Climate Investment Funds

January 18, 2019

FIP Risk Appetite Statement

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 Forest Investment Program (the program), one of the programs under the SCF. The Subcommittee should be particularly focused on risks which could affect the program's 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).

II. CONTEXT

4. When assessing the 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 program's objectives include the following.

   - Pilot replicable models to generate understanding and learning of the links between the implementation of forest-related investments, policies and measures and long-term emission reductions and conservation, sustainable management of forests and the enhancement of forest carbon stocks in developing countries;
   - Committing to apply a priori and ex post impact assessment of programs and projects to ensure that the outcomes and effectiveness of FIP-supported interventions in reducing deforestation and forest degradation can be measured.

- Provide valuable experience and feedback in the context of the United Nations Framework Convention on Climate Change (UNFCCC) deliberations on reduced deforestation and forest degradation (REDD);
- Initiate and facilitate transformational change in developing countries' forest related policies and practices; and
- Facilitate the leveraging of additional financial resources for REDD, including through a possible UNFCCC forest mechanism, leading to an effective and sustained reduction of deforestation and forest degradation, thereby enhancing the sustainable management of forests.

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. Piloting and learning by doing with a focus on developing countries requires a willingness to take substantial risk under certain circumstances. Because the program was established to take risks which other financiers 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).

a) **FIP Subcommittee (SC)** – 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 SC leverages the information, reports and advice it receives from the CIFAU and the Trustee to engage in risk-based decision-making.

b) **CIF Administrative Unit (CIFAU)** – supports the work of the program, and supports and makes recommendations to the SC. The CIFAU uses the

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

information it receives from the MDBs and Trustee to assess and monitor/report risk exposures to the SC.

c) **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.

d) **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.

III. 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:

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

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

Likelihood

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 SC 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 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.

IV. Risk Appetites

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

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

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

c) **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.

d) **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. The program will not tolerate any negative impact on its reputation, and will only accept minimal exposure to this risk (i.e. minor negative media coverage).

V. 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 of endorsed investment proposals. Over-programming is not permitted for the FIP, and the program's appetite for this risk is **Low**.

22. **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.

23. The program targets recipients that are (or are domiciled in) developing countries, many 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

[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.

with the program's projects. The program's appetite for this risk is therefore **Medium**.

VI. Financial Risk

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

25. **Credit Risk**: represents the risk that 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.

26. 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 reduce the funds available for cover the administrative costs of the program.

27. 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, or have not been assigned external credit ratings at all), and does not discriminate against recipients based on creditworthiness, the program's appetite for this risk is **High**.

28. **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.

29. 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**.

30. **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. While the program has not yet extended local currency-denominated loans, such loans could be useful in making future projects viable. The CIFAU recommends that these loans be permitted up to a limit of 5% of the program's contributions received, and that the program's appetite for this risk be **Medium**, with the acceptance of this recommendation.

31. **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 without limit and the program's appetite for this risk is therefore **High**.

32. **Asset Liability Management/Liquidity Risk**: represents the risk that the program will be unable to meet its financial obligations (e.g. transferring funds to MDBs to honor funding commitments) as they come due. The program's appetite for this risk is **Low**.

33. **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. The program's appetite for this risk is **Low**.

VII. Operational Risk

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

35. **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, many 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**.

36. **Model Risk**: represents the risk that reliance on models to make decisions will impede the achievement of the program's objectives. Going forward, the program will employ two models.

    a) The CIFAU will model expected credit losses associated with the program's loan portfolio to assess the portfolio's credit risk; and
    b) The Trustee or CIFAU will model the program's future cash flows to assess the program's ability to fund administrative costs.

37. 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 **Medium**.

VIII. Compliance, Legal and Reputational Risk

38. Presently the following compliance, legal and reputational risks to the program have been identified.

39. **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 SC members. The program has no appetite for fraud risk.

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

a) 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
b) 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.

41. The program has no appetite for this risk.

IX. Annex A – Summary of Risk Appetites

Category	Risk	Risk Appetite
Strategic Risk	Resource Availability Risk	Low
	Implementation Risk	Medium
Financial Risk	Credit Risk	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	Medium
Legal, Compliance & Reputational Risk	Fraud Risk	Low
	Risk of Sexual Exploitation or Abuse	Low