Thirty-Second Board Meeting

Applying Risk Differentiation

The Global Fund

The Global Fund Thirty-Second Board Meeting

GF/B32/14

Board Decision

APPLYING RISK DIFFERENTIATION

Purpose:

1. To present the key principles, methodology, and processes for applying risk differentiation in Global Fund grant management and supporting processes, for Board approval.

EXECUTIVE SUMMARY

1. This paper presents a framework for risk differentiation to the Board for approval. It is the first time that such a framework is being proposed.

2. Approving the principles for risk differentiation is one of the Board's four responsibilities vis-à-vis risk management.

3. It proposes to establish thresholds for differentiation in risk management, as well as upper and lower limits for the corporate key performance indicator that measures the overall level of risk in the grant portfolio.

4. The framework was discussed in meetings of, in consecutive order, the Finance and Operational Performance Committee ("the FOPC"), the Audit and Ethics Committee and the Strategy, Investment and Impact Committee. Input from each committee was incorporated, and the final proposal was endorsed by the FOPC in its November 2014 meeting. The FOPC is now recommending it for approval to the Board.

INTRODUCTION and BACKGROUND

5. The Global Fund's mission is to raise and invest funds to fight AIDS, Tuberculosis, and Malaria in countries where there is the greatest need. The Global Fund operates in partnership with multiple organizations and in challenging humanitarian and development contexts across the world. Risk is an everyday part of the Global Fund's work. There is a clear need to balance fiduciary risk with mission risk, that is, the risk of not delivering the Global Fund's mission.

6. Applying risk differentiation is an important element of risk management. It guides the organization in making decisions on the types and levels of risk exposure to accept, and not to accept, and where to subject these decisions to a higher level of management scrutiny. Risk differentiation helps to ensure that risks are managed appropriately, and that resources are utilized effectively.

7. It is a difficult task, particularly in a field where reliably measuring risk levels is not always possible. In the history of the Global Fund, guidelines for risk differentiation have not been expressed at an operational level, except for 'zero-tolerance' of misuse of funds.

8. Now that the Secretariat has an Operational Risk Management process in place, which systematically and thoroughly assesses all significant grant-related risks on a regular basis, we are able to define and apply a comprehensive set of guidelines for risk differentiation for grant-related risks.

9. The Secretariat has selected a framework for internal control[1] against which its own processes can be assessed for compliance, providing a means of measuring risk in those processes.

10. The existing risk management framework, as well as the draft Risk Management Policy that is being presented for approval to the Board separately (see GF/B32/13), both emphasize the need for the Global Fund Board to concur with the approach to risk differentiation as proposed by the Global Fund's management.

[1] The Internal Control – Integrated Framework from the Committee of Sponsoring Organizations of the Treadway Commission ('COSO'), 2013

11. For grant-related risks, the Secretariat has designed, and the Board has already approved, a measurement called the Portfolio Risk Index ("PRI"). This index is a corporate key performance indicator and represents the overall level of portfolio risk, derived from the individual grant ratings[2]. As it expresses the level of risk in a single metric, the index can be used to track risk management performance over time, as well as to enable the definition of an approach to risk differentiation.

12. There are several risk areas (at a grant, disease portfolio, country or regional level) that are currently ranked as 'high' to 'very high.' Closer analysis is warranted to establish whether the current risk-mitigation approach to these risks is optimal, and whether risk levels conform to the organization's desired levels of risk differentiation. Conversely, in some areas the question should be asked whether risk levels are currently too low, meaning the organization is not taking sufficient risk and/or is allocating disproportionate amounts of resources to risk mitigation.

13. The Global Fund supports grants in very complex environments, and its mission requires it to take risks there. Risk management should be differentiated to properly account for these external 'contextual' risk levels.

14. This paper outlines, for Board approval, the Secretariat's approach to establishing and implementing guidelines for risk differentiation for the first time. This approach will most likely need to be adjusted and improved upon as we gain experience.

