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GEF-6 REPLENISHMENT: ADDITIONAL INFORMATION ON FINANCIAL STRUCTURE

(PREPARED BY THE GEF TRUSTEE)

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I. Introduction

1. At the first meeting of the GEF-6 replenishment in April 2013 participants considered several financial issues, including the minimum contribution to participate in the replenishment discussions, the use of pro-rata rights to defer commitments, and possible alternatives to create incentives to clear arrears. Participants recognized that any decisions to change current practices related to these issues would involve tradeoffs and requested that the Trustee provide additional information for consideration at the second meeting. This paper responds to that request and provides additional financial management information related to the investment strategy and foreign exchange reserve.

2. The paper is structured as follows. Section II provides a brief overview of the principles of contributing to the replenishment and the replenishment process itself, including the steps leading to the conclusion of the replenishment process and donor pledges. In Section III, additional information regarding the minimum contribution for participation in the GEF-6 Replenishment meetings is provided. Section IV presents options for providing incentives to donors to fulfill their pledges. Section V presents information on the investment strategy and its performance to date for the GEF Trust Fund. Section VI provides a summary of the decisions made in the GEF-5 replenishment regarding foreign exchange management and outlines the process for reviewing the foreign exchange reserve.

II. Principles guiding GEF Contributions and the GEF Replenishment Pledging Process

3. The principal objective of the replenishment is to mobilize adequate funding to support the replenishment goals agreed by participants, while taking into consideration the objectives and constraints of each donor. The overarching principles guiding donor contribution levels to the replenishment are transparency, equity, and ability to pay. Each donor considers options that best fit its overall objectives under a common, agreed financing framework.

Roadmap to the Pledging Process

4. GEF replenishment negotiations are usually concluded in three or four meetings. Once the policy and programmatic directions are determined, donors agree on the overall target size of the replenishment (generally at the second-to-last meeting of the replenishment negotiations, i.e. December 2013 for the GEF-6). The target replenishment size depends on the estimated overall

funding requirements for the agreed future programming and on donors' priorities and ability to fund the replenishment.

5. Following agreement on the overall target size of the replenishment, and during the period leading up to the last replenishment meeting and pledging session, the Trustee and Secretariat will consult bilaterally with donors and develop illustrative pledging scenarios based on key assumptions that arise from the consultations. It is important to note that, due to the flexible nature of the GEF contribution system and the differences in individual donor approaches, the actual pledging process is asymmetric and as a result, it is not feasible to develop a common approach to determine contribution levels. For some donors, a "burden-shared" approach is important, correlating contribution levels to objective criteria (such as, e.g., GNI per capita, prior GEF burden shares, or contributions to other international funds or organizations). For other donors, a "burden-shared" approach is less relevant, as contribution levels are driven by domestic budgetary priorities and circumstances. Some donors use their contribution levels and or burden shares in prior GEF replenishments as a reference point.

6. At the final replenishment meeting, a pledging session is held during which donors confirm their intended financial commitment levels. The Trustee uses the pledge information provided by donors to prepare a table of contributions. Donors review the table and the Trustee makes any needed adjustments to the contribution table to reflect feedback from donors. The final contribution table is attached to the replenishment resolution.

III. Minimum Contribution

7. During the GEF-1 replenishment negotiations, to promote efficiency in the negotiation process, donors agreed that only those countries that indicated an intention to contribute a minimum amount should participate in the replenishment meetings.[1] Donors contributing less than the minimum threshold would be invited to attend as observers but not participate in the replenishment discussions. This minimum amount was set at SDR 4.0 million[2] (equivalent to approximately USD 5.5 million as of March 1, 1993), recognizing that the minimum amount should not be burdensome for donors. SDR 4.0 million has been maintained as the minimum contribution level for participation in the replenishment meetings in subsequent replenishments to date.

[1] There is no minimum amount established to contribute to the GEF Trust Fund.

[2] The SDR or Special Drawing Right is a currency basket consisting of fixed proportions of the EUR, JPY, GBP, and the USD. As of June 30, 2013, the SDR was equivalent to USD 1.50396. Contributions to GEF replenishments are typically pledged in national currencies. While the operating currency of the GEF is the US dollar (USD), the SDR is used in GEF replenishments as the base currency to provide a common denominator for expressing the overall size of the replenishment.

