



# **GREEN BANK**

## DESIGN SUMMIT

March 18–19, 2019



# Workshop B: Institutional Frameworks and Risk Management



# In this session we will cover:

- **Design choices** that affect risk, return and green impact
- **Risk management and governance settings** that an operating green bank uses to manage risk, optimise return and green impact and safeguard its reputation

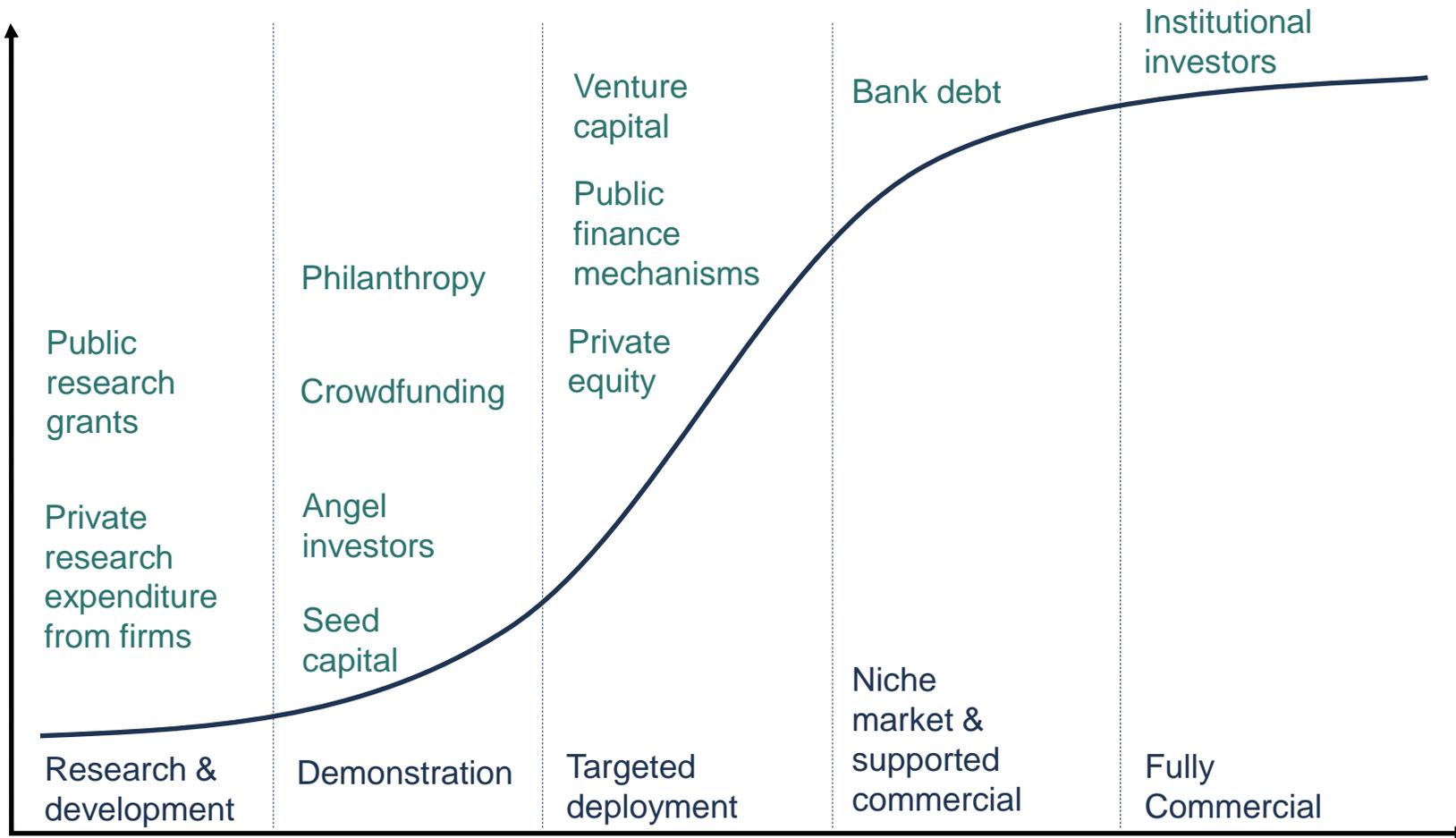


# Risk, return and green impact: design choices

# Finance needs change as a technology's market penetration increases



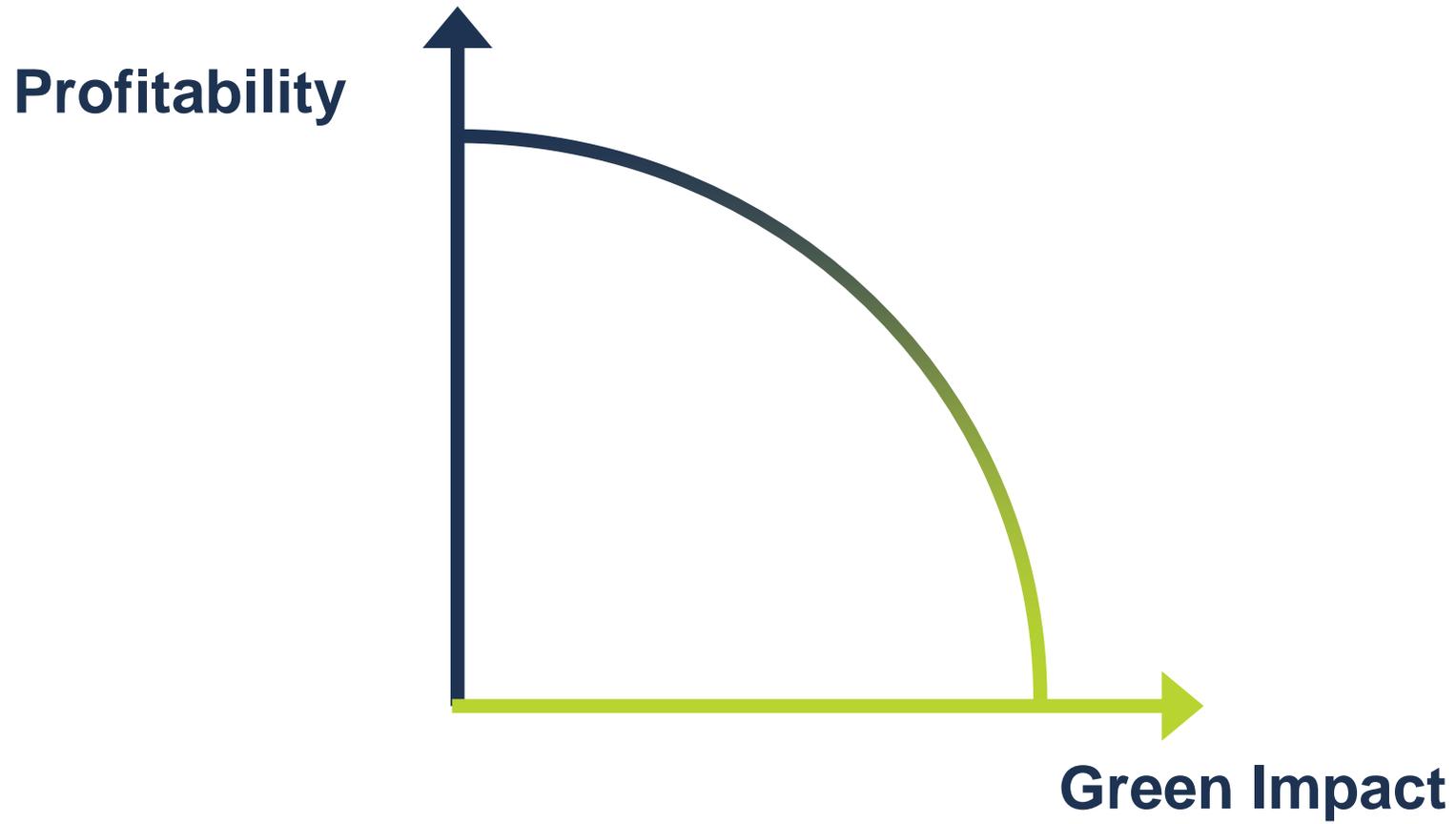
Market penetration



Adapted from Brown and Granoff

Time

# Where will your green bank sit on the impact-vs-profit curve?





# What financial instruments should your green bank offer?

## SOME OPTIONS:

- Debt at market rates
- Debt at concessional rates
- Equity (< controlling stake)
- Equity (controlling stake)
- Derivatives
- Guarantees

## SOME CONSIDERATIONS:

- A wide range of options provides **flexibility to meet the market's needs**
- Allowing controlling equity stakes or use of derivatives could promote **riskier or speculative investments**



# How broad is your green bank's sector focus?

## SOME OPTIONS:

- Limited focus on specified technologies
- Wide mandate with lots of flexibility

## SOME CONSIDERATIONS:

- A narrower focus **limits opportunities for portfolio diversification** and increases exposure to sector-specific business cycles
- A broader focus allows a green bank to **meet market needs that change** over time



# How much independence does your green bank need?

## SOME OPTIONS:

- Will the board be appointed by government or funding bodies?
- Will the chief executive appointed by the board?
- Will your green bank be subject to direction by the government? On strategy? On specific investments?

