GCF MONITOR

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for Climate & Sustainable Energy Finance

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The Green Climate Fund: An Appetite for Risk?

The GCF is currently developing its Updated Strategic Plan 2020-23 and has just undertaken its first replenishment. In this context, a first forward-looking Performance Review was conducted. The Performance Review indicated that the GCF has made a significant impact in its first phase; but also states that it must aim for more ambitious impact, including a clear vision for delivering paradigm shift (GCF, 2019).

In fostering the paradigm shift, the GCF must demonstrate how its risk appetite differs from other multilateral climate funds by increasing areas in which the GCF takes risks to deliver significant climate impact, innovative solution and large-scale mobilisation (GCF, 2020). It is necessary for all financial institutions to take on risks in order to function and pursue their objectives. However, it is important to identify and, where possible, quantify those risks in a structured way that also relates them to the organisation's business objectives and strategy (Deloitte, 2014). This GCF monitor assesses the GCF's risk appetite based on an analysis of its project portfolio to determine how the GCF has operationalised its Risk Appetite Statement so far.

Key messages

- Risk appetite of projects must be assessed against institutions' objectives and significant changes in strategy, such as the current development of the GCF Updated Strategic Plan 2020-23.
- In line with the risk statement, the GCF has a higher risk appetite in adaptation and projects in priority countries, which are both considered critical to achieving the GCF's mandate.
- The GCFs Fiduciary Standards offer options to make use of a broader range of financial instruments necessary to attract more co-finance in typically more risky set-ups and to trigger innovation. This underlines the importance of strategic selection and support of Accredited Entities (AEs).
- In projects earmarked with a low-risk appetite by the GCF (i.e. not grants), co-financing is particularly high, demonstrating that blending resources reduces risk and should contribute to a higher risk appetite.

ABOUT GCF

The Green Climate Fund (GCF) is the largest dedicated multilateral climate fund. It was set up in 2013 by the 194 countries who are parties to the United Nations Framework Convention on Climate Change (UNFCCC). It aims to deliver equal amounts of funding to limit or reduce greenhouse gas emissions in developing countries and to help vulnerable societies adapt to unavoidable climate change impacts.

The GCF's initial resource mobilisation in 2014 received pledges worth US$ 10.3 billion. These funds come mainly from developed countries, but also from some developing countries, regions, and one city (Paris). As part of the ongoing replenishment of the GCF, 30 countries and the region of Wallonia (Belgium) so far pledged to provide an additional US$ 9.9 billion for the next four years.

The GCF Secretariat is based in Songdo, South Korea. The fund is governed by a board of 24 members with equal representation from developing countries and developed countries. For more information, see: http://www.greenclimate.fund

GCF MONITOR

The GCF monitor reviews the progress of the GCF's efforts to respond to the challenge of climate change. Each edition analyses and briefly describes a unique topic selected because of its high importance at the recent Board meeting or other relevant event. The GCF Monitor is produced by the FS-UNEP Collaboration Centre of the Frankfurt School of Finance and Management.

Introduction

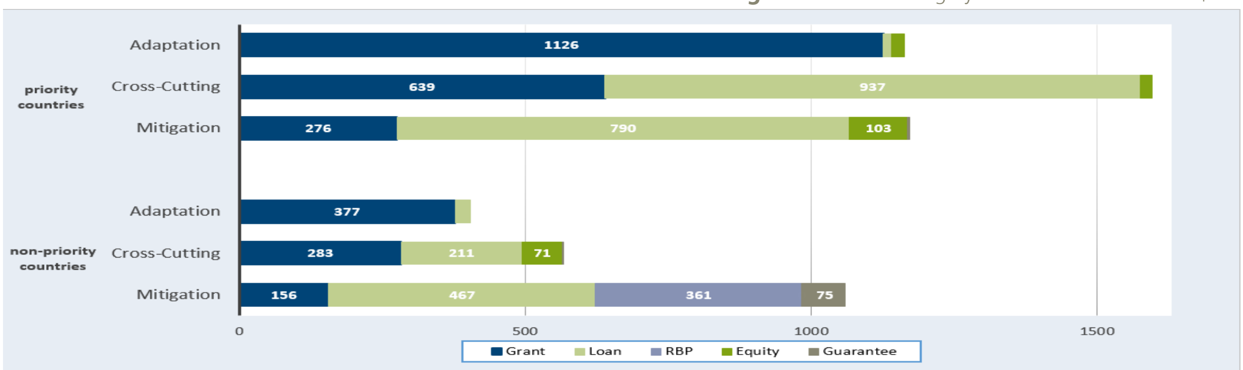
The GCF was established to drive the transformation to low-carbon, climate-resilient development and as such, the current draft of its Updated Strategic Plan states that the GCF is "designed to take more risks than other public and private investors" (GCF, 2019). Risk can be defined as a form of uncertainty about outcomes that may adversely effect the individual investor and project or partner, individuals and societies, or on environmental aspects. The GCF defines risk appetite as "[…] the overall level of risk an organisation is willing to take in order to achieve its objective" (GCF, 2014a). The Performance Review provided recommendations for the GCF to fulfil its potential to embrace risk to drive paradigm shift through developing a Strategic Plan; strengthening processes that better address differentiated developing country needs and capacities; reemphasising adaptation; and strengthening the role of the private sector (GCF, 2019). From the onset, the GCF set out to "take on risks that other funds/institutions are not able or willing to take, including risks associated with deploying innovative climate technologies" (GCF, 2016).