8. If the minimum contribution level were to be revised to take inflation into consideration, the adjusted value of SDR 4.0 million in today's prices would be SDR 5.4 million (USDeq. 8.1 million).[3] Table 1 below provides an illustration of the potential impact of a change in the minimum threshold, using GEF-5 contribution levels. Ten of the 35 donors to the GEF-5 pledged below SDR 5.4 million (the inflation adjusted value of SDR 4.0 million) for a total amount of SDR 43.0 million. Of these ten donors, five pledged the minimum contribution amount of SDR 4.0 million, for a total amount of SDR 20.0 million. An additional five donors pledged above SDR 4.0 million but below SDR 5.4 million for a total amount of SDR 23.0 million.

9. The potential change in the minimum contribution level would primarily affect donors representing smaller economies. Seven of the 10 donors affected by a potential change in the minimum contribution level are small non-recipient donors; three of whom contributed at the minimum level of SDR 4.0 million while four contributed above that level but below the inflation adjusted level of SDR 5.4 million. Three recipient donors would be affected by a potential change in the minimum contribution level, two of whom contributed at the minimum level while one contributed above the minimum but below the inflation adjusted threshold.

[3] The inflation rate for countries of the SDR basket (through 2000, and the Euro Zone, Japan, the United Kingdom and the United States for 2001 onwards), representing international inflation, is measured by the change in the SDR deflator. The SDR deflator is calculated as a weighted average of the SDR basket countries' (through 2000, and the Euro Zone, Japan, the United Kingdom, and the United States for 2001 onwards) GDP deflators in SDR terms, the weights being the amount of each country's currency in one SDR unit. The inflation adjustment of the SDR represents an increase of approximately 35 percent since GEF-1.

Table 1. GEF-5 Pledges
(*in SDR million*)

	GEF-5 Pledge
Pledges at minimum contribution amount (SDR 4 m)	**20.0**
Non-recipient Donors	***12.0***
Luxembourg	4.0
New Zealand	4.0
Portugal	4.0
Recipient Donors	***8.0***
Nigeria	4.0
Pakistan	4.0
Pledges above SDR 4m, but below SDR 5.4m	**23.0**
Non-recipient Donors	***18.6***
Slovenia	4.3
Greece	4.4
Czech Republic	4.6
Korea	5.3
Recipient Donors	***4.4***
South Africa	4.4
Pledges above SDR 5.4m	**2,268.2**
Non-recipient Donors	***2,230.4***
Ireland	5.6
Spain	27.8
Norway	38.5
Austria	40.2
Denmark	52.7
Australia	52.9
Finland	56.2
Netherlands	74.7
Switzerland	75.4
Belgium	77.1
Italy	82.9
Sweden	85.4
Canada	135.2
France	194.2
United Kingdom	214.4
Germany	312.6
Japan	329.6
United States	375.2
Recipient Donors	***37.8***
India	6.4
Mexico	6.5
Russian Federation	7.1
Brazil	8.0
China	9.8
Total	**2,311.2**

Possible Positive Impact of Increased Minimum Contribution Amount

10. If each of the ten donors that pledged below the inflation adjusted minimum contribution in GEF-5 chose to remain a participating donor to GEF-6 (rather than shift to observer status) and adjusted their pledges to SDR 5.4 million, an additional SDR 11.1 million could be mobilized compared to GEF-5. (See Table 2 below.)

Table 2. Possible Positive Impact of Increased Minimum Contribution Amount (*based on GEF-5 pledges, in SDR million*)

