigate/control risk exposures to the program's funds while they are under the Trustee's administration.

11. It must be recognized that the manner in which risk-related information is able to flow within the program's governance and organizational structures affects the nature of risk-related discourse and risk-based decision-making within the program.

Risk Levels

12. Appetite or tolerance for a given risk may be classified as either **Low** (which includes risks for which there is no appetite/zero tolerance), **Medium**, or **High**. The level of risk to which the program is exposed, is determined based on the combination of:

    1) The estimated **likelihood** (or frequency with which) the risk is expected to be realized; and

    2) The estimated **severity** of the impact of the risk if it is realized.

<u>*Likelihood*</u>

13. Risk likelihood is expressed (conservatively) in terms of the following probabilities.

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0 ≤ 1%	**1 < 20%**	**20 ≤ 50%**	**50 < 75%**	**75 ≤ 100%**
Very Unlikely	**Unlikely**	**Possible**	**Likely**	**Very Likely**

Severity

14. Generally, risk severity is expressed in terms of the following percentages of the total contributions received which are estimated to be impacted if the risk is realized.

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0 ≤ 1%	1 < 5%	5% ≤
Minimal	**Moderate**	**Severe**

15. However, the impacts on these funds may be very different depending on the risk which is assessed, and it may be prudent to deviate from these ranges. The criteria for classifying a risk exposure will be described in the corresponding risk report and risk dashboard in which the risk is reported. For example, the impact of currency risk arising from foreign currency-denominated promissory notes is the complete loss of the impacted funds, and inability to fund projects which would otherwise have been funded. The impact on funds exposed to implementation risk, on the other hand, may simply be delays in the funding of projects which are ultimately successful, and it may be worthwhile to widen the severity ranges when assessing this risk and determining the appetite for it. The realization of reputational risk may have no impact on the program's assets but may still have extremely adverse impacts on the program and TFC members which must be considered.

16. Additionally, it must be acknowledged that, in some cases (e.g. reputational risk), it may be difficult to provide a quantitative assessment of a risk exposure, and that, in these cases, qualitative assessments are necessary.

17. Risk exposures, and appetites for these exposures, are classified according to the following matrix.

Table 1. Likelihood/Severity Risk Scoring Matrix

	Impact		
Likelihood	Minimal	Moderate	Severe
Very Likely	Low	High	High
Likely	Low	High	High
Possible	Low	Medium	High
Unlikely	Low	Low	Medium
Very Unlikely	Low	Low	Low

18. The following section details the program's risk appetite for each risk type, as well as a brief explanation of the rationale for the risk appetite. As risks continue to be identified, they will be incorporated into this risk appetite statement.

II. Risk Appetites

19. The risks to which the program is exposed are classified according to four categories.

1) **Strategic Risk**: Risks which affect or are created by the program's business strategy and strategic objectives.

2) **Financial Risk**: The potential for exposure to credit, market or liquidity risks[2] to adversely affect the achievement of the program's objectives.

3) **Operational Risk**: The risk that inadequate or failed internal processes, people and systems or external events will adversely affect the achievement of the program's objectives.

4) **Compliance, Legal and Reputational Risk:**

   i. Compliance and Legal Risk: The risk that failure to comply with laws, rules, regulations, contractual obligations, prescribed practices, or standards or codes of conduct will result in fines, civil monetary penalties, payment of damages, the voiding of contracts, or otherwise adversely affect the achievement of the program's objectives.

   ii. Reputational Risk: The risk that a perception develops that the program is unethical or imprudent, adversely affecting the achievement of the program's objectives.

Strategic Risk

20. Presently the following strategic risks to the program have been identified.

21. **Resource Availability Risk**: represents the risk that the Trustee will not have sufficient resources to commit to fund all projects in the program's pipeline.

[2] **Credit risk** refers to the risk that a financing recipient will become unwilling or unable to satisfy the terms of an obligation to the program, or that the value of an asset declines due to a deterioration in the creditworthiness of the issuer.
Market risk refers to the risk that fluctuations in prices of traded assets and commodities as well as fluctuations in interest and exchange rates and other market indices, adversely affect the achievement of the program's objectives.
Liquidity risk refers to the risk that the program will be unable to meet its financial obligations (e.g. repay loan contributors or disburse funds to MDBs) as they come due, or will be forced to sell investments below their true value to meet these obligations, adversely affecting the program's financial position.