## SOME CONSIDERATIONS:

- A board appointed by the government can promote **alignment with policy objectives**, but may reduce **risk appetite**
- **Independence** of investment decisions is critical for **public trust** and **credibility** with counterparties



# Will your green bank have a target rate of return?

## SOME OPTIONS:

- No target rate of return
- Required to cover operating costs
- Specified target annual rate of return below, at or above cost of funds

## SOME CONSIDERATIONS:

- An ambitious target rate of return can **impose discipline on investment decisions** and reduce the risk of 'crowding out' private investment
- But too high a target rate may **discourage the use of concessional finance** and **reduce green impact**



# How will your green bank fund itself?

## SOME OPTIONS:

- Equity from public or private funds
- Issue bonds directly
- Recycling its own starting capital

## SOME CONSIDERATIONS:

- Managing funding is a **major task** and potentially a **distraction** from the organisation's main investment role
- Managing private money alongside public funds risks conflicts



# Managing Risk

# Goal of effective risk management

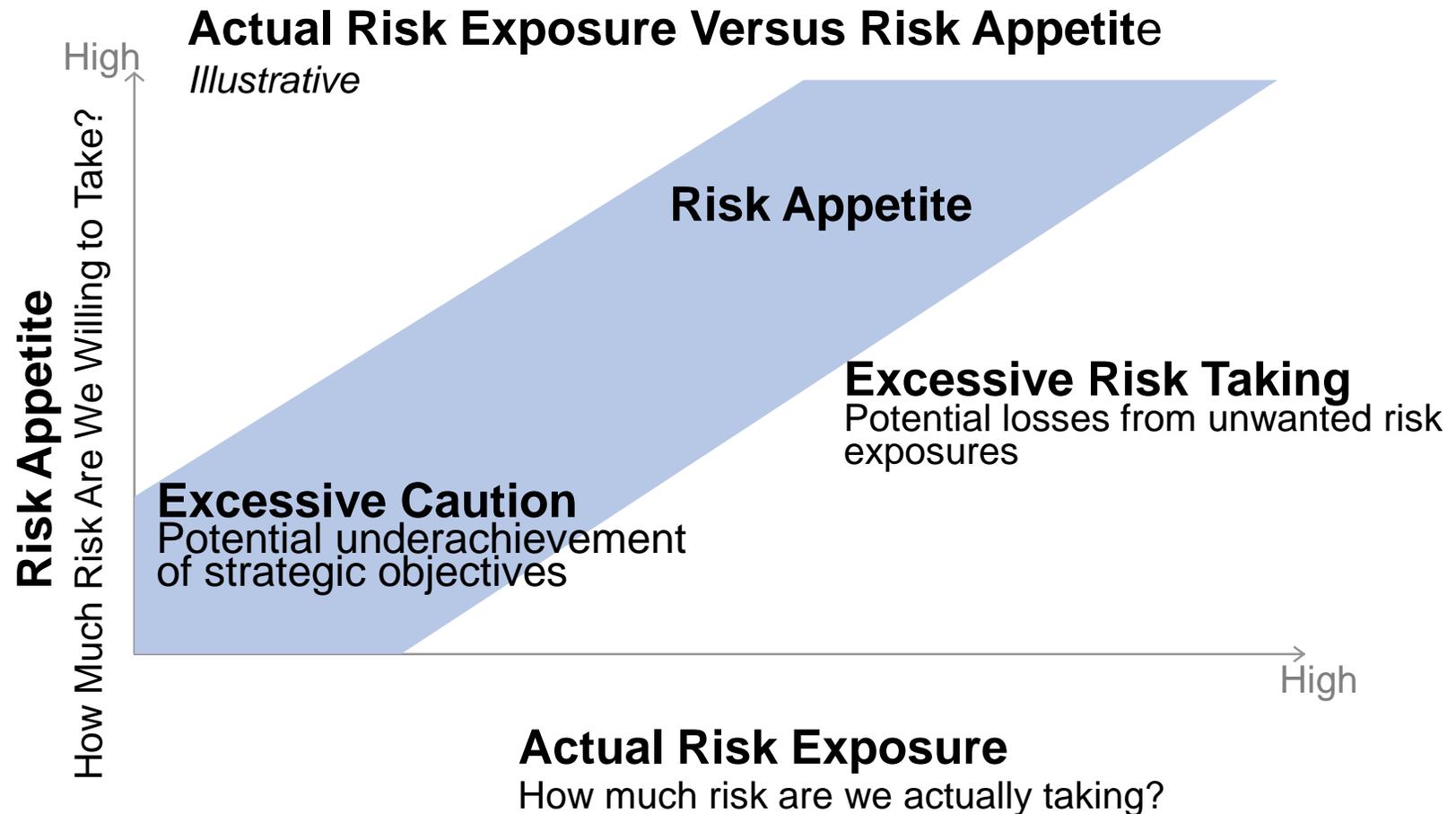
## Not risk elimination

It is about **informed risk taking**.