	As pledged in GEF-5	Positive Impact of Increased Minimum Contribution Amount	Difference
Pledges at minimum contribution amount (SDR 4 m)	**20.0**	**27.0**	**7.0**
Non-recipient Donors	*12.0*	*16.2*	*4.2*
Luxembourg	4.0	5.4	1.4
New Zealand	4.0	5.4	1.4
Portugal	4.0	5.4	1.4
Recipient Donors	*8.0*	*10.8*	*2.8*
Nigeria	4.0	5.4	1.4
Pakistan	4.0	5.4	1.4
Pledges above SDR 4m, but below SDR 5.4m	**22.9**	**27.0**	**4.1**
Non-recipient Donors	*18.6*	*21.6*	*3.0*
Slovenia	4.3	5.4	1.1
Greece	4.4	5.4	1.1
Czech Republic	4.6	5.4	0.8
Korea	5.3	5.4	0.1
Recipient Donors	*4.4*	*5.4*	*1.1*
South Africa	4.4	5.4	1.1
Pledges above SDR 5.4m	**2,268.2**	**2,268.2**	**-**
Non-recipient Donors	*2,230.4*	*2,230.4*	-
Ireland	5.6	5.6	-
Spain	27.8	27.8	-
Norway	38.5	38.5	-
Austria	40.2	40.2	-
Denmark	52.7	52.7	-
Australia	52.9	52.9	-
Finland	56.2	56.2	-
Netherlands	74.7	74.7	-
Switzerland	75.4	75.4	-
Belgium	77.1	77.1	-
Italy	82.9	82.9	-
Sweden	85.4	85.4	-
Canada	135.2	135.2	-
France	194.2	194.2	-
United Kingdom	214.4	214.4	-
Germany	312.6	312.6	-
Japan	329.6	329.6	-
United States	375.2	375.2	-
Recipient Donors	***37.8***	*37.8*	-
India	6.4	6.4	-
Mexico	6.5	6.5	-
Russian Federation	7.1	7.1	-
Brazil	8.0	8.0	-
China	9.8	9.8	-
Total	**2,311.2**	**2,322.2**	**11.1**

11. In addition to the core objective of mobilizing adequate resources for the replenishment, any adjustment to the minimum contribution amount would continue to be guided by the principles of transparency, equity, and ability to pay. In this context, participants should consider the potential tradeoffs, including the potential negative impact on incentives to contribute should current participants fall to observer status.

IV. Incentives for timely payment

Donor commitment and appropriation processes vary country by country. In some instances, donors have been unable, for different reasons, to pay the full amount of their replenishment pledges. These shortfalls have resulted in arrears to the GEF.

Table 3. GEF Arrears as of June 30, 2013
(*in millions*)

Countributing Participant	Repl.	Currency	Arrears Amount	USD eq.
Egypt	GEF-1	SDR	0.5	0.8
United States	GEF-2	USD	135.0	135.0
Nigeria	GEF-3	SDR	0.7	1.0
Spain	GEF-5	EUR	10.1	13.2
United States	GEF-5	USD	112.9	112.9
Total				**262.9**

Protracted arrears situations create difficulty for some donors as such arrears are seen as undermining equity principles and the "burden-sharing approach" that is an important factor in their pledging decision. Accordingly, donors have sought to establish measures, outlined below, that create incentives to avoid, or promptly resolve, arrears.

The pro-rata provision in the GEF

12. Over the four years of a GEF replenishment period, donors are expected to pay their contributions in four equal annual installments.[4] Due to domestic constraints, some donors deposit a Qualified Instrument of Commitment with the Trustee, which authorizes the full amount of the four-year contribution, pursuant to which a donor agrees to pay part of its contribution without qualification, while the remainder is still subject to enactment of the necessary appropriation legislation by its legislature.

[4] For additional information regarding terms of donor contributions and payment procedures, refer to Annex A.

13. To facilitate fair burden sharing between a ‘lead donor’ who provides a Qualified Instrument of Commitment and other donors, and to protect the interests of other donors in the event of delayed or reduced contributions by the lead donor the *pro rata* (deferment) clause was introduced in the GEF-1. The *pro rata* provision was also meant to provide an incentive to the lead donor to expedite necessary internal approvals of its GEF contribution. Timely provision of the donor’s financing for the new replenishment would therefore ‘leverage’ funding from the other replenishment donors who had invoked their *pro rata* rights. However, where donors avail themselves of the *pro rata* provision, the predictability of when resources will be made available to recipient countries is reduced along with the amount available for programming.

14. Replenishment resolutions for GEF-1through GEF-4 provided that if a donor that has deposited a Qualified Instrument of Commitment and whose contribution exceeds 20 percent of the total donor pledged amount failed to unqualify specific portions of its contribution by the agreed deadlines, other donors would have the right to defer the commitment by the Trustee of a corresponding portion of their contributions.[5] In GEF-5, no donor met the 20 percent threshold. The threshold was therefore reduced to 5 percent, resulting in more than one ‘lead donor’, and increasing the likelihood that the *pro rata* provision would trigger deferring commitments of contributions from other donors.