PRINCIPLES

15. Risk differentiation aims to manage risk such that variation relative to the achievement of the organization's objectives stays within acceptable levels. Given that many Global Fund grants are implemented in inherently risky environments, there is a need for clarity on how risk should be managed in order to meet strategic objectives.

16. Because of the inherent complexity of this topic, guidelines on risk differentiation should not be limited to a single aspect, but should be determined for different types of risks within an overall framework. In addition to the PRI, which measures the composite risk for all grants combined, this overall framework can take into account at least three additional levels: the individual grant; the country disease portfolio; and the overall country portfolio risk. In addition, risk differentiation also can be applied with respect to the individual types of risks as defined in the Operational Risk Management process[3].

17. At the Global Fund, risk differentiation does not prescribe absolute thresholds (other than for the Portfolio Risk Index). Rather, risks that exceed established thresholds should be subject to closer managerial scrutiny to explore further mitigating actions to bring risk levels to within the established range, for example, by increasing or decreasing controls or by avoiding taking a given risk altogether. In this way, risk differentiation thresholds are a guide and trigger for effective grant management and focus attention. This approach is consistent with practices in other organizations where the availability of risk data is limited[4].

18. Global Fund grants operate in different environments that are subject to varying degrees of risk. The risk differentiation methodology takes this into account by linking the

[2] The minimum achievable index value is 1 and the maximum possible value is 4
[3] The Operational Risk Management framework distinguishes 19 such individual risks, grouped around 4 areas: Programmatic & Performance risks; Financial & Fiduciary; Health Services & Products; and Governance, Oversight & Management.
[4] The Society of Actuaries in Ireland - Constructing a Risk Appetite Framework - an introduction

established risk threshold levels to the level of contextual risk for each country. As contextual risk increases or decreases over time, so will the threshold levels, both at a country level as well as at a portfolio level. In relatively low-risk environments, the Global Fund is willing to accept less risk than in high-risk environments.

GRANT RELATED RISK DIFFERENTIATION

19. Risk threholds for grants can circumscribe the degree of overall portfolio risk, of regional and country risk, and the individual risk type.

20. The PRI, which is the aggregate of all individual grant risk assessments, weighted by annual budget amount, is used as a high-level indicator of risk. It is one of the corporate key performance indicators and is monitored by the Secretariat Risk and Assurance Committee and by the Board on a regular basis. The current value of the PRI is 1.86; the acceptable range is set at +/- 10% i.e. 1.7 – 2.0. This is based on the current level of contextual risk for all countries combined; should that change significantly over time, then the target range for the PRI would move accordingly.

21. Categorization of eligible countries based on their contextual risk level into “very high”, “high”, “medium” and “lower” is a key step in operationalizing risk differentiation. This categorization is based on a composite index that combines ten different authoritative indices[5] that all measure aspects of the contextual risks that our grants face. The methodology incorporates an adjustment factor for current developments that are not accounted for in the indices, due to the typical updating time lag.

22. The distribution of the Global Fund eligible countries as per this contextual risk index (reference is made to Annex 1 for the details of this classification) as of August 2014 is as follows:

Contextual Risk Category	Number of Countries
Very High	15
High	25
Medium	50
Lower	36

23. Different risk threshold values are allocated to each of these categories of countries. The higher the contextual risk level in a country, the higher the risk threshold levels. This provides country teams and senior management with the necessary guidance on the appropriate risk thresholds to be applied in grant management. The key driver in setting this threshold is analysis of the distribution of risk levels at the grant, disease and country portfolio levels. The ranges as of August 2014 (to be revisited annually) are as follows:

[5] The ten indicators used are The Fund for Peace’s Failed States Index; Transparency International’s Corruption Perception Index; The World Bank’s Ease of Doing Business Index; five out of the six World Bank Governance Indices; The UN’s Safety and Security Index; and The Institute for Economics and Peace’s Global Peace Index. The Palestine/Gaza and Ukraine ratings are adjusted to account for political unrest; adjustments are made to the Sierra Leone and Liberia ratings to account for the Ebola outbreak.

