

Risk appetite and the GEF

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STAP

SCIENTIFIC AND TECHNICAL
ADVISORY PANEL

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LEAD AUTHOR:

Blake D. Ratner

STAP CONTRIBUTORS:

Edward R. Carr, Saleem Ali, Mark Stafford Smith and Chris Whaley

STAP SECRETARIAT CONTRIBUTORS:

Virginia Gorsevski and Thomas Hammond

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ABOUT GEF:

The Global Environment Facility (GEF) was established on the eve of the Rio Earth Summit to help tackle our planet's most pressing environmental problems. Since then, the GEF has provided more than \$22 billion in grants and mobilized an additional \$120 billion in co-financing for more than 5,200 projects in 184 countries. Through its Small Grants Programme, the GEF has provided support to nearly 27,000 civil society and community initiatives in 136 countries. <https://www.thegef.org>

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Emily Youers

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EXECUTIVE SUMMARY

STAP's 2018 guidance on innovation¹ provided a framework for thinking about innovation in GEF programming and underscored the importance of having a risk appetite. In OPS-7,² the GEF Independent Evaluation Office urged a continued emphasis on innovation for transformational change, noting that the GEF should encourage innovation and clearly articulate an acceptable level of risk. In its management response, the GEF Secretariat agreed and asked STAP for guidance in establishing an acceptable appetite for risk that would guide the preparation, selection, and design of innovative projects. In response to that request, this paper offers guidance on innovation and risk appetite and makes recommendations on steps to develop a robust risk appetite framework for the GEF.

In GEF-8, the GEF is seeking transformational change in several global systems, including natural ecosystems, as well as food, energy, and urban systems. Systems change requires greater innovation to explore new ways of delivering global environmental benefits at scale to achieve more impact. Such innovation often entails greater uncertainty, with a higher likelihood of failure, than is associated with tried and tested approaches, which may be more reliable but insufficient to deliver change at the pace and scale required. The GEF's commitment to transformational change will therefore entail greater innovation and risk.

BOX 1

In simple terms, **risk appetite** refers to the amount of risk an organization is prepared to accept in pursuit of its objectives. In the banking sector, where risk appetite is a core element of corporate governance, it may be defined as "the written articulation of the aggregate level and types of risk that a bank will accept, or avoid, in order to achieve its business objectives".³ United Nations guidance on risk appetite notes that the concept "sets out to propose that risk taking is a business necessity, since seeking zero risk is prohibitively costly, and moreover that some objectives deserve to attract relatively more or less risk".⁴

The practice has been widely adopted among financial institutions in recent years and is recognized as a key influencer of organizational culture.⁵ Evidence from a comparative analysis of global financial institutions indicates that "the practice of establishing firm-wide risk appetite has a profound impact upon firms' activities", reflected in improved risk monitoring and decision-making.⁶

At the strategic, programmatic, and project levels, the GEF needs to articulate how, where, and to what degree it is prepared to take well-informed risks that increase the likelihood of system-wide impact, while reducing avoidable risks that may undermine its chances of success.

An effective **risk appetite framework** begins with a clear risk appetite statement that sets up summary expectations about risk preferences and tolerances, as well as the tone for desired behaviour. The framework extends beyond this to influence the culture of the organization, setting norms for risk-taking, which cascade down into operational policies

and procedures and into metrics for monitoring and evaluating success.

Declaring that certain types of innovation and informed risk-taking are desired is helpful but is not sufficient to shift behaviours. A good risk appetite framework will facilitate deliberation on how different features of organizational culture, policies, and procedures may encourage or discourage desired levels of risk-seeking or risk aversion.

STAP recommends that the GEF should draft and deliberate a risk appetite statement and develop a



corresponding risk appetite framework in consultation with the Council and the GEF partnership.

The framework would cover different types of programmatic innovation and risk across the GEF portfolio, including different types of innovation (including in institutions and policy), the different phases of the project cycle (e.g. project identification, design), and different types of investment (e.g. non-grant instrument, innovation funding window). If

desirable, it could also address other risks related to implementation (e.g. conflict and security, implementation capacity, financial management).

The risk appetite statement and framework would inform relevant GEF policies and procedures, metrics, and monitoring systems, with regular assessments of the role of innovation and risk in decision-making, and would be updated as needed.