Table 5. Arrears and Deferred Contributions by Replenishment
(in USD million)

	GEF-1	GEF-2	GEF-3	GEF-4	GEF-5 (current) *
Arrears/unpaid resources	190	254	194	297	263
Deferred Contributions		192	214	232	-

* During the GEF-5 all deferred contributions were released.

Practices at other funds

15. **The International Development Association (IDA)** introduced the original *pro rata* provision in IDA7. It restricted the commitment of a corresponding part of donor contributions in the event of any shortfall from donors whose contributions exceed 20 percent of the total donor resources (or lead donors). The 20 percent threshold was set to ensure that the provision captured only the largest donors, without which the three-year replenishment could not proceed as planned. The *pro rata* exercise would be triggered if a lead donor did not unqualify at least 66

[5] When donors exercise their right to defer commitment of their contribution, such amounts are withheld from the amount available to support funding decisions by GEF Council and GEF CEO.

percent of its total subscriptions and contributions by the date specified in the replenishment resolution, or 31 days after the replenishment effective date, whichever was later.[6]

16. By IDA14, no donor exceeded a burden share of 20 percent. In the absence of a single lead donor, IDA Deputies determined that the incentive provided by the clause had been weak and that the reduction in the amount of resources available to recipient countries merited greater consideration. Therefore, in the IDA15 replenishment negotiations in 2007, Deputies agreed that the use of the provision should be removed to protect the interest of IDA recipient countries and enhance the predictability of resources.

17. **The African Development Fund (AfDF)** also implemented a *pro rata* reduction clause with similar objectives to IDA. According to the Board of Governors' resolution for the AfDF-10, the pro rata reduction clause would be triggered if a donor whose subscription represented no less than 10 percent of the total amount of subscriptions had not unqualified its second or third tranches of subscriptions by the due dates. Following IDA's initiative to discontinue the use of its *pro rata* provision to mitigate adverse effects on financial resources, the clause was removed in AfDF-11 in January 2008.

18. **The Asian Development Fund (ADF)** also implemented a *pro rata* reduction clause similar to that of IDA and AfDF. During ADF XI replenishment negotiations, there was broad consensus among donors that the *pro rata* provision has not served its intended purpose of encouraging donors with qualified contributions and delayed payments to accelerate their appropriations. Delayed payments of ADF donor contributions and the proportionate restriction on the use of payments due to the *pro rata* exercise reduced available resources for ADF recipients and complicated operational planning for ADB. The option of removing the *pro rata* provision and potential alternatives are being explored in preparation for the upcoming ADF XII replenishment.

Alternative options of incentives for timely payments

19. The strongest incentive to contribute is of course the development effectiveness of the GEF and the responsiveness of the package of policy and programming proposals to donor objectives. While the experience of other development funds suggests that the use of *pro rata* clauses has had limited effect on timely clearance of arrears, the GEF has limited alternatives to the current contributions-based approach. Outlined below are options based on incentives related to participation and to demand for resources. Any alternatives will need to be considered in terms of the potential tradeoffs and risk of introducing perverse incentives.

[6] IDA. 2007. IDA15 Financing Framework. Washington, DC.

A. Give greater weight to actual amounts paid in recent replenishments in the formation of non-recipient country constituencies and review it periodically to ensure alignment

20. This option would require an amendment to the Instrument as it would require changes to the current guidance provided to determine formation of the constituencies for the non-recipient countries. The GEF Instrument provides for 32 Council constituencies, 16 representing Members from recipient countries, 2 from the countries of central and eastern Europe and Former Soviet Union, and 14 from non-recipient countries. The Instrument also establishes that the formation of non-recipient country constituencies is carried out through a consultative process among interested donors with the expectation that grouping be primarily guided by total contributions as defined in paragraph 25(c)(iii) of the Instrument. Of the 14 non-recipient country constituencies, eight are single constituency chairs (Canada, France, Italy, Germany, Japan, the Netherlands, the United Kingdom, and the United States).[7]

21. Shifting from the guidance that considers sustained contributions over time to one giving greater weight to paid-in contributions from the most recently closed as well as the current replenishment may provide incentives for donors to clear arrears as well as make timely payments from such replenishments. However, such a change may also provide a disincentive for donors to clear arrears from earlier replenishments. Careful consideration must also be given to how this approach might be implemented if— similar to the intent of the *pro rata* clause—the intent is still to increase incentives for lead donors (where arrears create the greatest equity concerns) to make timely contributions to the current replenishment.