22. The TFC agreed to accept this risk and permit over-programming by 30% of the program's pledged resources to accelerate the implementation of viable projects rather than waiting until after unviable projects had been identified and removed from the pipeline. This is proving to be a successful strategy, allowing the acceleration of project implementation while numerous projects were indeed removed from the pipeline leaving a resource surplus after the program's pipeline was sealed. The program's appetite for this risk is therefore **Medium**, (however, the program's appetite for over programming above 30% of the program's pledged resources is zero).

23. **Implementation Risk**: represents the risk that a project is not implemented in a timely manner. Committing funds to projects which are not implemented in a timely manner leaves these funds unavailable for other projects which may have been promptly implemented, postponing the realization of the climate-related benefits which the funds were intended to achieve.

24. The program targets recipients that are (or are domiciled in) developing countries, some of which possess characteristics (e.g. political and economic instability, lack of local level capacity and expertise, or above average exposure to external events such as hurricanes, pandemics and military conflict) which heighten the level of implementation risk associated with the program's projects. The program's appetite for this risk is therefore **Medium**.

Financial Risk

25. Presently the following financial risks to the program have been identified.

26. **Credit Risk**: represents the risk a financing recipient will become unwilling or unable to satisfy the terms of an obligation to an MDB in its capacity as an originator and servicer of the program's outgoing financing.

27. Financing recipients' inability or unwillingness to repay disbursed funds to the program can affect the viability of the corresponding project(s), postponing the realization of the climate-related benefits which the funds were intended to achieve. Additionally, this can impede the program's ability to repay loan contributors.

28. Because the program targets recipients that are (or are domiciled in) developing countries (most of which have been assigned external credit ratings which are below investment grade), and does not discriminate against recipients based on creditworthiness, the program's appetite for this risk is **Medium/High**.

29. **Currency Risk via Promissory Notes**: represents the risk that fluctuations in currency exchange rates will cause the value of the foreign currency in which a promissory note is denominated to decline.

30. The program must accept contributions in the form of foreign currency denominated promissory notes as per the contribution agreements. Also, rejecting contributions which are made in the form of promissory notes, simply because they are not denominated in USD, would be more detrimental to the program than accepting these contributions along with the associated currency risk. The program's appetite for this risk is therefore **High**.

31. **Currency Risk via Outgoing Loans**: represents the risk that the value of the foreign currency in which an outgoing loan is denominated will decline after the program has disbursed the loan due to a decline in the local currency in which the loan is denominated. Given that unhedged local currency lending, according to the CTF Financial Product Classification Criteria, would be classified as a higher risk financial product, local currency loans may not therefore be financed using loan contributions. While the program has not yet extended local currency-denominated loans, such loans could be useful in making future projects viable. Under no circumstances may loan contributions be used to finance local currency loans.

32. **Interest Rate Risk via Floating Rate Outgoing Loans**: represents the risk that declining interest rates will reduce the reflows from the program's outgoing floating rate loans. Declining reflows would adversely affect the ability of the program to repay loan contributors. The MDBs may extend private sector loans to the program's recipients at floating rates, subject to a pricing floor of 0.75%, and the program's appetite for this risk is therefore **High**.

33. **Asset Liability Management/Liquidity Risk**: represents the risk that the Trustee will be unable to meet its financial obligations (e.g. obligations to loan contributors, or obligations to transfer committed funds to MDBs) as they come due, or will be forced to sell investments below their true value to meet these obligations, adversely affecting the program's financial position and reputation.

34. The program's appetite for this risk is **Low**, and the Trustee maintains a cash balance above a prudential minimum liquidity level equal to the program's cumulative debt service payments for the following 12-month period plus projected 6-months disbursements to MDBs. The Trustee also does not invest the program's cash in illiquid investments.

35. **Investment Risk**: represents the risk that the program's investment portfolio (i.e. funded with contributions which have not yet been transferred to the MDBs, and from reflows) will fail to achieve the expected return. This could impact the program's ability to fund administrative costs, and to repay loan contributors. The program's appetite for this risk is **Low**.

