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GEF-7 Replenishment: Financial Structure

Seventh Replenishment of the GEF Trust Fund

January 23-25, 2018

Prepared by the GEF Trustee

Overview

1. **Key Components of GEF-7 Financial Structure**
   - Replenishment Resources
   - New Donor Contributions
   - Encashment Schedule
   - Pro-rata Provision
2. **Options to manage Foreign Exchange (FX) Risk**
3. **GEF Investment Strategy and ESG approach**

1. Key Components of GEF-7 Financial Structure

GEF Replenishment Resources

GEF Replenishment Resources

New Donor Funding	Funds Carried Over from Previous Replenishments	Projected Investment Income

- Unpaid Resources
- Paid-in Deferred Contributions
- Paid-in Unallocated Resources

New Donor Contributions

Donor Instrument of Commitment	Payment Timing	Form of Payment	Encashments
• Pledge is formalized by the deposit of an instrument of commitment (IoC)	• Four annual installments by November 30th each year • That is: - Nov 30, 2018 - Nov 30, 2019 - Nov 30, 2020 - Nov 30, 2021	• Cash, promissory notes or similar obligations payable on demand	• Indicative encashment schedule is 10 years, with options to accelerate • From FY19 to FY28

GEF-7 Encashment Schedule

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- The indicative encashment schedule for GEF-7 is as follows:

Fiscal Year (July 1 to June 30)	GEF-7 Indicative Encashment Schedule (%)
FY 2019	3.0%
FY 2020	8.0%
FY 2021	11.0%
FY 2022	15.0%
FY 2023	16.0%
FY 2024	16.0%
FY 2025	13.0%
FY 2026	9.0%
FY 2027	5.0%
FY 2028	4.0%
Total	**100.0%**

Pro-rata Provision

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- The pro-rata provision has had limited effect on the timely clearance of arrears, and has not been widely used
- **Participants broadly agree that it should be dropped from GEF-7**
- Due to some country constraints, the change may not be able to take place before the start of GEF-7
  - If it does, changes to the Replenishment Resolution will be presented at the April 2018 meeting

2. An FX Exposure Management Framework for the GEF TF

Key conclusions after the Addis Ababa meeting

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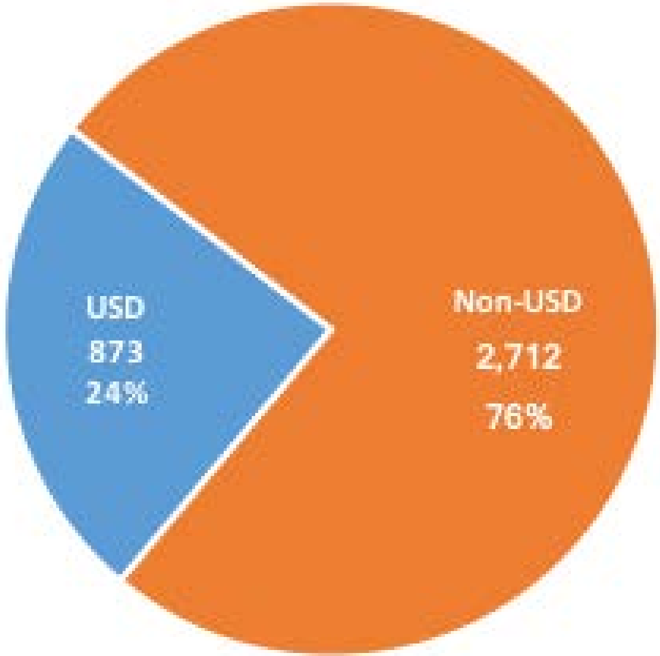
Hedging is the most efficient way of managing GEF currency risk

- Introducing a second operating currency not suitable from a recipient perspective
- Donors continue to have the option to contribute in US Dollars

Hedging should be done using the existing Trust Fund investment infrastructure

- Fastest and the most cost effective way for the GEF TF to access the capital markets
- Leverages the Bank's relationships and experience

GEF currency risk by numbers



Currency	Amount (USD mln)	Share
EUR	985	36%
JPY	607	22%
GBP	324	12%
CAD	210	8%
SEK	191	7%
CHF	124	5%
AUD	84	3%
DKK	77	3%
NOK	73	3%
MXN	18	1%
ZAR	7	0%
CZK	6	0%
NZD	6	0%
Total	**2,712**	**100%**

Which exchange rates matter, when and why

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Reference Rate

When?

- Throughout the latter part of the replenishment process and at pledging date

Why?

- Determines each donor's USD contribution to replenishment

Spot Rate

Cash Instalments

When?

- At instalment date

Why?

- Determines instalment USD value and what resources are available

Promissory Notes

When?

- After note deposit date

Why?

- Determines the USD value of the liability created by making commitments

When?

- At encashment date

Why?

- Determines whether the GEF TF records a balance sheet gain or loss

Objective & Impact of the FX hedging

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OBJECTIVE of hedging

Hedging offers **predictability** and **stability** in terms of resources available for programming

IMPACT on the value of resources

Hedging preserves the economic value of pledges, by "locking-in" at the time of hedging the USD equivalent value of contributions. It may result in a higher or lower resource envelope than the target envelope

IMPACT on the availability of resources

Once the hedges are in place, programming level can be determined based on the "locked-in" USD value

Overview of Proposed Hedging Framework

WHAT do we hedge?