B. Participation in committee/working groups to exclude donors with protracted arrears[8]

22. The GEF Council makes limited but occasionally important use of committees and working groups. GEF participants could create a more direct link between the presence of arrears and participation by focusing on these groups rather than Council constituencies. Given the infrequent use of committees and working groups, this option would provide a limited but still visible incentive for GEF donors to fulfill their pledges. However, tradeoffs would still need to be considered carefully as it could lead to a situation where exclusion of lead donor(s) from participation in committees/working groups might have a negative impact on future replenishments.

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[7] For additional information on the rules regarding the formation of the GEF constituencies see GEF/C.41/11.Rev.01, Rules regarding GEF Constituencies, dated November 15, 2011

[8] Protracted arrears include arrears from donors from previous replenishments and payments overdue for more than 6 months.

C. Use full amount of the GEF-6 replenishment, including arrears and carryovers from previous replenishments, as the target programming amount for allocation to countries.

23. Some global funds with flexible funding arrangements have opted to provide incentives for donors to fulfill their pledges by focusing on demand for resources. Under this type of approach, the total amount pledged by donors is used as the basis for planning and country funding allocation decisions with subsequent adjustments of the resource envelope through the project pipeline management.

24. For example, in the Climate Investment Funds (the CTF and the SCF), total pledged amounts are used as a basis for endorsement of country investment plans.[9] The investment plans are agreed between, and owned by, the Government and the MDBs and contain a summary of the proposed projects for CTF/SCF co-financing. Development of the CTF/SCF pipeline is then based on projects identified in the country investment plans and the available pledges and contributions to the CTF. Prior to the start of each fiscal year, the MDB Committee agrees on an overall programming figure for the fiscal year (based on the projection of resources provided by the Trustee) and the MDBs propose a month-by-month forecast of projects to be submitted to the relevant Committee for funding approval. The pipeline is reviewed on a quarterly basis, and the proposed project approval calendar is updated and revised to reflect any changes in circumstances. MDBs then present projects for approval by the relevant Committee in line with actual paid-in contributions from donors (cash and promissory notes).

25. With changes to the current approach to planning and pipeline management, the GEF could make use of demand for resources as an incentive for donors to fulfill pledges. Participants agree on a targeted size for each replenishment based on donor contributions, anticipated investment income, and carryover from previous replenishments. This is then used to establish a target programming level, consisting of the agreed replenishment level less arrears and deferred contributions from previous replenishments. The target programming level is used for planning purposes. The level is adjusted periodically throughout the replenishment to take into account (i) any reserves for foreign exchange and investment income volatility implemented by the Trustee; (ii) the likelihood of unfulfilled pledges; and (iii) the risk of non-payment of Instruments of Commitment (IoC) or Qualified IoCs (i.e. new arrears). Funding decisions made by the Council or the GEF CEO are based on available fund balance in the GEF Trust Fund at the time of the decision.

26. Changing the target programming level to include arrears and deferred contributions from previous replenishments for planning purposes could provide a strong signal to the replenishment

[9] The country investment plans, or "business plan" of the MDBs, are developed under the leadership of the government to assist a county with CTF/SCF co-financing in implementing its national development strategies.

participants that all pledges, including arrears and amounts carried over from previous GEF replenishments, are expected to be received for programming.

27. As funding approvals would continue to be based on funds available the change in targeted programming for planning purposes would remain consistent with the Instrument.[10]

28. Some changes in current practice would be required to effectively manage a project pipeline where planning is based on a targeted level while approvals are still based on funds available. Based on experience from other funds like the CIFs, a periodic and transparent pipeline review process would need to be established, allowing adjustments to the proposed project approval calendar based on actual funds received from contributors, project cancellations, investment income, and other factors.

V. Balances in the GEF Trust Fund - Investment strategy

Background

29. As Trustee for Financial Intermediary Funds ("FIFs") and for trust funds administered by IBRD and IDA, the World Bank commingles funds that will be needed for disbursement in an investment portfolio of liquid assets (the "TF Pool"). The assets in the TF Pool are managed in accordance with the investment strategy established by the World Bank and approved by the World Bank Board of Executive Directors, and pursuant to IBRD's and IDA's General Investment Authorizations.[11] The investment objectives of the investment Strategy for the TF Pool are to (i) maintain adequate liquidity to meet foreseeable cash flow needs, (ii) preserve capital and (iii) optimize investment returns subject to the objective to preserve capital.