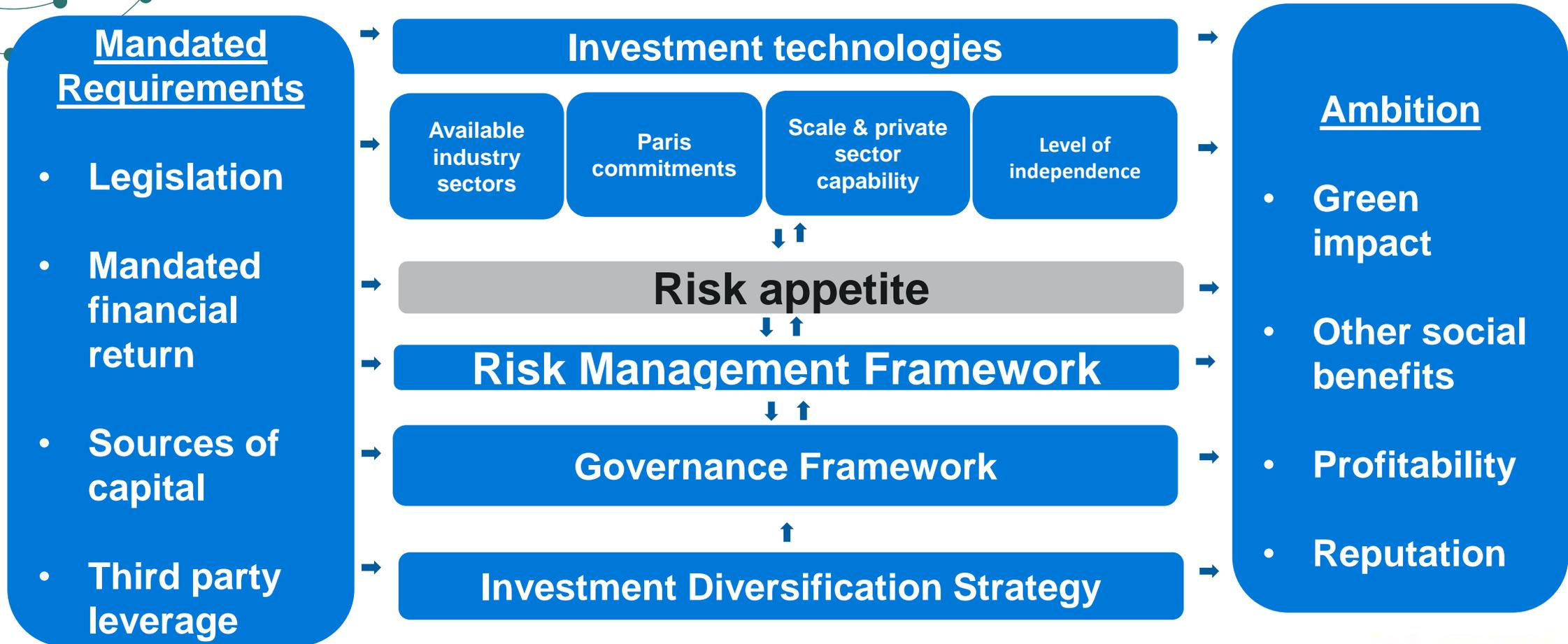
We need a balanced risk profile within **tolerance levels**

**Risk appetite** is the amount of risk we will accept, within our risk tolerance levels

Relates to both **investments & the organisation**



# A green bank's risk appetite is driven by mandated requirements and green and financial ambition





# Maintaining reputation is key element of risk appetite

- **Public and political support** is essential for an enduring green bank
- Risk events can lead to a critical **loss of reputation** and ability to operate
- Risks can arise from **both investments and operational** failures
- As **custodians of public money**, a heightened organizational risk culture is required



# What framework is needed to effectively manage risk?

- A Risk Management Framework relates to **investments as well as operations** of the organisation itself
- Mitigating **investment risk** requires an auditable trail of decision making, showing detailed analysis, formal consideration and the right people decided.
- Investment decision making must be **robust and embedded** in the culture of the organization
- Must be **efficient** and not bureaucratic
- Internal **policies and controls** need to be designed for your green bank's unique strategic and operational circumstances
- Existing development banks can **repurpose** existing processes



