
Photo by Aris Sanjaya/CIFOR

# White Paper

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# Leveraging private sector finance for REDD+ implementation

## Financing mechanisms and investible entities

This White Paper was produced by
**Global Canopy Programme**; **United Nations Environment Programme** (UNEP); **Environmental Defense Fund** (EDF); **Permian Global**

# Background

About 90% of the USD 9 billion pledged to date for Reducing Emissions from Deforestation and forest Degradation (REDD+) has come from the public sector. Incentivizing large-scale private sector finance from 2015–2020 and beyond, however, is critical to limit global climate change, improve livelihoods and meet increasing global food and fiber demand. Policies, actions and measures related to REDD+ are a crucial means of creating positive performance-based economic incentives for large-scale forest protection. Private sector commitments to zero-deforestation supply chains can complement the incentives created through pay-for-performance policies; this, in turn, can reinforce the positive incentives from REDD+ finance by tying market access and private investments in the production of agricultural commodities to reductions in deforestation and compliance with environmental laws.

The promise of REDD+ and zero-deforestation supply chain incentives has not yet been fully realized. The UN climate talks have established a framework for REDD+ finance, readiness efforts are progressing worldwide and significant public funding has been pledged. Even so, private capital — the only source large and durable enough to achieve tropical forest protection and green economic growth at scale over the long run — remains on the sidelines. Public funds have failed to leverage significant private investment. Carbon markets of a scale sufficient to finance large-scale long-term reductions in deforestation have not yet materialized, and those compliance markets that exist do not yet accept REDD+ credits. In this brief, we consider the need to both "produce and protect" and explore public–private financing mechanisms at both national and international levels for mobilizing capital to meet these twin imperatives. Especially in the near term, with market-based REDD+ still not underway, international and domestic public REDD+ funds can mitigate private investment risks; help lower the net cost of capital for forest countries and subnational jurisdictions to borrow and otherwise attract financing; and encourage stronger political will on the part of forest-country policy makers to commit domestic REDD+ resources and develop policies to promote sustainable commodity production and forest protection. This combination of international REDD+ finance, forest country political will and public resources can support public–private partnerships and leverage private capital from capital markets, agri-business, commodity buyers, traditional and mission-driven investors and emerging carbon markets. Such finance can then generate further private investment at a local level to support local low-carbon development strategies.

This cluster session will look, from a private sector perspective, at what needs to be put in place to meet the required scale of investment. The session will consider how public sector interventions can increase private investment for achieving REDD+ at large jurisdictional scales, as well as satisfy financing objectives based on payments for performance. The group will investigate what that means for the public sector, particularly multilateral funding institutions such as the Inter-American Development Bank, Global Environment Facility (GEF) and Green Climate Fund (GCF), as well as national institutions. The anticipated outcome of the session will be one or more practical proposals for innovative financial instruments that can be deployed by key public institutions, in partnership with the private sector. In addition, concrete next steps for their implementation will be identified during the session and the formal constitution of a working group will be explored.

# Production and protection

Increasing agricultural productivity will lower the pressure on forests only if accompanied by proactive, professional and ecologically based forest protection. What practical steps can we take to start this process? If we are to leverage the potential of forests as a carbon mitigation channel, reducing emissions and safeguarding sequestration must be clearly recognized and integrated into business practices and policy decisions as key metrics of success.

To understand the need for protection as well as production, consider a typical tropical lowland landscape, with the remaining forest fragmented and degraded, and larger areas given over to farming. The "produce" challenge is to intensify agriculture and achieve higher yields. If this can be achieved, it is assumed that deforestation pressure will be reduced, farming-related emissions will fall, farmer incomes will rise and "deforestation-free" labels can be attached to a wide range of domestic products.

However, this leaves out a vital piece of the plan — the need for large-scale forest protection, implemented alongside the drive toward sustainable sourcing. Without protective measures, the risk is that higher agricultural productivity would facilitate the conversion of more forests to farmland. So the private sector needs to be closely involved with both improved production and more effective protection.

There are three distinct challenges associated with enhanced forest protection: deforestation, degradation and sequestration. While the issue of deforestation is widely recognized (and known to account for at least 8% of all carbon emissions), the dynamics and emissions contributions of degradation and sequestration are less well understood. Research over the last decade has found that emissions from degradation, which is largely driven by legal and illegal logging, fuelwood and charcoal, could contribute 6%–14% of all emissions, perhaps more.[1] Further, new findings on sequestration indicate that current $CO_2$ removals by both intact and recovering forests are very significant — gains that would be greater still if more degraded forests were to be fully protected. A new report by the Prince of Wales's International Sustainability Unit estimates the mitigation potential of stopping emissions from tropical deforestation and degradation plus safeguarding existing sequestration is in the range of 24%–33% of all carbon mitigation — much higher than previously realized.

From this perspective, ensuring the proactive protection of tropical forests is the first stage of a potentially larger terrestrial recovery process, an insight that suggests we need a thriving "protect" industry to leverage the full potential of this mitigation pathway.

Options for different financial mechanisms are highlighted below. Some of these mechanisms will be discussed in the context of Peru and other tropical forest countries and subnational jurisdictions. We will choose jurisdictions where the government, through its financial architecture for forests and climate change, will be looking at avenues and mechanisms for leveraging private sector investment for productive activities in the rural sector in the context of large-scale forest protection.