30. The TF Pool is made up of three portfolios (called tranches): a cash portfolio (Tranche 0) which comprises bank deposits and investments in money market instruments with an investment horizon of less than three months; a short horizon portfolio (Tranche 1) which increases security selection and has an investment horizon of up to one year; and a longer horizon portfolio (Tranche 2) which adds more instruments and has an investment horizon of up to three years. The TF Pool is actively managed so that the probability of incurring negative returns in Tranches 1 and 2 is no more than 1 percent over the applicable investment horizon. These model portfolios cater to the risk appetite of participating Trust Funds, allowing investment returns to be optimized across different investment horizons.

[10] For additional information regarding programming and availability of funds, see GEF/R.5/5. Review of the GEF Trust Fund: Contributions, Funding Availability, and Financial Risk. March 11, 2009

[11] General Investment Authorization for IBRD (Resolution No. 97-1, adopted on April 18, 1997); General Investment Authority for IDA (Resolution No. 2001-1, adopted on January 23, 2001).

31. Over long periods of time, returns for the longer horizon (i.e. Tranche 2) are expected to outperform those of the shorter horizon tranches (i.e. Tranches 0 and 1) due to the higher risk tolerance and broader range of available instruments. For example, over the past five years, a trust fund which initially invested USD 100 million in Tranche 0 would have seen a compound annual growth rate[12] of 2.7 percent, which would have translated into a cumulative return of approximately USD 14 million. The same amount invested in Tranche 1 and 2 respectively would have seen compounded annual growth of 3.7 percent and 5.7 percent. This would have meant returns of approximately USD 20 million and USD 27.5 million, respectively (i.e., 6 million and 13.5 million over and above that of Tranche 0 for the same USD 100 million initial investment).

Investment strategy for GEF Trust Fund

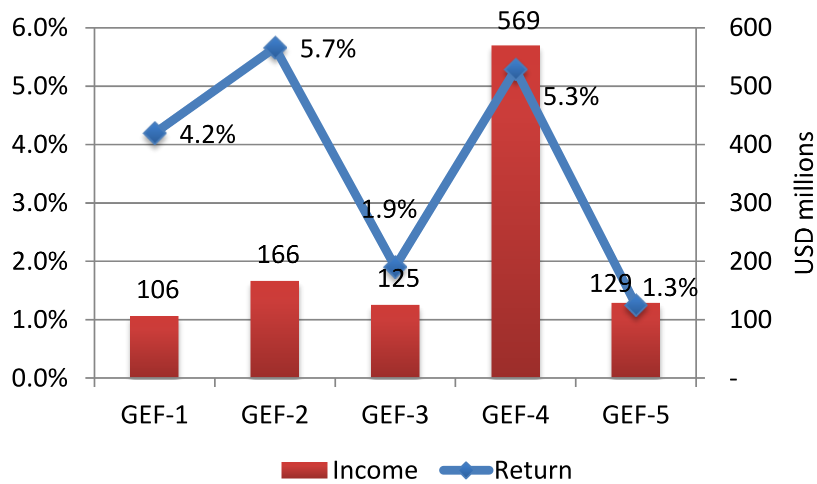
32. On a quarterly basis, the World Bank reviews the balances in all Trust Fund Pool investment Tranches against projected cash flows across each FIF and trust fund. If needed, the amounts in each Tranche are rebalanced and adjusted to ensure appropriate matching of balances and projected cash flow needs. The Trustee reports periodically to the GEF Council on investment performance through its Trustee Report.

33. GEF liquid assets are invested across all three investment tranches. To maximize returns, 90 percent of liquid assets are in Tranche 2. There is a prudent level of liquidity in GEF Trust Fund funds in Tranches 0 and 1. These balances are held at a level to ensure the Trustee can meet anticipated cash transfer requests from the Agencies over a one-year period.