BACKGROUND

In OPS-7,⁷ the GEF's Independent Evaluation Office (IEO) urged continued emphasis on innovation for transformational change in the GEF portfolio. It noted that "GEF project review mechanisms should incentivize innovative projects across the partnership," explicitly address the associated risks at the project level, and "clearly articulate the level of acceptable risk across the various instruments and approaches for clarity across the partnership and to encourage innovation through a managed approach."

The GEF Secretariat's management response to the IEO's evaluation noted that "the Secretariat agrees that it is critical to define an acceptable appetite for

risk that will guide the preparation, selection and design for innovative projects." Recognizing that "this needs to be jointly addressed by members of the GEF partnership", the response further notes that "the Secretariat will seek guidance from both STAP and the GEF Council so as to examine the tradeoffs of risk versus innovation, with an aim to establishing a clear baseline for risk acceptance in GEF-8 programming".⁸

This paper provides STAP's high-level guidance on risk appetite and makes recommendations on steps to develop a robust risk appetite framework for the GEF.



1. WHY RISK APPETITE MATTERS

In GEF-8, the GEF is seeking transformational change in a number of global systems, including natural ecosystems, as well as food, energy, and urban systems. Systems change requires greater innovation to explore new ways of achieving more impact.⁹ Such innovation often entails greater uncertainty, with a higher likelihood of failure, than is associated with tried and tested approaches, which may be more reliable but insufficient to deliver change at the pace and scale required.¹⁰ The GEF's commitment to transformational change will therefore entail greater innovation and risk.

The issue is, therefore, how should the GEF approach **programmatic risk** to encourage higher risk–higher reward investments?

STAP's 2019 guidance¹¹ provides a framework for thinking about innovation in GEF programming: it distinguishes five types of innovation (in policy, technology, financial instruments, business models, and social and cultural institutions) and introduces the importance of risk appetite. STAP guidance on achieving durable outcomes¹² emphasizes the importance of clearly articulated expectations regarding risk appetite across the breadth of the GEF portfolio.

In simple terms, **risk appetite** refers to the amount of risk an organization is prepared to accept in pursuit of its objectives.¹³ In the banking sector, where risk

appetite is a core element of corporate governance, it may be defined as “the written articulation of the aggregate level and types of risk that a bank will accept, or avoid, in order to achieve its business objectives”.¹³ United Nations guidance on risk appetite notes that the concept “sets out to propose that risk taking is a business necessity, since seeking zero risk is prohibitively costly, and moreover that some objectives deserve to attract relatively more or less risk.”¹⁴

The practice has been widely adopted among financial institutions in recent years and is recognized as a key influencer of organizational culture.¹⁵ Evidence from a comparative analysis of global financial institutions indicates that “the practice of establishing firm-wide risk appetite has a profound impact upon firms’ activities”, reflected in improved risk monitoring and decision-making.¹⁷

A framework for communicating risk appetite transparently and ensuring that it is reflected in decision-making is especially important under conditions of significant uncertainty. For the GEF, this relates both to risks that should be avoided, such as project failure due to poor design, and risks that should be actively embraced, such as investments in innovative approaches that offer a significant (though far from certain) chance of achieving system-wide impact.



2. HOW RISK, INNOVATION, AND IMPACT ARE CONNECTED

Global environmental change is inherently fraught with risk. Events that cannot be predicted in advance and may be highly improbable are termed “black swan events” by the risk theorist Nassim Taleb.¹⁸ While certain natural disasters may fit this definition, the definition does not apply to most issues of global environmental change. Even pandemics or extreme climate events have some calculable probability of occurrence based on measurable biophysical properties and, indeed, are increasingly recognized among leading global risks.¹⁹ Instead, these events may well be what Michele Wucker has termed “grey rhino events” – easily neglected events with an increasingly high probability of occurring, such as species extinctions in degraded ecosystems.²⁰

For the GEF, the concept of risk appetite applies at multiple levels of decision-making. At the **strategic level**, for example, there are choices concerning programmatic directions or broad areas of investment. At this level, consideration of global trends is key, alongside considerations of mandate and comparative advantage in influencing those trends. Within particular **investment portfolios**, such as a GEF focal area or a large integrated programmatic investment such as an Impact Program, there is also a series of choices that reflect degrees of risk acceptance or aversion. At the individual **project level**, there is a range of more specific decisions related to risk, from

identification (when multiple competing candidate project concepts and approaches are considered), through design (when risks and mitigating actions are identified), and implementation (when risks should be monitored and responded to adaptively).