	Risk Threshold Levels		
	Grant	Country Disease Portfolio	Overall Country Portfolio
Very High	1.6 – 2.6	1.5 - 2.5	1.5 - 2.5
High	1.4 – 2.6	1.4 - 2.5	1.3 – 2.4
Medium	1.2 – 2.5	1.3 – 2.4	1.2 – 2.3
Lower	1.2 – 2.2	1.2 – 2.3	1.2 – 2.2

24. Applied to our current grant, disease and country portfolio risk assessment outcomes, these thresholds result in the following numbers:

	No. of Grants / Portfolios Outside the Thresholds		
	Grants	Country Disease Portfolios	Overall Country Portfolios
Very High	6	2	0
High	13	4	0
Medium	7	3	1
Lower	4	3	1

25. Among the more than 180 individual grants for which detailed risk assessments are maintained, thirty are outside the risk threshold values. Of these, fourteen grants are above and sixteen are below the values. In addition, 14% of disease portfolios and 7% of country portfolios are outside the risk threshold values. Annex 1 contains an illustration that shows the distribution of individual grants against the values.

26. In addition to reviewing risk management in grants, country disease portfolios and overall country portfolios using the above threshold levels, the Global Fund also applies the same methodology to review individual risk types across the entire portfolio. The risk threshold levels that apply here include the five highest risks and the two lowest, out of a total of nineteen different risk types:

No	Risk Type	Side of threshold
1	Limited Program Relevance	Lower
2	Inadequate Secretariat, LFA Management & Oversight	Lower
3	Not Achieving Program Outcome & Impact Targets	Exceeding
4	Inadequate M&E and Poor Data Quality	Exceeding
5	Poor Financial Reporting	Exceeding
6	Poor Quality of Health Services	Exceeding
7	Treatment Disruptions	Exceeding

27. The Secretariat's Regional Operational Risk Committees will oversee the monitoring and reporting of risk differentiation in grants. In addition to the discussion during meetings when grants or portfolios are reviewed, these committees will review overall trends and developments, and escalate selected issues to the Secretariat Risk and Assurance Committee. Relevant analyses will be prepared and disseminated on a quarterly basis.

28. Any grant, disease portfolio or country portfolio which exceeds the agreed risk threshold levels will be reviewed by the Regional Operational Risk Committee for a decision on the appropriate course of action, which can be to further strengthen controls; reduce the underlying risk exposure; accept the higher (or lower) risk levels; or combinations of these alternatives.

29. The risk differentiation framework captures the key considerations for implementing risk differentiation as documented across different organizations. It appreciates the fact that implementing risk differentiation can be complex. It uses measurable, but flexible approaches to defining and using guidelines for risk differentiation. The implementation of risk differentiation to grants is well integrated with grant management practices and processes and is well supported by the risk management capability of the organization.

30. Management does not have a view yet on what the net impact, if any, on required resource levels will be of applying the proposed approach to risk differentiation.

RISK DIFFERENTIATION IN SUPPORTING PROCESSES

31. In addition to our grant related risks, the Secretariat's various supporting processes also present different degrees of risk to the organization. This degree of risk is measured by assessing the state of compliance of each main process with the COSO Framework, the standard for internal control that has been adopted by the Global Fund. This indicator will be initially measured through a self-assessment process, which will be validated by the Risk Management Department. The relevant organizational key performance indicator states: "the degree to which every department is showing reasonable progress towards making the processes in the department COSO compliant" that will then measure the evolution and progress in risk management in supporting processes.

32. The Secretariat Risk and Assurance Committee will be the governing body to review this area.

MONITORING RISK DIFFERENTIATION

33. The risk differentiation framework and its use in practice will be reviewed every year. The Risk Management Department and the Grant Management Division will jointly undertake this exercise and present the findings to the Risk and Assurance Committee, taking into account lessons learned. Management, by revisiting and reinforcing guidelines for risk differentiation, will be in a position to strengthen the risk-aware culture and improve the accountability of implementing risk management within the risk differentiation threshold values.

