Forest Carbon Partnership Facility (FCPF)

Readiness Fund

Risk Management in the FCPF Readiness Fund

Answers to Questions Raised on FMT Note 2011-11

As requested in Resolution PC/10/2011/4 in October 2011 in Berlin, and as referenced in FMT Note 2011-12, the Facility Management Team (FMT) has prepared answers to the questions raised by the Participants Committee (PC) concerning the FMT's proposal for coverage of the costs of accountability presented in FMT Note 2011-11 presented before the PC10 meeting in Berlin. This Note contains the requested answers. The answers must be read in conjunction with FMT Note 2011-12 which supersedes FMT Note 2011-11.

Original questions from Berlin (Resolution PC/10/2011/4)

1. *What is the basis upon which the FMT is requesting the amount?*

The FMT reviewed the costs of management responses to both the World Bank's Inspection Panel over the past decade and the IDB's Independent Consultation and Investigation Mechanism (ICIM). These costs were outlined in the FMT Note 2011-11 and indicated average response costs for a full Inspection Panel case of about $1 million. An estimation of the probabilities of cases occurring and entering different phases indicated costs of between $2.2 million for a low-case scenario and $18.5 million for a high-case scenario. The average of the two scenarios is $10.3 million. With the addition of an estimate for the incremental costs related to the use of the DPs' accountability mechanisms (as defined in Resolution PC/9/2011/1) the overall estimate on this basis was around $11.5 million. Another way to look at it is that costs of $18.5 million might be incurred in the high case, which might be shared more or less equally between the Readiness Fund and the DP, and to which said incremental costs would be added.

Given that

a) the estimated costs and probabilities were necessarily approximations;
b) it was a provision that would only be used as required (as opposed to a budget);
c) if early evidence indicated an over-provision, it could be returned to the main FCPF Readiness trust fund and become available for programming; and
d) if more countries were accepted into the Readiness Fund, the probability of more cases was increased thus indicating that a percentage rather than a fixed amount was more appropriate

the FMT decided to propose a provision of 5% of the fund capital, currently equivalent to $11.5 million.

2. *How does this amount relate specifically to the Common Approach or to Readiness work more broadly?*

The Common Approach requires that all DPs have an accountability mechanism to respond to/address claims related to the Common Approach. The specific incremental costs related to the use of the DPs' accountability mechanisms (as defined in Resolution PC/9/2011/1) referred to in the response to question 1 above are therefore specifically related to the Common Approach.

The actual costs of responding to claims under the accountability mechanisms are not wholly related to the Common Approach, however. The Common Approach was developed to ensure adequate safeguards were followed by DPs other than the World Bank in the FCPF REDD+ countries where the Bank does not currently have an active forest sector engagement. At the same time that the DPs other than the World Bank were requesting some kind of coverage of the accountability mechanism response costs, World Bank management recognized the risk of an Inspection Panel case relating to FCPF and the associated potential costs. Given the attention being paid by a wide range of entities to the World Bank's role regarding forests and REDD+, even without a Common Approach and without the additional DPs, there would likely have been the same focus within the World Bank of the increased risks and the associated potential costs.

3. *If the basis is formulated upon risks of accountability claims being filed, what are the details of this risk-based formulation?*

As explained broadly in 1 above the provision is formulated upon the probabilities of accountability claims being filed and entering different phases. This probability or risk-based formulation uses probabilities and costs at each of the different phases on a low-case scenario, a medium-case scenario and a high-case scenario. The resulting estimated overall costs were then used as a basis for the 5% provision.

4. *Are there other formulations the Delivery Partners have considered to manage potential costs of accountability, and if so, what are they and what is the basis for these other formulations?*

As explained above, the three different scenario levels (low, medium and high) were used to inform the provision. Other formulations for sharing of the response costs between the Fund and the DPs were also assessed, including the possibility of all response costs being covered by the DPs themselves from their own budgets. The FMT had presented what the Trustee and DPs felt was the fairest cost-sharing arrangement whilst minimizing perverse incentives and moral hazard, and ensuring that DPs were adequately compensated for the risks associated with REDD+ Readiness support.

5. *Can these funds be made available without reopening the Participation Agreements of any Readiness Fund Donor Participants?*

Yes, these funds could be made available to the DPs without having to make any revisions to current Participation Agreements. The Fund is managed in accordance with the Charter, which provides the legal basis for the Fund to cover such response costs (see Section 19.2 (a) (iv)), and relies on an annual budget approval process and decisions taken by the FCPF governing bodies (the Participants Assembly and Participants Committee).