34. The indicative schedule for encashment of donors' promissory notes is established to ensure that the cash is received from donors when it is needed for transfers to the Agencies. Once funding is approved by the GEF Council and subsequently committed by the Trustee, funds are expected to be transferred to the Agencies over a period of up to seven years. This time lag between commitments and transfers to Agencies results from the nature of the GEF project cycle. Also, some of the GEF investment assets result from contributions that are paid in by donors before the GEF requires these funds for disbursements as some donors choose to 'accelerate' their encashment payments for budgetary purposes (and receive either a credit or discount in exchange).

[12] Compound annual growth represents the smoothed annualized return of an investment over a given time period.

Figure 1.GEF Investment Income and Return by Replenishments



35. Figure 1 provides a snapshot of the returns that GEF Trust Fund has earned in each replenishment since inception. The prevailing low interest rate environment and risk of upward moves in yields means returns on fixed income assets are likely to remain very low in the near term.

Current Market Situation and Implication for the GEF-6 Replenishment

36. The current market environment poses challenges for investors in conservative fixed income portfolios. The re-emergence of sovereign debt worries and spillover into the banking sector has resulted in investor risk-aversion and a flight to quality assets. High grade government bonds in the United States and Europe have been in high demand, resulting in historically low yields on these instruments. These low yield levels are challenging institutional investors to position fixed-income portfolios against the risk of rising interest rates and resulting adverse re-pricing (i.e., "marking-to-market") of fixed-coupon bonds. With interest rates near historical lows and more room for yield increases rather than decreases (all else being equal), total fixed income returns are likely to be low relative to historical averages.

Other investment options available

37. In addition to the three investment tranches mentioned in the Background section above, the Bank offers a five-year horizon tranche ("Tranche 4") with a limited allocation to equities. By incorporating equities in a fixed income portfolio, this option is designed to provide diversification benefits resulting from the often negative correlations between bonds and stocks over the longer term. Historically, this diversification has produced slightly higher average returns for a given level of risk. Nevertheless, investing in equities adds more price volatility to a portfolio, especially over the short term. Therefore, Tranche 4 has a five-year investment horizon in order to optimize the potential benefits.

38. Because of GEF's adequate core assets and the ability to forecast its liquidity needs over a reasonably long horizon, Tranche 4 may be a suitable inclusion to its investment portfolio. The GEF Council would be required to approve participation in this longer-term tranche.

VI. Foreign Exchange Risk Management

39. During the GEF-5 Replenishment, participants considered three options presented by the Trustee for managing foreign exchange volatility in the GEF Trust Fund: (i) hedging; (ii) expanding the foreign exchange reserve; and (iii) matching currencies of contribution to currencies of disbursement. Participants expressed concerns with respect to the cost and feasibility of both hedging and currency matching and agreed to proceed with the option of expanding the foreign exchange reserve. The Trustee conducted an analysis to expand the foreign exchange reserve of the GEF Trust Fund in order to provide the Trust Fund resources with additional protection against any fluctuations in donor cash flows resulting from foreign exchange volatility. Consequently, the foreign exchange reserve was revised upwards from USD 45 million to USD 60 million.

40. During the GEF-6 period, the Trustee will continue to use a foreign exchange reserve to help protect the GEF Trust Fund against adverse exchange rate movements without constraining the GEF-6 programming levels. The reserve level will be reviewed for the GEF-6 replenishment and the actual level of the reserve confirmed at the completion of the GEF-6 replenishment negotiations to take into account changes in market conditions, GEF-6 programming level requirements, and the currency composition and amounts of the final donor pledges. The Trustee will adjust the reserve level as needed, on an annual basis through the GEF-6 replenishment period, and inform the Council. Factors in this review will include (i) changes in projected foreign exchange; (ii) the track record of donor payments received and actual investment income earned; and (iii) project cancellations. If necessary, the reserve level could be increased or decreased from the initial established level, depending on changes in the key parameters and the impact on the amounts needed to protect the GEF Trust Fund from an over-commitment of resources.