At the strategic level, the programming priorities and directions over successive GEF replenishment cycles have evolved in ways that embrace greater degrees of systems change and transformation and, implicitly, greater programmatic risk. For example, the GEF has moved to address **systemic problems further upstream**, which requires looking at factors such as the policy environment, institutional dynamics, and consumer behaviour, where there is high potential impact but no guarantee of success. (On the other hand, collective failure to address these global challenges brings its own potentially catastrophic consequences, so there is no risk-free path available.) The GEF’s strategy has also increasingly acknowledged that achieving its goals requires influencing the decisions of a broader range of actors, including private enterprises and institutional investors, over which it has no direct leverage.

The primary focus of this paper is portfolio-level risk. Consider, for example, investments in climate adaptation, which illustrate the relationship between

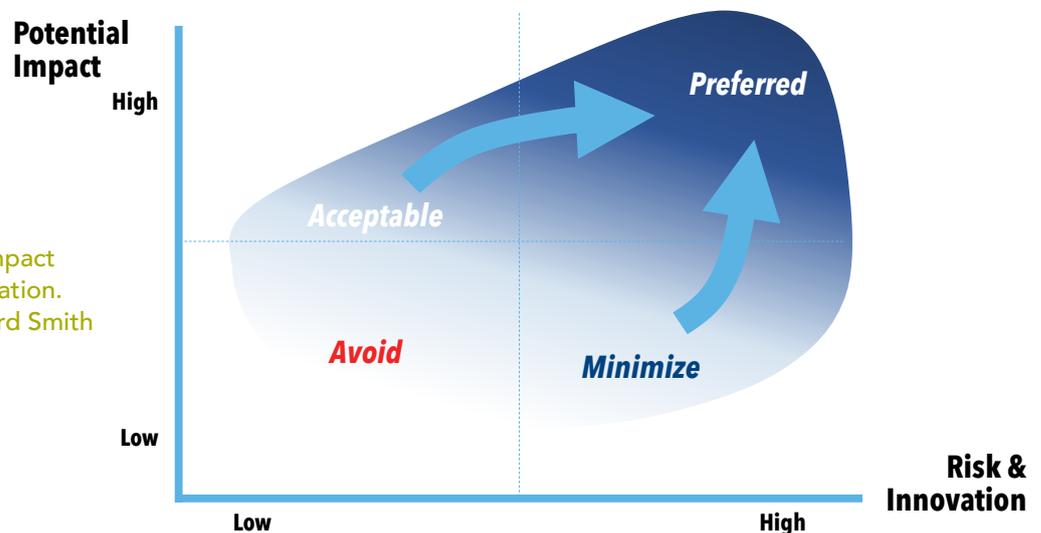


Figure 1. Potential impact versus risk and innovation. Updated from Stafford Smith et al., 2019.²¹



risk, innovation, and potential impact (figure 1). Effective adaptation approaches have to be tailored to local contexts. Such tailoring presents opportunities to learn about: (i) how to design particular interventions for effective adaptation outcomes in different contexts; (ii) the efficacy of particular interventions or approaches in different contexts; and (iii) generalizable lessons about adaptation programming that might highlight knowledge or implementation gaps. For innovations to produce pathways for system transformation, contributing to the achievement of global environmental benefits at scale, it is critical that projects aim beyond demonstrating the suitability of well-established approaches in new contexts.

To do so requires taking on a degree of risk in the selection of projects, informed by a broader understanding of the gaps in knowledge and practice in the field, whether in specific contexts or at the global scale. Linking particular projects to those gaps gives the projects value even when they do not work, as they then yield lessons about the barriers to effective adaptation programming. Thus, the failure of a risky adaptation project becomes less of a problem to the agency that funded it, instead serving as an opportunity for knowledge and learning. The most promising projects are those with a high degree of innovation, providing the basis for high potential impact.

3. WHAT MAKES A GOOD RISK APPETITE FRAMEWORK?

At strategic, programmatic, and project levels, the GEF needs to articulate how, where, and to what degree it is prepared to take well-informed risks that increase the likelihood of system-wide impact, while reducing avoidable risks that may undermine its chances of success. A risk appetite framework enables this achievement of organizational objectives and complements systems for risk management. (In the absence of such a framework, risk appetite in practice may be inconsistent or misaligned with organizational objectives, in particular risk aversion may be reinforced in areas that merit greater risk-taking.)