6. *Will the provision of these funds set a precedent for provisioning of funds for accountability costs in other Delivery Partner administered trust funds?*

Any provision would be a decision taken by the FCPF Participants solely for the FCPF. Similarly, any decision on provisioning would be based on the special circumstances in the FCPF (the relatively high risks associated with potentially high rewards), the possibility of not being able to support a large number of FCPF REDD Country Participants, and the possibility of DPs choosing not to provide support to particular high-risk countries. Thus, the decision would be FCPF-specific. However, the implications for other initiatives are hard to predict and would depend on the specific circumstances of those initiatives and require decisions of the governance bodies of the same.

7. *If funds are provisioned, is there a date at which the funds will cease to be required for this purpose?*

The FMT Note states the following on this subject:

"If and when the PC, in consultation with the Trustee and the DPs, assesses that the level of the Provision is greater than the likely cost to be borne by the Fund, the corresponding excess funding would be returned to the main FCPF Readiness trust fund and become available for programming. If the excess funding cannot be reprogrammed in this way, it would be returned to the Donor Participants pro rata to their share of the Readiness Fund, as per the provisions of the respective Donor Participation Agreements signed between the Trustee and the Donor Participants."

With regard to the specific question, World Bank Inspection Panel requests must be filed prior to 95% disbursement of the funds, or by the closing date of any grant, so funds would cease to be required for this purpose by the World Bank when all REDD+ Readiness preparation grants are closed. In the case of the Inter-American Development Bank (IDB) and its Independent Consultation and Investigation Mechanism (ICIM), requests may be filed up to two years after the last disbursement. So, as the numbers of Readiness preparation grants remaining within the timeframe for requests reduces, funds from the provision could be made available for programming. Similarly, if early evidence indicated an over-provision, funds could be also be returned to the main FCPF Readiness trust fund and become available for programming.

8. *Would these dates differ depending on the Delivery Partner and, if so, to what extent would they differ?*

Simply based on the deadlines for accountability mechanism requests in the two currently operational accountability mechanisms (as outlined in 7 above), it would appear that the dates for future availability of the any provisioned amount would differ depending on the DP. To provide more information on timing of future availability, grant periods for Readiness Preparation grants to date have been for periods of between two and three years, though this can be amended by agreement between the parties to the agreement. So far no grants have been signed by any DPs other than the World Bank. However, provisioned funds could be made available earlier if the PC, in consultation with the Trustee and the DPs, assessed that the level of the provision was greater than the likely cost to be borne by the Fund.

9. *If funds are capped, should they be capped by project, or by country?*

The proposal for capping was outlined in the FMT Note 2011-11 (para. 19. ii). For ease of reference the relevant text is repeated below:

"…the cost sharing arrangement would be the following:

a. The Readiness Fund would take "first loss", i.e., cover the first portion of the cost, up to a **maximum amount to be approved by the PC for each case** (the "Case Cap"). The PC and the DP could agree that the Case Cap could be higher for the first claim received from a single country ("First Case Cap") than for any subsequent claim received from the same country ("Subsequent Case Cap") to ensure that the DP handles the first claim as exhaustively as possible and the first claim generates lessons for the future. As an example, the PC could choose to set the First Case Cap at $500,000 and any Subsequent Case Caps at $250,000;

b. For individual claims with costs exceeding the First Case Cap or Subsequent Case Caps, as applicable ("Excess Costs"), the Readiness Fund and DP would share the Excess Costs equally, i.e., 50% to be borne by the Fund and 50% to be borne by the DP, **up to a certain maximum per country** to be borne by the Fund ("Maximum"). This Maximum would be approved by the PC, e.g., at the level of $1,000,000".

Thus a cap would be applied initially by case and then by country (see text in bold).

10. *If funds provisioned are not fully drawn upon, to what use will they be put?*

The use of the funds would depend on the timing of the release from the provision and the possible uses within the Readiness Fund at that time. If the excess funding cannot be reprogrammed in an agreed way through the Readiness Fund, it would be returned to the Donor Participants pro rata to their share of the Readiness Fund, as per the provisions of the respective Donor Participation Agreements signed between the Trustee and the Donor Participants, unless agreed otherwise.

11. *If funds provisioned are inadequate to meet the accountability costs, will Delivery Partners be permitted to request additional funding?*

As outlined in the FMT Note 2011-11 (para. 19. i),

"This Provision would be the maximum that the Readiness Fund, based on the current committed and pledged amounts, would contribute towards cost sharing in relation to the costs of accountability mechanisms under the Common Approach. Should the Fund capital increase, the amount of the Provision would need to be revised accordingly to maintain the five percent ratio, unless the PC, in consultation with the Trustee and the DPs, determines otherwise…"

So, the PC would be under no obligation to provide additional funding even if the provision was inadequate to meet the accountability costs.

12. *If more REDD Country Participants are added to FCPF, will additional funds be provisioned?*

Only if the PC approves an increased provision in accordance with the paragraph outlined in 11 above.