RECOMMENDED RISK DIFFERENTIATION FRAMEWORK

34. Based on the methodology and analysis presented in this paper, the Secretariat recommends the following risk-differentiation framework to the Board for approval at the Thirty-Second Board Meeting.

35. This risk-differentiation framework covers both the Secretariat's operational risk management of the grant portfolio as well as the Secretariat's various supporting processes.

36. With respect to operational risk management of the grant portfolio:

a. The target Portfolio Risk Index (the "PRI"), which serves as a measurement of effective operational risk management under the Global Fund Corporate Key Performance Indicator Framework (GF/B31/DP07), will be set within a range, to be approved annually when the KPI targets for the next year are approved by the Board (the "PRI Target");

b. Countries in the grant portfolio will be categorized based on a composite of indicators deemed by the Secretariat to appropriately measure the contextual risk in countries, with thresholds applied at the grant, country disease component and overall country levels within each contextual risk category;

c. Threshold values of risk at the grant, country disease component and overall country levels, as well as individual risk types impacting grant operations, guide management decisions by the Secretariat with respect to the appropriate assessments, mitigation measures and resources to apply depending on whether an operational case fits within or outside such threshold values, provided that the composite risk measured across the portfolio remains within the PRI Target; and

d. The Global Fund affirms it does not tolerate corruption, fraud, misappropriation or abuse of any kind in its grants.

37. With respect to the Secretariat's various supporting processes, risk is measured by the degree of compliance with the COSO Framework that the Global applies as an internal control and risk management standard.

References:

Risk Appetite and Tolerance Guidance paper (2011), Institute of Risk Management, United Kingdom

Governance Challenges, 2014 and Beyond (2013), National Association of Corporate Directors and Its Strategic Content Partners

Understanding and Communicating Risk Appetite (2012), Committee of Sponsoring Organizations of the Treadway Commission

Constructing a Risk Appetite Framework: an Introduction (2011), The Society of Actuaries in Ireland

DECISION

38. Based on the discussion and recommendation outlined in this paper, the FOPC is recommending the following Decision Point for Board approval:

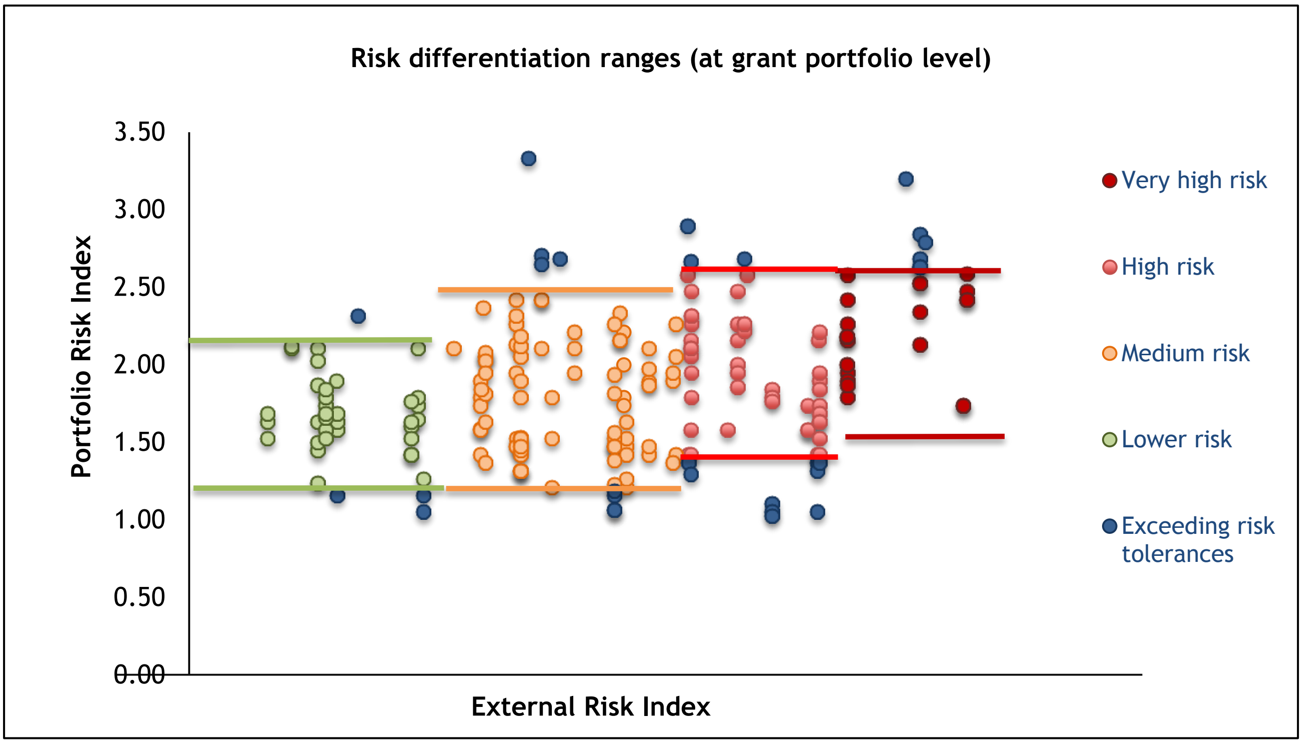
GF/B32/DP12: Applying Risk Differentiation