It is fundamental for any institution to consider the risk appetite across all significant business decisions and to have a risk management framework. This is a prerequisite for effective risk governance since it creates the strategic, organisational, methodological and behavioural framework by translating risk metrics and methods into strategic and investment decisions, reporting, and day-to-day business decisions. This includes information on concentration and funding, delays, reports of integrity or policy breaches, and financial investment risk, as published quarterly on the GCF risk dashboard. Any significant changes in strategy need to be assessed against the GCF's risk appetite determined by instrument and geography (GCF, 2014a). In terms of risk appetite, there is officially no differentiation between mitigation / adaptation / cross-cutting projects. GCF's risk appetite classifies a grant-based project implemented in a priority country as having a higher risk appetite compared to a revenue-generating loan-based project in a non-priority country. This way, the GCF addresses the fact that priority countries are typically less developed and implementing projects is riskier. Counterintuitively, a lower risk appetite in a particular area does not necessarily mean that the project supported by the GCF has itself a lower risk. Rather, the risk appetite is strategic and related to the amount of risk the GCF is willing to seek, while the actual risk tolerance is operational and refers to the maximum amount of risk within a project the GCF can bear, which may be different on individual project basis.

Portfolio Analysis

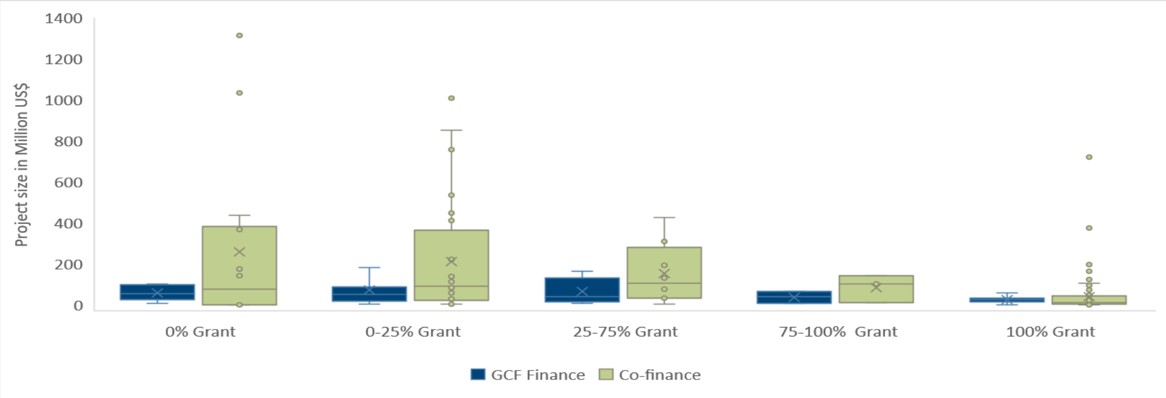
Figure 1 depicts the GCF funding volumes by theme, non-priority versus priority countries (Africa, Small Island Developing States and Least Developed Countries), and instruments. Across themes, the share of grant finance is larger in priority countries, reflecting the GCF's higher risk appetite. In both priority and non-priority countries, adaptation projects are funded almost exclusively with grant instruments. This high risk appetite partially lies in the nature of adaptation projects. Public good provision means that the project generates benefits for third parties not involved in (funding) the project, which do not generate revenues that could be used to repay, e.g. a loan. Hence, projects proving public goods often have a grant component. However, there are some examples with loans and adaptation such as FP078

Figure 1: GCF funding by instrument in million US$



Note: In total 143 projects funding 5.960 million US$. Data is based on the GCF project homepage. A small discrepancy regarding total GCF amount (6.2 billion US$, see www.greenclimate.fund project dash board) and reported amount due to data availability.