# Illustrative enterprise risk management framework for managing investments and operations

**GOVERNANCE**

**STRATEGY**

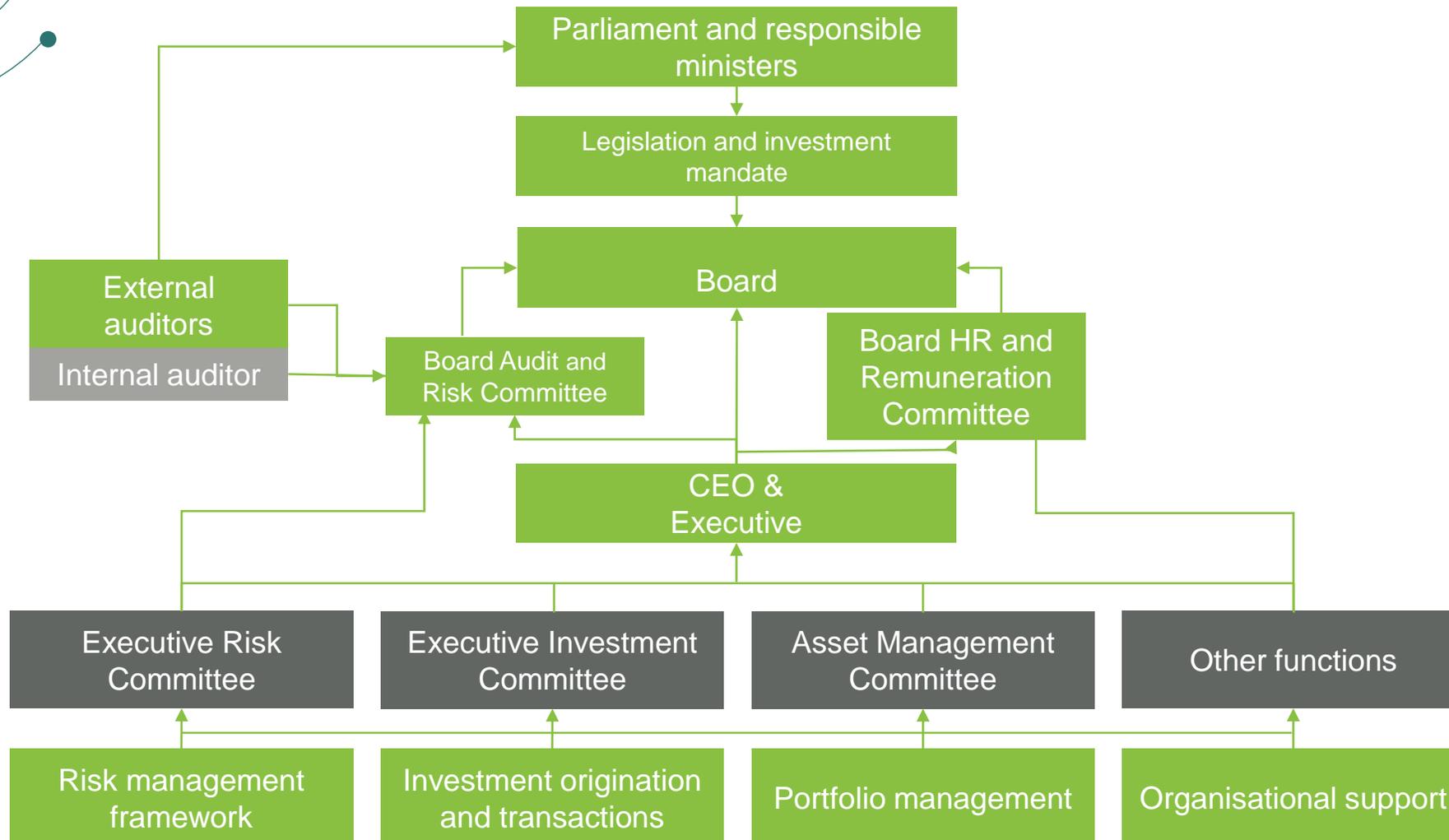
**RISK ANALYSIS**

**CULTURE AND CONDUCT**

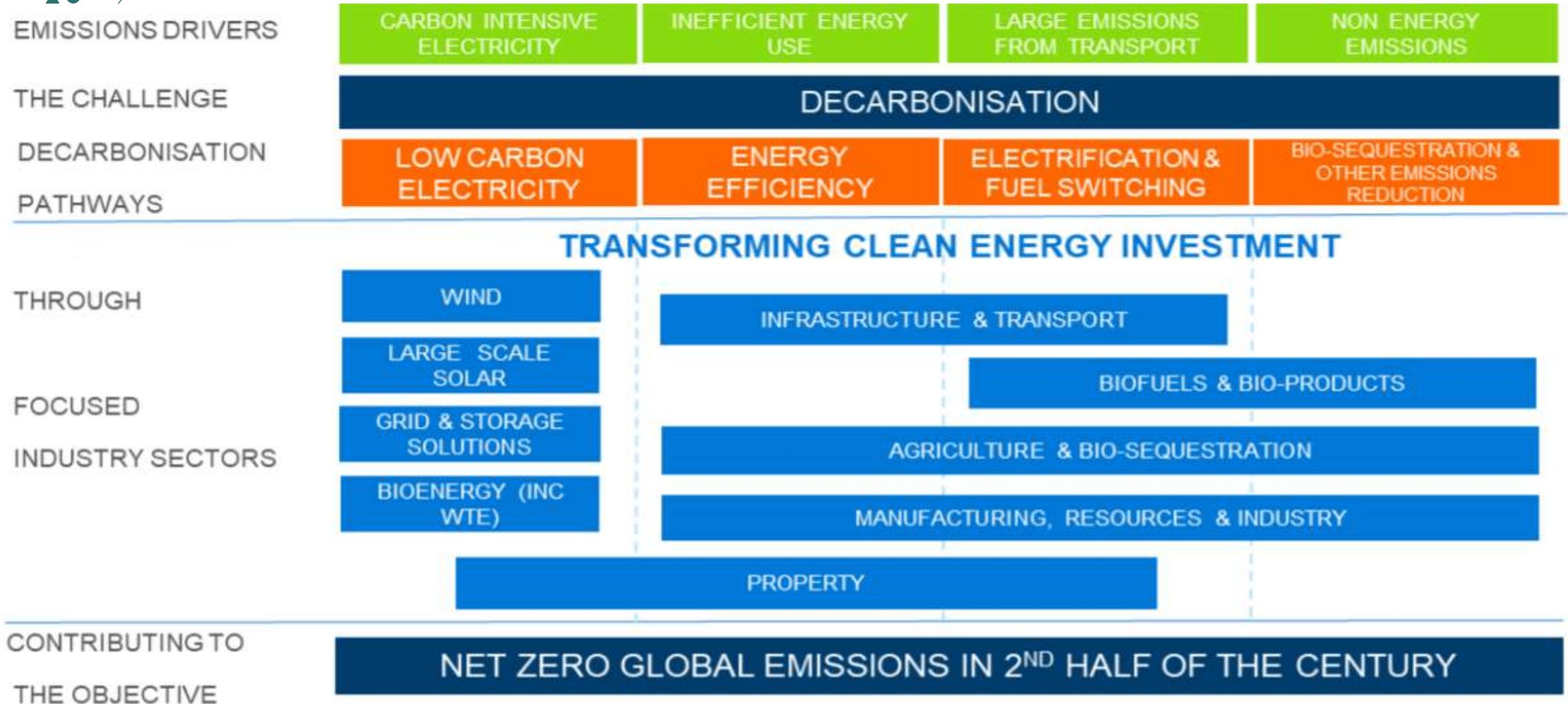
**CONTROLS**

**ASSURANCE**

# A typical governance framework



# A diversified investment strategy helps to mitigate risk and enhance green impact





# Risk management is fundamentally about maintaining your green bank's reputation

Risk management is fundamentally about:

- **Informed and measured** risk taking
- **Balancing** mandated requirements with green and financial ambition
- A well-functioning **risk management framework**
- A **diversified** investment strategy
- Supportive **governance**
- A risk conscious **culture, conduct and effective controls**
- Protecting **taxpayers' money** to achieve **optimum impact**
- And ultimately maintaining **reputation** as a key **licence to operate**



# Questions for small-group discussion

- What **financial instruments** should your green bank offer?
- How broad is your green bank's **sector focus**?
- How much **independence** does your green bank need?
- Will your green bank have a **target rate of return**?
- How will your green bank **fund** itself?

Where will your green bank sit on the impact-vs-profit curve?



# Workshop B: Institutional Frameworks and Risk Management



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# Process of Designing Green Banks/ Financial Institutions

Dileimy Orozco, E3G

19<sup>th</sup> March, 2019

# The need for a more strategic approach...

- **Developing countries are at critical stage in infrastructure development**, which in turns makes it critical that capital and investments can directed to sustainable areas.
- Public balance sheets alone are not sufficient.
- Private finance sector is rather conservative, and it tends be slow to embrace new technologies.
- In emerging/ developing economies, **the political risk sometimes can be overestimated** by the private sector as there is a lower understanding of the policies in the country.
- Textbook solutions alone will not deliver
  - Boosting private investment by only increasing rewards is a costly way of dealing with risks and market failures.
  - Low carbon responses such as a carbon price are not enough.

**Green Banks/Financial Institutions bridge the gap between finance and policy**



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# Perception from Decision Makers



## Our experience shows:

- Creating ambitious institutions doesn't have to be a highly complex process.
- It can be done quickly.
- There are methods and tools that you can use to make this process easier.



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# The process of designing Green Banks/ Financial Institutions - 5 phases



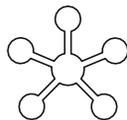
KEY DECISIONS AND CHOICES



Decision Making Process



Stakeholder Engagement



Analytical support



Standards and Frameworks





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# How the process works



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Decision-Making Process



Agenda setting can be influenced by different factors: external events, political driver, structural issues, pure advocacy, or a combination of the above.