<u>Decision Point:</u> GF/B32/DP12: Applying Risk Differentiation

1. Based on the recommendation of the Finance and Operational Performance Committee, the Board adopts the risk differentiation framework presented in paragraphs 34 through 37 of GF/B32/14.

2. The Board directs the Secretariat to operationalize this risk differentiation framework and report on its implementation at each Board Meeting. Furthermore, the Secretariat shall conduct annual reviews to update the risk differentiation framework as appropriate, and report to the Board once a year on the outcome of such reviews.

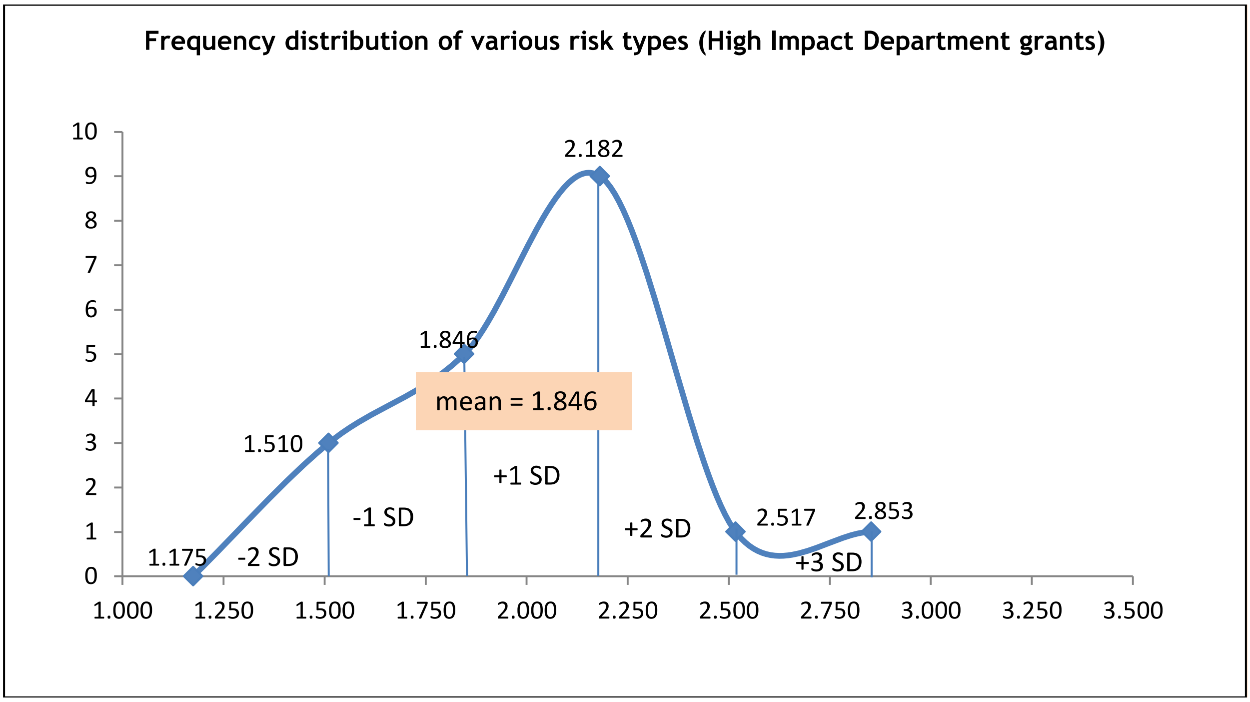
<u>This decision has no material budgetary implications.</u>