The **risk appetite statement** sets summary expectations about risk preferences and tolerances in different areas, which then cascade down into operational policies and procedures and, ultimately, to metrics for monitoring and evaluating success (figure 2).

An effective **risk appetite framework** (figure 3) begins with a clear risk appetite statement that sets the tone for desired behaviour and extends beyond this to influence the culture of the organization, establishing not only procedures for monitoring but also norms for supporting appropriate risk-taking. Far from being fixed and unchanging, the framework serves as a catalyst for dialogue, enabling adaptation

to changing conditions. The GEF, moreover, is a financial mechanism that depends on recipient countries and agencies to lead the project and program design and implementation. As such, the GEF's risk appetite framework must take into account complementarity with agency-specific policies and procedures (see box 2).

One of the key features of a good risk appetite framework is that it distinguishes between **different types of risk**.²³ Many of the risks that GEF operations incur are external or contextual, stemming from the mandate to work in particular countries and often in conflict-sensitive environments. Some risks are cross-cutting features of doing business, such as risks of financial fraud, for which there is no tolerance. Some risks are addressed through specific safeguard policies, such as environmental and social risks. Other risks are design features of the project or program investment, including the types of innovation supported; the shifts in behaviour, practices, or policies targeted; and the diversity of stakeholders. It is also important to distinguish the types of risk associated with different funding windows, such as medium-sized versus full-sized projects and grant versus non-grant instruments.