Figure 2: Total Funding Volume by GCF and Co-finance

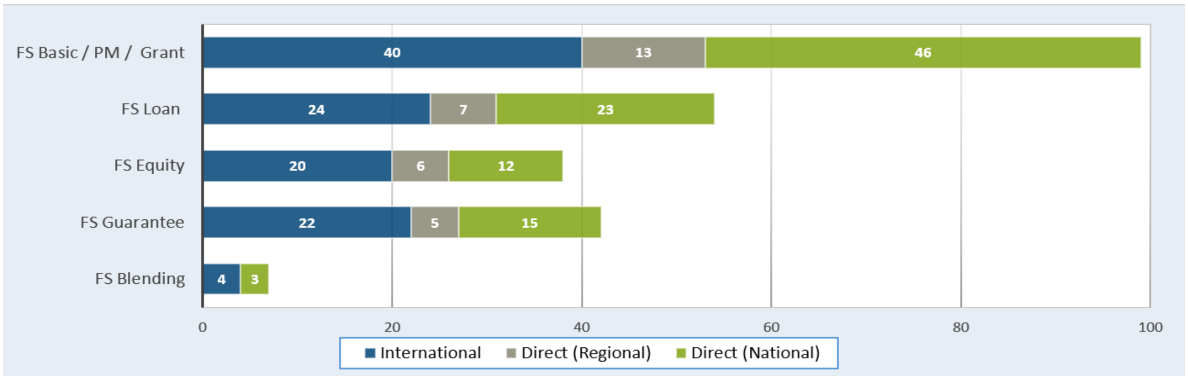


Note: Vertical boxes (blue and green) represents interquartile range covering projects between the 25th and 75th percentile of the project size. Total GCF finance per project in blue boxes, total co-finance per project in green boxes. Whiskers span all projects within 1.5 interquartile of the upper and lower quartile. Projects outside the whiskers represent outliers (maximum and minimum project sizes). Lines represent median (GCF finance 27.40 million US$; co-finance 20.00 million US$).

(US$ 23 million equity, US$ 3 million grant), and FP096 (US$ 12.5 million loan, US$ 3 million grant), demonstrating the possibility to finance adaptation other than by grants. In the case of cross-cutting and mitigation projects, the use of grants is notably lower for all countries. Although the GCF has a lower tolerance for losses, it may seek additional risk mitigation measures. For instance, support may only be provided through an intermediary which would guarantee repayment, in case of a loan. Considering the large share of grant-based adaptation and cross-cutting projects, leveraging private finance remains a challenge. In the current portfolio, the amount of co-finance changes particularly for grant shares (GCF grant funding divided by total GCF funding): the smaller the GCF grant share, the larger the amount of co-finance (see Figure 2). The low risk appetite of the GCF might serve as a signal for co-financiers that the respective project entails relatively low risk. As a result, they are willing to provide relatively large amounts of co-financing.

The GCF Board aims for a 50:50 balance between mitigation and adaptation over time and a floor of 50 percent of the adaptation allocation for particularly vulnerable countries. One option to increase the use of non-grant GCF resources could be to work with Accredited Entities (AEs) and particularly national direct AEs, to strategically and systematically support them to upgrade their scope of accreditation in terms of fiduciary standards (FS). The GCF's FSs distinguish between different types of fiduciary risks that are implied depending on the nature of the activities that an AE may take on, including the type of financial instruments (GCF, 2014b). As illustrated in Figure 3, only a small number of AEs are accredited for specialised FS concerning guarantees, equity, and particularly blending, which reflects the actual occurrence of

Figure 3: Number of Accredited Entities by Fiduciary Standards



Note: See the first bar. All 99 AEs are accredited to Fiduciary Standards Basic, Project Management, and Grant award.

such financial instruments across the portfolio. Blending different instruments is a proxy for making use of innovative financial approaches. Assessing the project portfolio by AE with specific FS, more than half (34 out of 57) are designed with two GCF instruments. This underlines the IEUs recommendation on the need to develop a strategy for accreditation (GCF IEU, 2020) to improve access to the GCF by blending finance. Having both grant and revenue-generating parts in adaptation projects would be one option to implement "smart risk allocations" and help to diversify the financial instruments. Additionally, flexibility on the terms and conditions may open new markets, trigger innovation, and increase the project viability and impact.

The portfolio assessment indicates that the GCF currently has a higher risk appetite in areas with expected higher development impact or in areas considered critical to achieving the GCF's mandate, such as adaptation projects in priority countries.

The GCF Updated Strategic Plan 2020-23 states The to be finalised GCF Update d Strategic Plan 2020-23 states that the GCF must be willing to take risks to unlock climate action and de-risk more conservative sources of finance to serve as an accelerator and amplifier for climate action. Therefore, the Updated Strategic Plan needs to have a strong statement on GCF risk appetite, demonstrate on how to operationalise it and how this differs from other multilateral funds. This is not currently the case as it is not possible to determine whether or how the GCF takes on risks that other public and private investors are not able or are unwilling to take. The current risk management framework does allow a measurement of risks undertaken to deploy innovative climate technologies.

Recommendations

- The to be finalised GCF Updated Strategic Plan 2020-23 should demonstrate a strong statement on GCF risk appetite and how to operationalise its risk to match the GCFs latest objectives and strategy.
- The Updated Strategic Plan, risk management framework and risk appetite statement must be updated in parallel; embracing risk to drive a paradigm shift.
- "Smart risk allocations", thus blending financial instruments, and flexibility on the terms and conditions, may open new markets, trigger innovation, or encourage different actors to co-finance projects and increase the project viability and impact. This underlines the importance of the ongoing review of the Financial Terms and Conditions of GCF Financial Instruments
- Developing an accreditation strategy should improve access to the GCF and encourage more AEs to upgrade their scope of accreditation in terms of FS to facilitate blending and co- finance in riskier projects. Assessing and incentivising capacity building especially for direct national AEs would facilitate the diversification of GCF financial instruments.

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