CLIMATE INVESTMENT FUNDS

CTF/TFC.15/4
April 13, 2015

Meeting of the CTF Trust Fund Committee
Washington D.C.
Tuesday, May 12, 2015

Agenda Item 4

REVIEW OF MINIMUM THRESHOLD MARGIN BETWEEN CTF PROJECTED NET INCOME AND PROJECTED LOSSES AS A KEY RISK INDICATOR

(SUMMARY)

PROPOSED DECISION

The CTF Trust Fund Committee reviewed the document CTF/TFC.15/4, *Review of Minimum Threshold Margin between CTF Projected Net Income and Projected Losses as a Key Risk Indicator*, and requests the CIF Administrative Unit, in collaboration with the Trustee, to:

i. refine and operationalize the Enterprise Risk Management Dashboard as a reporting tool for key risk metrics by the end of Q2 F2016;

ii. closely monitor and report on the margin between the CTF's projected net income and projected losses on outgoing CTF financial products[1] on a regular basis via the Enterprise Risk Management Dashboard. The CTF Trust Fund Committee agrees that establishing a target or minimum threshold for the CTF margin is unnecessary at this time; and

iii. commence stress testing using the CTF's cash flow model to determine the effects of stressed scenarios on the CTF's projected net income and projected losses, and report the results on a quarterly basis through the Enterprise Risk Management Dashboard.

[1] Details on the calculation of the CTF net income and losses on outgoing CTF financial products are as set forth in the Principles regarding Contributions to the Clean Technology Fund, attached to the Contribution and Loan Agreements/Arrangements between the CTF contributors and the Trustee, as may be amended from time to time.

I. Introduction

1. At the June 25, 2014 meeting, the CTF Trust Fund Committee reviewed the *Risk Report of the CTF and SCF Trust Funds* and requested that the Trustee, in consultation with the CIF Administrative Unit and MDBs, propose a specific target for the margin between the CTF's projected net income and projected losses on outgoing CTF financial products (CTF margin).

2. At the November 17, 2014 meeting, the CTF Trust Fund Committee reviewed the *Proposal for a Specific Target for the Margin between Projected CTF Net Income and Projected Loan Losses* and requested that the CIF Senior Risk Management Officer, once appointed, work with the Trustee, MDBs, and interested Committee members, to propose to the Committee an appropriate methodology and level of such a target at the next Committee meeting. The rationale for establishing the target was to give the Committee 'early warning' that projected CTF net income might not be sufficient to cover potential losses, and theoretically enable the Committee to consider actions to mitigate such an event. Table 1 displays the level of the CTF margin over time.

II. Enterprise Risk Management and Improving the CTF Margin

3. At a high level, risk reflects the possibility of an event occurring *which will have an impact on the achievement of objectives*, and is measured in terms of the likelihood and severity of the event occurring.

4. Correspondingly, enterprise risk management (ERM) refers to a structured, consistent and continuous process across the whole organization for identifying, assessing, monitoring and responding to opportunities and threats *which affect the achievement of its objectives*.

5. It is essential for ERM to begin with a clear understanding of the enterprise's objectives. Because no two organizations are identical, individual enterprises have unique strategies and objectives, therefore face different types of risk, and have different options available to them for responding to risk. An organization's objectives provide the necessary context and direction for ERM to be successful. Risk management efforts which fail to incorporate an organization's objectives can cause more harm than good, and undermine the ability of an organization to achieve, or even pursue, its objectives.

6. From a risk management perspective, the CTF is unusual because its objectives are so fundamentally different from those of most private sector enterprises. The CTF was established as a trust fund, and, as such, functions differently than an investment fund. The CTF is funded by contributors rather than investors, and the CTF was created to provide concessional financing to middle income countries focusing on projects in renewable energy, energy efficiency and transport, rather than to maximize returns for investors.

7. Options for responding to risk generally fall into one of the following categories.

a) Risk Avoidance – not undertaking the associated initiative
b) Risk Reduction – implementing exposure limits or collateral requirements
c) Risk Transfer – obtaining insurance or guarantees
d) Risk Acceptance – doing nothing

8. Given that the strategic objectives of the CTF necessitate a significant exposure to the risk of losses, options to avoid, reduce or transfer risk are extremely limited and many traditional risk responses are simply not applicable to the CTF. For example, implementing controls such as minimum credit rating requirements for borrowers or loan guarantee requirements, to minimize or prevent credit losses, would undermine the ability of the CTF to pursue its objectives (e.g., extending concessional loans and loan guarantees to middle income countries and private sector entities for projects in renewable energy, energy efficiency and transport).

9. Failing to keep the CTF's strategic objectives at the forefront of ERM efforts, and instead focusing on goals which conflict with the CTF's objectives, can lead to the avoidance, transfer or reduction of risk which must instead be accepted if the CTF is to achieve its objectives.

10. This is not to say that contributors should not seek assurance that the CTF is exercising prudent stewardship over the funds it manages. Additionally, contributors must be kept apprised of their exposure to the risk of losses. However, many of the most commonly employed risk mitigants would prevent, rather than assist the CTF in fulfilling its strategic objectives, and may not therefore be applied to the CTF. It is impossible to eliminate many of the risks to which the CTF must be exposed in order to fulfill its strategic objectives, or for the CTF to guarantee that losses will not exceed the CTF's net income.

III. VALUE OF A MINIMUM CTF MARGIN THRESHOLD

11. It is likely that most, if not all, options for ensuring that the margin remains positive would be most prudently implemented as soon as possible, rather than at the time a minimum CTF margin threshold is breached. Additionally, focusing on a target, whose achievement is beyond the CTF's control, would add little value and would not serve the purpose of providing an early warning indicator

12. The CTF margin should be one of the most closely monitored CTF-related metrics. Therefore, rather than establishing a threshold or target for the CTF margin, it would be most prudent for the CIF Administrative Unit, in collaboration with the Trustee, to begin reporting the margin on a quarterly basis in the Enterprise Risk Management Dashboard. Additionally a clearer understanding of the behavior of the CTF margin under adverse conditions (i.e. stress testing) is needed.