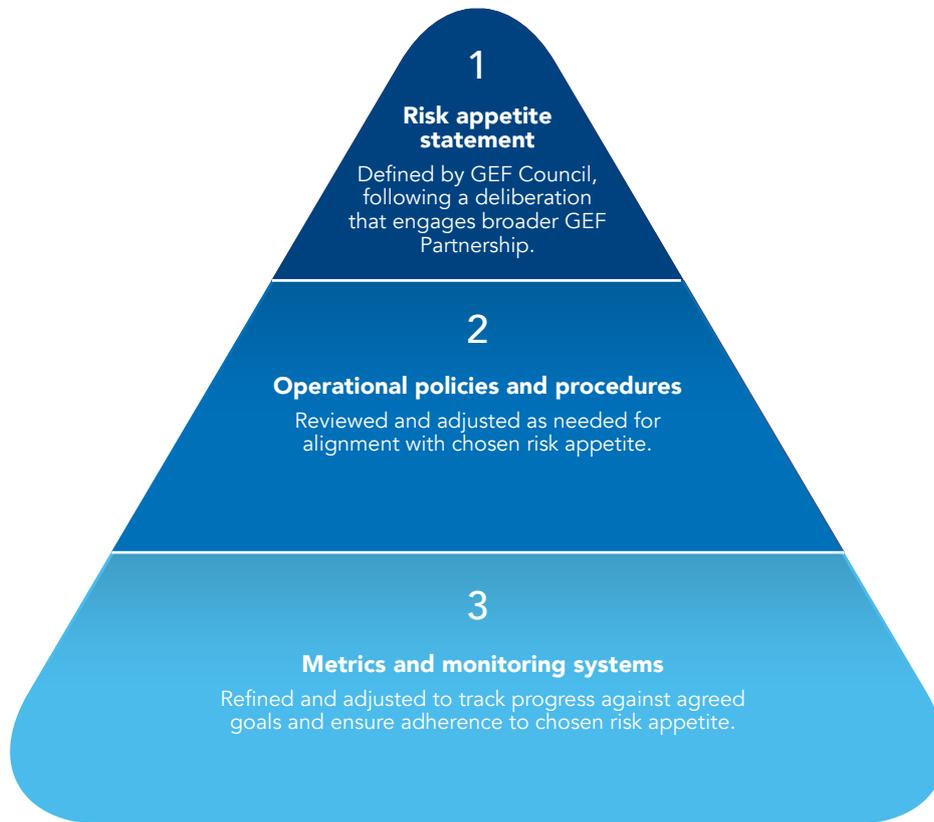


Figure 2. Risk appetite framework. Adapted from Scotchie and Murphy, 2019.²²

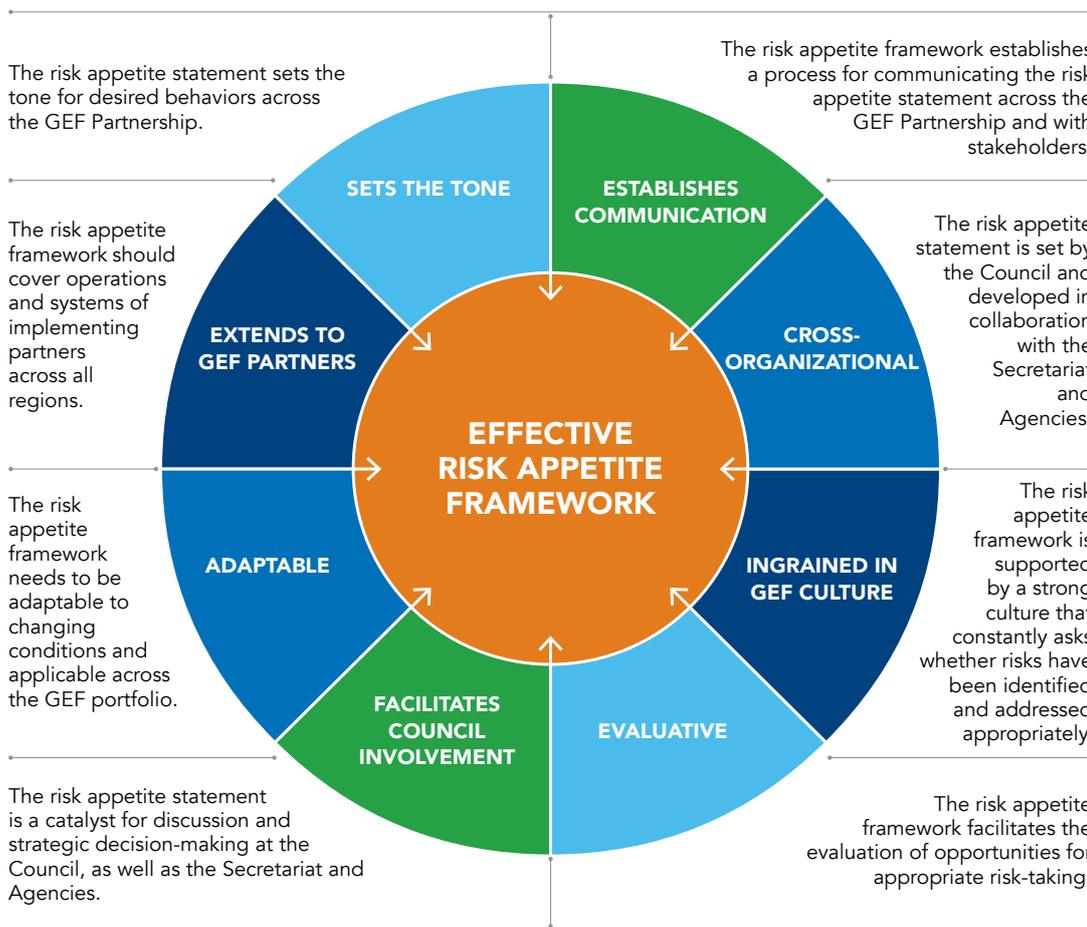


Figure 3. Key characteristics of a strong risk appetite framework. Adapted from Protiviti, 2015.²⁴



Also important is the **distribution of risk** among different actors. From a private sector perspective, for example, a key attractor is the ability of the GEF to reduce and mitigate financial investment risk (risk of losing capital invested). By absorbing some types of programmatic risk, for example by piloting and testing new business models for ecosystem conservation and restoration, the GEF can contribute to de-risking certain opportunities for private investment. The same logic applies to promising new technologies: GEF investment can help test commercial viability in the demonstration phase, sometimes called the “valley of death” (figure 4). Individual countries may be similarly wary about taking on risk through GEF investments that increases uncertainty about domestic benefits (as compared to less innovative, tried and tested approaches), while generating lessons of broader relevance to others.