Additional questions from Canada

13. *As a donor Canada would welcome a deeper explanation than offered in FMT Note 2011-11 of what has triggered this new requirement to defray the cost of responses to claims under the World Bank's Inspection Panel against the Readiness Fund? Has corporate-level policy at the World Bank corporate shifted? If this is not the case, Canada would welcome if the WB/FMT document why these costs have not been included in original budgets or cost recovery policies.*

Please refer to 2 above. There have been a number of 'triggers' including the following:

a) the DPs other than the World Bank requesting some kind of coverage of the accountability mechanism response costs;

b) World Bank management recognizing the increased risk of an Inspection Panel case relating to FCPF and the associated potential costs (these increased risks are described in paras. 16 and 17 of the FMT Note), based on experience, expressions concerning REDD from the Panel itself, and recent developments ;

c) the recognition of the possibility of not being able to support a large number of FCPF REDD Country Participants without such a provision, given the impact on the ability of the Trustee and DPs to sign Transfer Agreements; and

d) the background of increasingly tight budgets of the World bank regional teams during a flat budget period in the World Bank and in times of global austerity.

The above triggers would combine to make claims to the accountability mechanisms almost inevitable, regardless of the quality of the safeguards approach, which would thus raise costs to DPs at a time of budgetary restrictions.

14. *The proposal made in FMT Note 2011-11, if it were it to go forward, would increase the WBG's administrative costs at least with respect to the FCPF. The obvious question that arises is would this cost be unique to the FCPF, given its particular design, or might this lead to such costs being built into the administrative fees being charged by the WBG for other new multi-donor trust funds in the future? Canada is concerned about the potential precedent that this additional cost sets for other trust funds where the World Bank acts as trustee and delivery partner, as well as, potentially, for other international financial institutions. Are there mitigation measures that could be put in place to preclude this from setting a precedent?*

Please refer to 6 above. At present this would be specific to FCPF.

15. *We recognize that claims under accountability mechanisms are initiated by parties outside Bank control and can generate significant costs to resolve. What particular elements about the FCPF Readiness Fund would justify it covering the cost of responses to Inspection Panel claims (versus other trust funds where the World Bank is a delivery partner)? Canada understands the breadth of risks that accompany REDD+ Readiness, however would put forward that there are surely projects with similar or higher risk profiles in the portfolio of World Bank-managed trust funds.*

While there are other trust funds that may have similar or higher risk profiles, the FCPF work on REDD+ Readiness presents a rather unique combination of high risks *and* low financing levels for planning and strategic activities with potentially significant social impacts. Please also refer to 13 above, particularly the level of inevitability of an accountability mechanism case in the Readiness Fund of the FCPF and the possibility of choosing not to provide support to particular high risk countries or projects (i.e., higher risk projects or countries being avoided).

16. *Section 19.2 of the FCPF Charter outlines the costs and expenses that are covered under the cost recovery policy, and sub-bullet (iv) states "the costs in connection to application of the Bank's Operational Policies and Procedures" (p. 42). To provide a more detailed accounting of the expenses currently recovered from the Readiness Fund, please cross-reference the expenses listed under section 19.2 of the Charter with the administrative fees identified in the FCPF Readiness Fund annual budgets (i.e. those identified as FCPF Secretariat and Readiness Fund Administration)?*

Expenses under FCPF Secretariat Costs predominantly fall under the expenses detailed in subsections i, ii, iii, iv, vii, x, and xi of Section 19.2 (a) of the FCPF Charter. Expenses under Readiness Fund Administration Costs predominantly fall under the expenses detailed in subsections i, ii, iii, iv, vii, and x of Section 19.2 (a) of the FCPF Charter. The types of expenses covered under each budget cost category are outlined in the FY12 budget presentation (see slides 5 to 9 inclusive of http://www.forestcarbonpartnership.org/fcp/sites/forestcarbonpartnership.org/files/Documents/PDF/Jun2011/7c.%20PC9%20FY12%20Budget_Revised_FINAL_pptx.pdf)

The expenses in section 19.2 (a) (iv) of the Charter are included in all the budgeted cost categories.

17. *Does this create any moral hazard - i.e., in what ways might the behavior of the World Bank as trustee and/or delivery partners be changed as a result of having access to funds to pay for the cost of responses to claims under the World Bank's Inspection Panel?*

As explained in 4 above, the cost-sharing mechanism outlined in the FMT Note was designed to avoid any moral hazard. Also please refer to 9 above and the proposed cost-sharing mechanism repeated therein. It was proposed that the limit above which costs were to be borne by the DPs (the Maximum) would have to be agreed by the PC.

18. *Should this proposal proceed to set aside funds to defray the costs of responses to claims under accountability mechanisms, but these funds are not called upon, when would they be released (i.e., when would a determination be made that the funds would not be needed)? What would be the process of returning set-aside funds back to the Readiness Fund, given that the Readiness process is working under fairly strict timelines (e.g. 2013 vs. 2015)?*

The way that funds could be released is explained in 7, 8 and 10 above.