Operational Risk

36. Presently the following operational risks to the program have been identified.

37. **External Event Risk**: represents the risk that external events (e.g. natural disasters, disease, war) will adversely affect the implementation and/or success of the program's projects. The program targets recipients that are (or are domiciled in) developing countries, some of which are in unstable regions, or regions highly susceptible to the impacts of external events. The program's appetite for this risk is therefore **High**.

38. **Model Risk**: represents the risk that reliance on models to make decisions will impede the achievement of the program's objectives. Presently the program employs two models.

    1) The CIFAU models expected credit losses associated with the program's loan portfolio to assess the portfolio's credit risk; and
    2) The Trustee models the program's future cash flows to assess the Trustee's ability to meet its obligations to loan contributors.

39. As is the case with all models, these models are based on numerous assumptions, and the first model is essentially forecasting uncertainty. Therefore, a certain level of potential inaccuracy must be accepted in these endeavors. The program's appetite for this risk is **Low**.

Compliance, Legal and Reputational Risk

40. The program will not tolerate any negative impact on its reputation, and will only accept minimal exposure to reputational risk (i.e. minor negative media coverage), regardless of whether the exposure is incurred by the reputational risks outlined below, or by any other source of reputational risk not yet identified in this document. Presently the following compliance, legal and reputational risks to the program have been identified.

41. **Mismatch between Loan Contributions and Outgoing Financial Products**: represents the risk that loan contributions are used to finance outgoing:

    1) loans and other financial products, such as guarantees, on terms more concessional than the terms of the contributions; or
    2) financial products which are classified as high-risk as per the **CTF New Financial Product Classification Criteria**.

42. The CTF is contractually obligated to use loan contributions only to finance projects on terms which are no more concessional than the terms of the loan contribution, and the CTF New Financial Product Classification Criteria mandates that loan contributions may not be used to finance high-risk financial products. The program has no appetite for this.

43. **Country Concentration Risk**: represents the risk that that a single country receives more than 15% of the CTF's resources. The CTF's governance framework mandates that no single country may receive more than 15% of the program's contributions. The program has no appetite for this risk.

44. **Fraud Risk**: represents the risk that an individual or group of individuals, employing intentional deception, will use the program's funds for personal gain or an unauthorized purpose. Fraud can deplete the resources intended to be used to achieve the program's strategic objectives, and can damage the reputation of the program and TFC members. The program has no appetite for fraud risk.

45. **Risk of Sexual Exploitation or Abuse**: represents the risk of

    1) actual or attempted abuse of a position of vulnerability, differential power or trust for sexual purposes, including profiting monetarily, socially or politically from the sexual exploitation, by anyone associated with the program's projects; or
    2) actual or threatened intrusion of a sexual nature, whether by force or under unequal or coercive conditions, by anyone associated with the program's projects.

46. The program has no appetite for this risk.

47. **Risk that the Investment Portfolio Contains Investments in Fossil Fuels**: represents the risk that the program and/or its stakeholders will be perceived either imprudent or unethical because they permit undisbursed funds or reflows to be invested in fossil fuels. The program could be discredited by the perception that it invests in companies whose primary business is perceived to aggravate the very problem which the program was designed to address (the impacts of climate change). The program has no appetite for this risk and the program's tolerance for this is **<u>Low</u>**.

III. Annex A – Summary of Risk Appetites [3]

Category	Risk	Risk Appetite
Strategic Risk	Resource Availability Risk	Medium
	Implementation Risk	Medium
Financial Risk	Credit Risk	Medium/High
	Currency Risk via Promissory Notes	High
	Currency Risk via Outgoing Loans	Medium
	Interest Rate Risk via Outgoing Loans	High
	ALM/Liquidity Risk	Low
	Investment Risk	Low
Operational Risk	External Events Risk	High
	Model Risk	Low
Legal, Compliance & Reputational Risk	Mismatch: Loan Contributions vs Outgoing Financial Products	Low
	Country Concentration Risk	Low
	Fraud Risk	Low
	Risk of Sexual Exploitation or Abuse	Low
	Investment Portfolio Contains Investments in Fossil Fuels	Low

[3] Low risk appetite includes exposures to risk types for which there is no appetite. There is no appetite for Legal, Compliance and Reputational Risks.