For these reasons, attention to the **incentives** that guide decisions regarding programmatic risk is essential. Simply declaring that certain

types of innovation and informed risk-taking are desired is a start, but it is not sufficient to shift behaviours. A good risk appetite framework will facilitate deliberation on how different features of organizational culture, policies, and procedures may encourage or discourage desired levels of risk-seeking or risk aversion in different domains. For example, the framework can distinguish between risks that are discouraged or tightly managed because they have only negative consequences (e.g. environmental and social safeguards, financial management) versus risk associated with programmatic innovations in technology, policy, or institutions that may directly contribute to scaling of impact. The framework may also differentiate between risks with reasonable mechanisms of redress versus those without.

Promoting a culture of innovation and smart programmatic risk-taking is also influenced by the **metrics** used to measure success. The venture capital perspective, for example, takes a portfolio view of net impact rather than a project-by-project

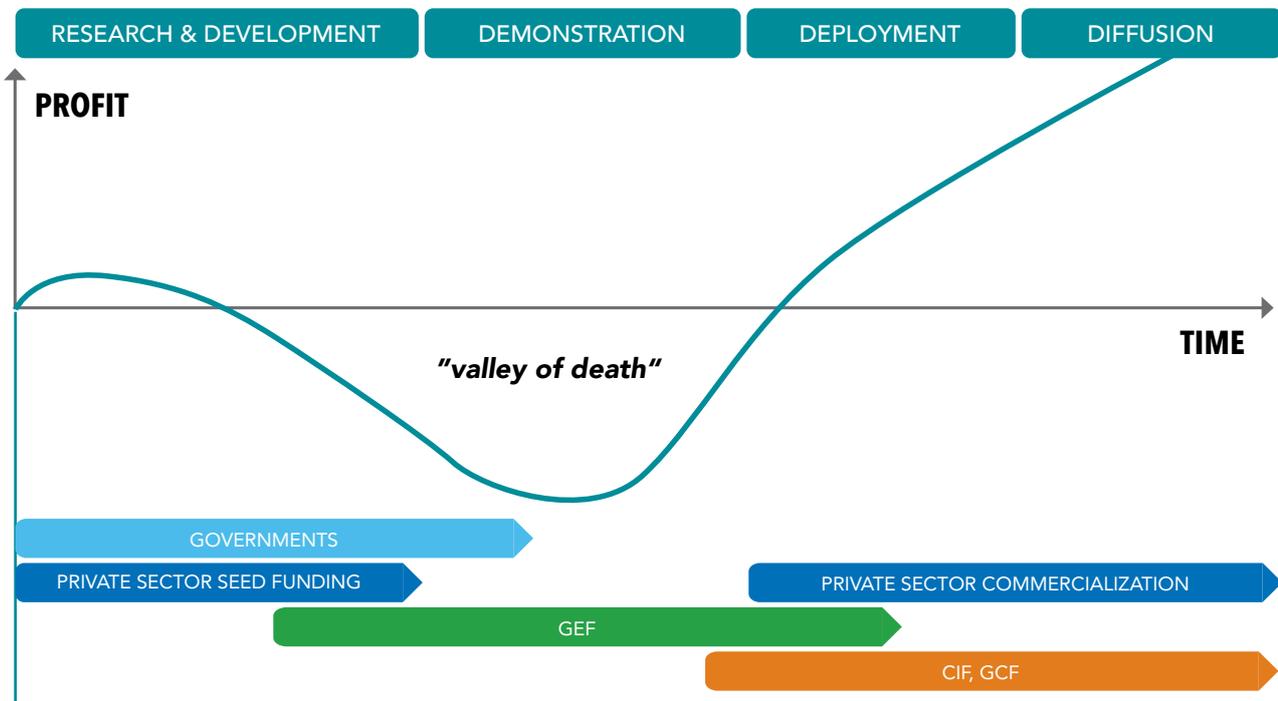


Figure 4. Schematic view of GEF role in financing demonstration and early deployment of decarbonization technologies; presented by GEF Secretariat at Technical Advisory Group Meeting (February 9, 2021).

CIF refers to Climate Investment Funds, GCF is Green Climate Fund.



calculation of win–loss. This perspective accounts not only for “downside risk” (the possibility of sub-par returns on investment) but also for “upside risk” (the uncertain possibility of outsized gains). This has parallels for the GEF in indicators of performance that track progress towards system transformation and impact at scale.²⁵ It also has implications for the way project outcomes are assessed and for the incentives that drive the performance of different actors in the GEF partnership, from Secretariat staff to GEF agencies and the country teams responsible for project development and implementation. (Simply measuring projects individually upon completion as “satisfactory” or not, for example, fails to capture the quantum of change or benefit achieved at a portfolio

scale and therefore fails to incentivize positive programmatic risk-taking.)