- Unqualified non-USD IoCs, in currencies with liquid FX forward markets

HOW do we hedge?

- Buying USD by entering FX forwards, with maturity dates equal or close to installment/encashment dates

WHEN do we hedge?

- On IoC receipt, or at a later time, if “bunching” together several IoCs schedules leads to increased efficiency

HOW are hedges managed?

- GEF’s exposure to changes in FX rates (for the hedged IoCs) will be reflected daily in the MtM of the forwards. The MTM determines the collateral and can only become a real gain or loss if contracts are prematurely closed

Hedging simulation for GEF-6 Replenishment

WHAT do we hedge?

- According to the Framework, we choose for the simulation the unqualified IoCs denominated in EUR, JPY, GBP, SEK, CHF, AUD. This accounts for 77% of non-USD contributions, amounting to USD 2.1 billion at FX forward rates

HOW do we hedge?

- We simulate closing 298 FX Forward transactions, with an average size of USD 7 million and an average maturity of 4.4 years

WHEN do we hedge?

- The transactions were simulated to take place between 1 July 2014 and end-August 2015, when the last IoC was received

HOW are hedges managed?

- Mostly because of the USD strengthening since 2015, the MtM would have been positive, with a maximum of USD 230 million
- GEF exposure to FX risk before hedging – expressed as the average loss in 2.5% of worst loss cases in the USD value of the GEF-6 contributions, was USD 691 million. After the hedging, GEF's exposure would have been USD 93 million

Risks associated with hedging

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- **Delays or cancellations by donors may trigger financial costs**
  - Premature closing out of hedges may need to be done at a loss
- **Collateral associated with GEF hedges may become very large**
  - This may result in temporary rebalancing of portfolios or closing out of hedges
- **Market counterparties to GEF hedges may default**
  - May result in the need to put on new hedges
  - Pool collateral netting might result in complex settlement arrangements in case of counterparty default

How can donors help hedging efficiency?

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Maintain timely payments

- This reduces the risk of real losses due to hedge unwinds

Where possible, provide unqualified IoCs

- This will increase risk coverage of the replenishment

Provide IoCs as early as possible

- This will give earlier risk coverage and certainty of envelope

Accelerated encashment schedules

- This will reduce mark to market of hedges and any associated collateral

Next steps in implementation

Trustee to obtain internal World Bank Approvals for hedging

(by April 2018)

GEF Council to approve FX Hedging Framework

(June 2018)

Hedging to begin

(July 2018)

3. GEF Investment Strategy and ESG approach

Integrating ESG into the Investment Process

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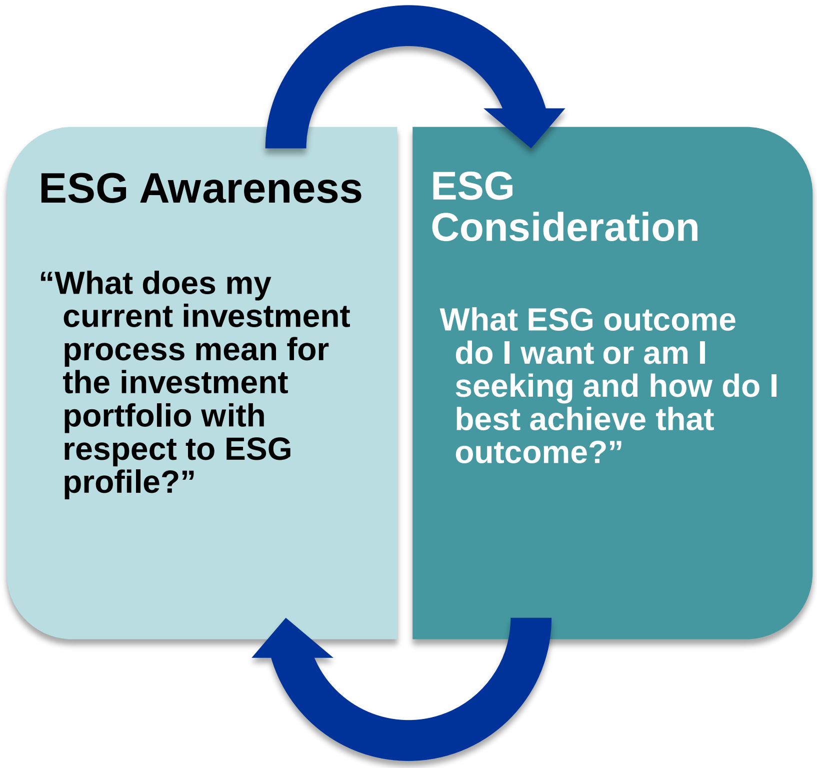
- Integration of ESG factors into the Trustee's investment process will follow a dual approach



A timeline for ESG Integration

In progress - World Bank investment staff receiving formal ESG Training

April 2018 – Presentation of joint GPIF/World Bank research

July 2018 – Adoption of ESG policy into Bank investment process

Future – World Bank possibly signing up to UN PRI

Thank you

Historical Changes in GEF Funding Envelope