Stakeholder Engagement



Engage with key decision makers and establish their role in the process  
Market testing: real economy and financiers – input to refine proposals

Analytical Support



- What's the **low carbon strategy**? What is the **total financing requirement to deliver it**?
- What's the **financial landscape in the economy**? Is there a bond market; is it easy to issue equity; bank debt.
- What is **the current finance gap, and how will it be met**?
- Can the **current financial system deliver the transition**?
- Why is a policy solution better than an institutional one?
- What is **the real vs perceived risk, who owns the risk** and how to reduce the risk?

Standards and Frameworks



Precedents from alike institutions



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Case  
Making

Design

Establishment

Operation

Evolution

### **OUTPUT OF CASE MAKING**

- ✓ Mapping the current financial landscape.
- ✓ Low carbon agenda including targets.
- ✓ Total infrastructure financing requirement, green requirements by sector.
- ✓ Determine the missing markets.
- ✓ The objective of the GIB and proposal of the functions based on the finance strategy and market barriers.
- ✓ Market testing (finance, government, NGOs, political parties).

**The output is the foundation for the key decisions and choices in the next phase.**

# Example: UK Green Investment Bank



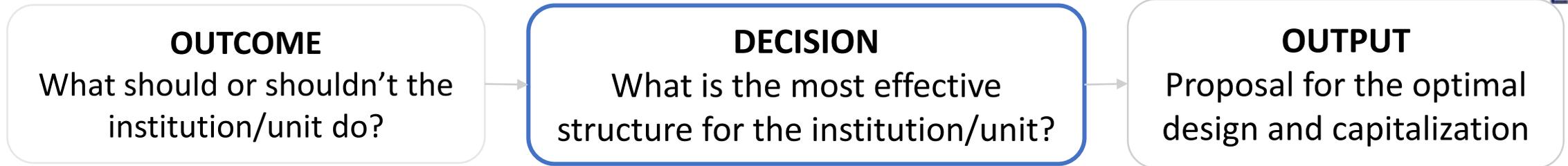
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- In response to the 2008 Global Financial Crisis, **E3G proposed a UK Sectoral Stimulus Package** including a Green Infrastructure Bank
  - **The scale of financing need was unprecedented** ~£40-50 Bn per year over 15 years relative to ~£6-7 Bn actually invested.
  - **Another fund wasn't the solution:** have finite resources aimed at specific purposes, static.
  - **Rising rewards weren't correcting the risks,** inefficient to reward investors for their perception of the political risk
  - **The solution needed to address at least two challenges:** provision of finance and the coherence around policy frameworks.
- **Transform UK** created. A coalition members supportive of Green Infrastructure Bank
- **GIB commission** was set up to consult on the creation of a GIB



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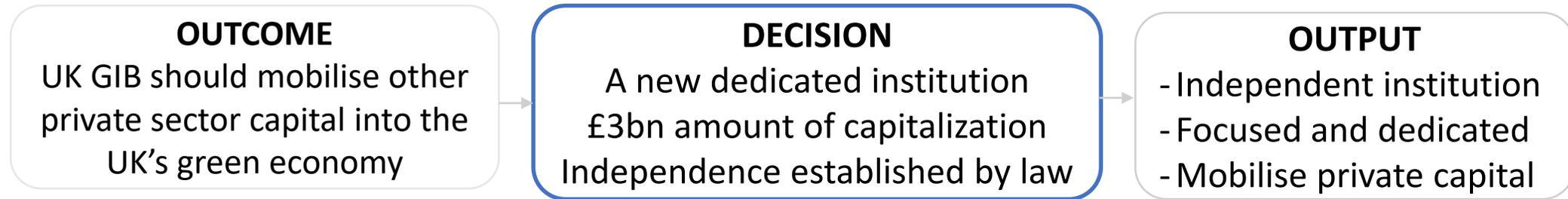


- What does **the process look like?**
- Which **government departments need to be consulted** about the GIB?
- Why **wouldn't the finance gap be met by existing financiers?**
- What is **the form of the institution?** and why?
- How should it most effectively be set up: **governance, shareholders?**
- What is the **scale of the capitalization?**
- How is the capitalization **going to be financed?**
- What should it use its financial resources to support?
- How is **the institution going to evolve ?**

# Example: UK Green Investment Bank



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- Coalition **government included GIB in their agreement**, but differed on scale, focus and structure
- **Treasury** didn't see the value, **prefer a wait-and-see approach**
- **Unprecedented scale, urgency and nature of the challenge**
- Pros and cons of establishing a new or using an existing financial institution were explored.
- The capitalization depends on priority sectors and the ability and willingness of the private sector to invest. Alternative sources could have been bonds, existing quangos, Green ISAs.
- Govt initially announced £3bn for capitalization
- **6 operating principles including** working towards a **'double bottom line', green impact and + returns**
- **GIB needs to have sufficient flexibility to adjust to changing market needs**



## Tools and inputs for the establishment phase

Decision by Government

### Policy recommendations



Jun '10

### Options analysis on capitalization



Oct '10

Update on the design of the Green Investment Bank

HM Government

May '11

Groups mobilized



Green Investment Bank Position Statement – September 2010

The UK is facing a time of considerable economic stress. Restoring growth and re-balancing the economy are urgent priorities. Focusing our recovery effort on low carbon growth can re-power the economy, increase our energy security and help tackle climate change.