Finally, harvesting the gains from a portfolio approach to innovation and risk depends significantly on **systems and practices of learning**, both within and across different investments. This approach may imply a substantial increase in the priority given to experimentation, rapid generation, and documentation of evidence on successes, failures, obstacles, and adaptive measures taken, especially for investments deemed high risk and high potential impact. It also suggests a need for knowledge management and learning systems that expressly serve these functions.²⁶

BOX 2. RISK APPETITE APPROACHES ACROSS GEF IMPLEMENTING AGENCIES

Among the 18 GEF agencies, STAP has identified eight that have a formal risk appetite statement (AfDB, ADB, BOAD, EBRD, IFAD, IUCN, UNDP, and WWF). All but two were adopted during the last three calendar years (2020, 2021, and 2022). Several other agencies that do not have formal, publicly available risk appetite statements have established enterprise risk management systems as part of their operations or have a department or group dedicated to risk management (CAF, DBSA, FECO, UNEP, UNIDO, and the World Bank).

The focus and scope of risk appetite and risk management efforts differ significantly across agencies as well. Among the regional development banks (e.g. AfDB, BOAD, DBSA, and IDB), there is a key focus on credit risk and credit rating. Many agencies have risk categories and policies addressing social and environmental safeguards, financial risks relating to procurement (fraud and corruption), and operational risks relating to safety and security as well as capacity for implementation.

A number of agencies have categories for “strategic” risk (e.g. IFAD, IUCN, UNDP, UNEP, UNIDO, and WWF), while the World Bank distinguishes between political, governance, and macroeconomic risks, as well as those related to sector strategies and policies and to technical design of the project or program. UNDP has adopted a risk appetite scale that progresses from “minimal” to “cautious”, “exploratory”, and “open.” The highest level, “seeking”, is defined as “working with new ideas and approaches, looking for innovation and recognizing that failures are an opportunity for learning and improving”.²⁸



4. RECOMMENDED STEPS FOR THE GEF

STAP considers it very important that the GEF's commitment to articulating risk appetite be pursued in a way that influences the **overall culture and practice of GEF decision-making**, including new funding modalities and dedicated windows. An effective risk appetite framework that drives decision-making and influences a culture of innovation across the GEF partnership requires leadership from the GEF Council and Secretariat, robust reflection on past experience, and thoughtful deliberation on future opportunities in ways that meaningfully engage key constituencies. STAP recommends the following:

1. Draft and deliberate a risk appetite statement.

The statement could be developed in a focused way, specifically addressing the various dimensions of programmatic innovation and risk in different areas of the GEF portfolio. While much current attention focuses on innovation in financial mechanisms, business models, and technology, there is a similar need for risk-taking with regard to institutional and policy innovations. This includes efforts to improve the effectiveness of multi-stakeholder collaborations, to support champions of reform who may shift systems over time, and to promote greater exchange of experience on innovative governance approaches and lessons learned.

The risk appetite statement could also take a more comprehensive view, incorporating a broader set of categories of risk applicable in different areas of GEF operation. It may be useful, for example, to distinguish phases of the investment cycle (e.g. project identification, design) as well as specific types of risk (e.g. conflict and security, implementation capacity). As illustrated in table 1, using a scale from risk-seeking to risk averse can help clarify the desired level of risk appetite. A balanced approach is likely to include some areas characterized by strict risk avoidance, such as financial management, and others characterized by an informed embrace of risk, notably innovation in the pursuit of transformational change.

2. Develop and adopt a risk appetite framework.

Following consultation engaging GEF agencies, country constituencies, and key stakeholder groups, including civil society, the Council may review and adopt a risk appetite statement and its associated policy implications. This policy could direct the Secretariat to periodically review and propose revisions as required to other relevant GEF policies and procedures, metrics, and monitoring systems and to report on progress.

For example, the time and process requirements of the GEF project cycle can impose significant constraints on the ability to source and apply innovative approaches. Modifications could be made to the format and assessment criteria of the Project Identification Form (PIF) to centre on the theory of change, with greater emphasis on choices relating to programmatic risk and innovation. Similarly, integrating risk and innovation criteria into the proposed metrics for transformational change could help build incentives that influence project and program design choices.