Annex A: Financial terms of donor contributions and payment procedures

1. *Currency of denomination and exchange rates.* While the operating currency of the GEF is the US dollar (USD), the SDR is used in GEF replenishments as the base currency for burden sharing purposes and to provide a common denominator for expressing the overall size of the replenishment. Contributions are denominated in national currencies; donor countries with high inflation rates must contribute in SDR or in USD.[13]

2. *Donor Instrument of Commitment.* Donor pledges to the four-year replenishment are formalized by the deposit of an Instrument of Commitment (IoC) with the Trustee. An IoC constitutes a legally binding obligation on the part of the donor to pay the total amount specified to the GEF Trust Fund. Some donors are not able to provide legally binding IoCs for the entire replenishment period; they may deposit a Qualified IoC with the Trustee, agreeing to pay a part of their contribution without qualification while the remainder is still subject to enactment by their legislature of the necessary appropriation legislation. A donor depositing a Qualified IoC undertakes to exercise its best efforts to obtain legislative approval for the full amount of its contribution by the same payment dates applicable to unqualified IoCs, as set out in a replenishment resolution.

3. *Payment of contributions*

   a) *Timing*: Donors are required to fulfill their financial commitments in four annual installments by November 30 of each year. Upon written request from a donor, the Trustee may agree to allow a donor to expedite the installment payment in fewer than the standard four installments. Alternatively, the Trustee may agree to a donor's request to postpone the payment of any installment, or a portion of the installment, up to, but not beyond, June 30 of the calendar year following the year in which the installment is due. Payments made pursuant to these agreements with the Trustee are deemed to be timely (i.e., not in arrears).

   b) *Form of payment*: Payments for each subscription can be in cash or, at the option of the donor, by depositing in the designated GEF Trust Fund custody account, non-negotiable non-interest-bearing notes (promissory note) or similar obligations, to be drawn down in cash (encashed) on demand by the GEF Trustee.

4. *Encashment of Promissory Notes*: Promissory notes are payable on demand and are normally encashed (or drawn down) on an approximately pro rata basis among donors. The Council approves the replenishment work program over the four-year replenishment period. Trustee commitments and disbursements for those same funding decisions occur over a more

[13] For more information, refer to paper entitled "Reference Exchange Rates for Use in the Sixth GEF Replenishment" (Prepared by the Trustee), GEF/R.6/09, March 8, 2013.

extended period as activities are implemented. Accordingly, draw downs on promissory notes typically occur over the period set out in an indicative encashment schedule, which is attached to the replenishment resolution. The encashment schedule, which normally extends up to ten years, is based on the projected disbursement needs of the GEF Agencies, while also taking into consideration donor preference for encashment levels which do not fluctuate sharply from period to period. Indicative encashment schedule for the GEF-6 will be provided by the Trustee at the third meeting of the GEF-6 replenishment.

5. In the past, donors paying their installments with promissory notes, or similar obligations, have also been able to benefit from some flexibility in encashment arrangements. The Trustee may agree to encash promissory notes on a basis other than that of the indicative schedule provided that the revised encashment schedule is no less favorable to the GEF Trust Fund than the indicative schedule. Additionally, at the written request of a donor experiencing exceptionally difficult budgetary circumstances, the Trustee may permit postponement of encashment for: (i) up to two years for a donor that is also a recipient of the GEF, and (ii) up to 45 days for all other donors.

6. *Accelerated encashment framework*. As described above, a donor may choose to take advantage of the flexibility provided for in the payment procedures, as long as the present value of its cash payments to the GEF Trust Fund is at least the same as the present value generated under the indicative schedule. Donors can accelerate either their cash installment payments or the encashment of their promissory notes. Donors can choose to use the acceleration in either of two ways:

- <u>Reducing the actual payment amount</u> in the currency of contribution or taking a “discount”. In this case, the present value of the contribution is maintained through a combination of accelerating the payment schedule and reducing the actual cash payment amount. Under this option, there is no impact on the SDR value of the contribution.

- <u>Increasing the SDR value</u> of the contribution while maintaining the actual payment amount in the currency of contribution, or taking a “credit”. In this case, the present value of the contribution is increased by accelerating payment, and the burden-share can be increased or the donor can receive credit for a supplemental contribution. The option of selecting a credit enhances the SDR value of a contribution and can be applied to the donor’s basic and or supplemental contribution.

7. The selection of a discount or credit (and corresponding increase in the basic or supplemental contribution amount) is generally made at the pledging session and reflected in the final contribution table attached to the replenishment resolution. The discount or credit selection is also expected to be confirmed at the time an Instrument of Commitment is deposited with the Trustee. If, for any reason, a donor were to change its discount or credit decision after replenishment negotiations are completed, its burden-share, and the SDR value of its contribution, would be affected retroactively.