Classification of Global Fund eligible countries as per the External Risk Index 2014	
Very high risk (15)	Afghanistan, Burundi, Central African Republic, Congo (Democratic Republic), Guinea-Bissau, Iraq, Korea (Democratic Peoples Republic), Libya, Nigeria, Palestine/Gaza*, Somalia, South Sudan, Sudan, Syrian Arab Republic, Yemen
High risk (25)	Angola, Chad, Congo, Cote d'Ivoire, Egypt, Eritrea, Guinea, Haiti, Honduras, Iran, Kenya, Lebanon, Liberia*, Mali, Mauritania, Myanmar, Niger, Pakistan, Sierra Leone*, Tajikistan, Uganda, Ukraine*, Uzbekistan, Venezuela, Zimbabwe
Medium risk (50)	Albania, Algeria, Armenia, Azerbaijan, Bangladesh, Belarus, Belize, Benin, Bolivia, Cambodia, Cameroon, Colombia, Comoros, Djibouti, Dominican Republic, Ecuador, El Salvador, Equatorial Guinea, Ethiopia, Fiji, Gabon, Gambia, Guatemala, Guyana, India, Indonesia, Jamaica, Kazakhstan, Kosovo, Kyrgyzstan, Lao, Madagascar, Malawi, Maldives, Moldova, Mozambique, Nepal, Nicaragua, Papua New Guinea, Paraguay, Peru, Philippines, Russian Federation, Solomon Islands, Swaziland, Tanzania, Thailand, Timor-Leste, Togo, Turkmenistan
Lower risk (36)	Argentina, Bhutan, Bosnia and Herzegovina, Botswana, Brazil, Bulgaria, Burkina Faso, Cape Verde, China, Costa Rica, Cuba, Georgia, Ghana, Jordan, Lesotho, Macedonia, Malaysia, Mauritius, Mexico, Mongolia, Montenegro, Morocco, Namibia, Panama, Romania, Rwanda, Sao Tome and Principe, Senegal, Serbia, South Africa, Sri Lanka, Suriname, Tunisia, Uruguay, Viet Nam, Zambia

* Rating reflects an upward adjustment by one category to reflect current developments

Annex 2
Distribution of Risk Types



† where SD (standard deviation) is a measure of the dispersion of the data points from the mean

Distribution of the 19 individual grant risks, from lowest to highest:

PRI value	Individual grant risk
1.19	Limited Program Relevance
1.37	Inadequate Secretariat and LFA Management & Oversight
1.40	Market and Macroeconomic Losses
1.54	Inadequate CCM Governance & Oversight
1.60	Poor Aid Effectiveness and Sustainability
1.72	Not Achieving Grant Output Targets
1.72	Poor Access and Promotion of Equity & Human Rights
1.82	Inadequate PR Governance & Oversight
1.91	Low Absorption or Over-commitment
1.89	Inadequate PR Reporting & Compliance
1.92	Fraud, Corruption or Theft of Fund
1.92	Substandard Quality of Health Products
1.98	Poor Financial Efficiency
2.00	Theft of Diversion of Non-Financial Assets
2.05	Not Achieving Program Outcome & Impact Targets
2.12	Inadequate M&E and Poor Data Quality
2.20	Poor Financial Reporting
2.25	Poor Quality of Health Services
2.56	Treatment Disruptions