Distinct decision criteria addressing risk and innovation could be developed for the non-grant instrument, targeted research, and for innovation funding windows, with streamlined decision-making and approval. These criteria could include processes of project identification and design that emphasize co-creation, open-sourcing of ideas, flexibility, and experimentation. All investments deemed high programmatic risk with high potential impact could also be tied to more intensive expectations for rapid monitoring, learning, and reporting on lessons. There could be scope as well for sequencing risk over time by taking quick, smaller bets on innovative ideas, then assessing, culling, and doubling down on the most promising experimental efforts. This approach could include a more intentional use of medium-sized projects as sources of rapid innovation and learning to inform larger investment choices.



		RISK TOLERANCE				
Risk approach		Risk seeking	Risk Tolerant (or Open)	Risk Neutral	Moderately Risk Averse	Risk Averse
Definition		Eager to be innovative and choose options with potentially higher rewards (despite greater inherent risk)	Willing to consider all options and choose those most likely to result in success while providing acceptable level of reward and value for money	Preference for safe options with a low degree of inherent risk, which may have only limited potential for reward	Preference for very safe options with a low degree of inherent risk and limited potential for reward	Avoidance of risk and uncertainty is a key organizational objective
RISK TYPE (examples)	Financial fraud					Allow no tolerance for misuse of funds, and implement standard control procedures, including audit
	Security and conflict		Support project implementation in regions that have emerged from conflict or where environmental peacebuilding may address conflict drivers			Avoid project implementation in sites with active or high likelihood of armed conflict
	Country capacity		Recognize capacity-building as a central objective in achieving global environment benefits			
	Portfolio design	Actively seek to address "wicked problems" characterized by uncertainty and complexity		Expect high rate of success in efforts to replicate proven technologies or approaches in new places		
	Project design	Actively seek to support innovations with potential for system transformation, recognizing risk of failure			Demonstrate low tolerance for poor design that fails to anticipate and identify mitigating measures for known risks	
	Project implementation			Accept a moderate degree of risk that some projects will fail to be implemented successfully		

Table 1. Tool to deliberate risk appetite for specific types of risk, adapted from UNECE, 2017.²⁷ Risk types and content are examples for illustrative purposes only.



3. Regularly assess the role of innovation and risk in decision-making and adapt as needed. The function of a risk appetite framework is to promote smart choices regarding innovation and risk and to influence the culture of risk assessment and the quality of decision-making as steps towards increasing the effectiveness and impact of GEF investment. Regularly assessing the way that risks are avoided or embraced, and the results of these choices, can yield valuable lessons in particular program areas and in the GEF portfolio overall. Likewise, broad shifts in the external context and an evolving understanding of the role of the GEF in relation to other actors may usefully prompt adjustments to risk appetite.

The risk appetite framework should be viewed as a vehicle for organizational learning and should therefore be integrated with the GEF's broader approach to knowledge management. The lessons from periodic assessment of progress can help identify not only adjustments in policies and procedures but also "soft" incentives to nurture

organizational change. These soft incentives may include informal mechanisms to exchange lessons on emerging innovations, peer-judged awards, and other positive ways to spotlight, celebrate, and reward well-informed GEF risk-taking in pursuit of transformational change. There may also be scope for streamlining project development and other operational procedures in defined areas to better facilitate such rapid experimentation and learning.

Taking a portfolio perspective, it is important to recognize that the GEF's interest in learning across a pool of investment projects is distinct from the interest of project management teams focused on the success of their particular project. For that reason, especially for those areas of the portfolio deemed highly innovative, with a high tolerance for programmatic risk, there should be a structured approach with the necessary investment to rapidly distill emerging lessons and feed those lessons back into the next cycle of investment decisions.





5. CONCLUSION

The magnitude of GEF financing remains a small fraction of the global need. To be more impactful in contributing to transformational change, a strategic approach is needed to define the desired level of innovation and concomitant risk tolerance in different areas of GEF programming. An explicit risk appetite framework can help achieve this, with

implications not only for how programs and projects are selected, designed, and implemented but also for how the learning from these investments is leveraged. The GEF's approach to innovation and its role as a knowledge broker, generating and sharing the evidence derived from its investments, could become key drivers of greater impact.





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