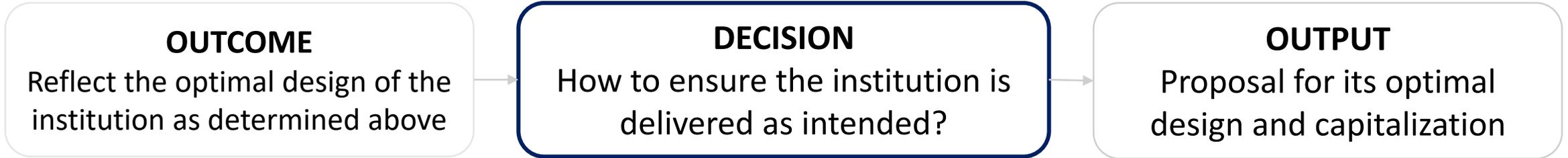
Groups mobilized



Green Investment Bank  
The case for legislation



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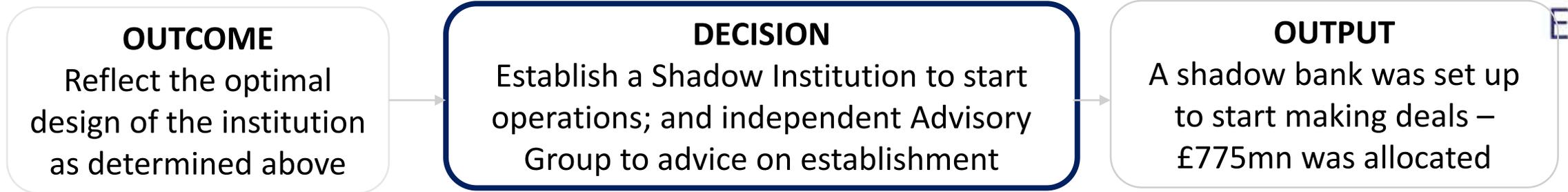


- Who could advise on the details of establishing the GIB?
- What is **the governance model**?
- What about **securing funds for initial establishment**?
- What is the strategy?
- How does **this type of institution fit within the current financial landscape**?
- What are the **borrowing powers of the institution**?
- What is the **accounting treatment required**?
- What are the **screening criteria** to be eligible for GIB support?
- What is the **risk management** e.g. guidelines, geographical, sectoral?



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# Example: UK Green Investment Bank



The **proposed governance** model had 5 components



- Funds were allocated for GIB to start operating via **Shadow Bank**
- **Legislative process** started where the GIB was going to be given a clear green mandate, key financial powers, operational independence and permanence.
- **Chairman, CEO and Board were appointed**, including six Non-Executive Directors (backgrounds in academia, business, investment funds, equity finance and the low carbon sector)
- **Ensure maximum 'additionality' and minimum market distortion**

# Key takeaways

- Everything is different but everything is the same
- The process is the same across countries, and breaking it down into bitesize chunks makes it easier to deliver and explain.
- The core functions of this type of institutions are highly similar between countries.
- There are some critical decisions that are going to take you along different pathways which are bespoke to the country context.

**WE WOULD LIKE TO HEAR FROM YOU**



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# Thank you

You can read more at:

<https://www.e3g.org/showcase/green-investment-bank>

<https://www.e3g.org/showcase/mexico-in-focus/>

<https://www.e3g.org/showcase/international-climate-finance/>

<https://www.e3g.org/showcase/international-financial-institutions>

Contact me at: [dileimy.orozco@e3g.org](mailto:dileimy.orozco@e3g.org)



## About E3G

E3G is an independent climate change think tank operating to accelerate the global transition to a low carbon economy. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere. In 2018 E3G was ranked the fifth most globally influential environmental think tank for the third year running.

More information is available at [www.e3g.org](http://www.e3g.org)

## Next steps

- Create a general framework for designing Green Banks/Financial Institutions as a tool for decision makers.
- Illustrate the process with different designs and tools that are going to be available for use in your own process
- Planning to incorporate more case studies:
  - South African Green Fund
  - Colombia Sostenible – land-related fund

**we would like to hear from you!**



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# E3G has global experience in National Climate Financing Strategies



## Core principles learned from each process

- Functions are relatively similar across countries
- Constitutional and institutional landscape are very different
- Process of building an institution is iterative.

\*This is not an exhaustive representation of E3G's experience.