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[1] The Prince's Charities International Sustainability Unit. 2015. *Tropical Forests: A Review*, available at: http://www.pcfisu.org/wp-content/uploads/2015/04/Princes-Charities-International-Sustainability-Unit-Tropical-Forests-A-Review.pdf

# Redirecting capital formation in agriculture

According to various studies on the economics of avoided deforestation, $0.5–2/tCO$_2$ could make a significant difference between revenues from investment into traditional, deforestation-producing agriculture and intensive agriculture that does not put pressure on forests. However, future REDD+ revenues are unknown for agricultural investors and thus do not factor heavily in public or private actors' financial analysis. Any upfront payments or guarantees of future revenues from REDD+ will change the profit calculus and could tip the balance in favor of agricultural production that does not require deforestation.

Potential revenues from REDD+ (current and future) should be used to crowd investment out of traditional agriculture and into alternative practices that result in more intensive, low-emissions agricultural production.

Proposed financial mechanisms should mobilize new resources and **redirect existing capital inflows** toward lowering pressure on forests. This could be accomplished by changing the return profile on capital invested in agricultural production in a jurisdiction to favor less invasive development. This can be done in two primary ways:

- "Engineer" cost of capital invested in agriculture.
- Create new revenue streams monetizing global ecosystem services of REDD+.

*"Engineer" cost of capital.* Weighted average cost of capital (WACC) is determined by risk and return on capital invested. At present, investors are more comfortable relying on past performance and projecting returns focused on traditional agriculture that contributes to deforestation. As a rule, they are not aware of the returns possible from less extensive agricultural development and sustainable forest management, or else deem those returns as overly risky. Investors are especially concerned about potential revenues from REDD+, which are discounted to zero in many return calculations. Two steps could be taken simultaneously:

- *Decrease attractiveness of investment into traditional agriculture* by effectively increasing risk-adjusted cost of capital for traditional agriculture through the adoption of leading supply chain management practices that make traditional agriculture obsolete.

- *Decrease financial cost for alternative business models that do not require deforestation* through direct and immediate monetization of REDD+, increasing the attractiveness of zero or low-deforestation agriculture, reducing the *risk–return ratio and therefore decreasing the cost of capital for this kind of land use.*

# Examples of financing mechanisms

There are a range of potential financing instruments for deploying public funds to leverage private capital invested in agriculture, including through the provision of price and loan guarantees.

## Minimum (and maximum) price guarantees for REDD+

A potentially effective way to deploy existing and future funds for results-based payments from the GCF, as well as other sources would be to *guarantee public and private-sector investors a minimum price for REDD+ credits in case carbon markets do not emerge and/or value REDD+ credits enough*. This can be accomplished through a minimum price guarantee or "put option", creating an insurance policy that guarantees a return for REDD+ regions that decide to transition to more sustainable and higher-productivity agricultural models. Put options would serve to "crowd in" private sector money now, delivering a "bridge to the future" for REDD+ finance until carbon markets emerge and carbon prices rise. Furthermore, once these prices do rise, put options could cost public-sector funders nothing. The World Bank is testing an approach of auctioned put options through its new Pilot Auction Facility for Methane and Climate Change Mitigation; a version of this approach could be applied to leverage private capital for REDD+.

Alongside a publicly provided put option, segments of the private sector might also find it attractive to purchase "call" options on REDD+ that provide the right, but not the obligation, for regulated entities to buy REDD+ credits for a fixed price in the future. For example, a public fund could guarantee a tropical jurisdiction or REDD+ investor the right, but not the obligation, to sell an emission reduction from avoided deforestation for $5/tonne $CO_2$ at the same time that a private buyer paid $1 or more for the right to buy these reductions at $10/tonne any time until 2025. This would provide the REDD+ jurisdiction, or other REDD+ provider, funding up front and a guaranteed price of $5, plus a possible upside of up to $10 if the private buyers exercise their purchase rights. It would also limit the private buyers' future compliance cost in the event the price rises above $10.

Depending on the level of the put option, more private capital could potentially be leveraged up front. In turn, the minimum price guarantee (and sale of call options) could help developers secure debt financing through bank loans or through the issuance of jurisdictional REDD+ bonds.

A minimum price guarantee for future revenues from REDD+ can provide additional assurance of returns on bonds for sustainable agriculture and large-scale forest protection. This can raise investment rating and desirability of a bond from the perspective of institutional investors. By adding proceeds from call options, jurisdictions could further reduce the average cost of capital of investments in forest protection and sustainable agriculture.

Some additional instruments like loan guarantees and credit enhancement instruments will also be useful to close the financial gap between deforesting and non-deforesting agriculture in favor of more sustainable development.

## Loan guarantees

Loan guarantees are well known to the private sector, and are an emerging tool in the area of sustainable land use. There is a wide range of forms they can take. While some general principles can be established, the mechanism will need to be tailored to the specific initiative and associated financing arrangements that the guarantee is intended to support.

## Examples of financing mechanisms

Key features of a loan guarantee are likely to include:

- Funds are only expended if a borrower defaults. By only offering guarantees to well-designed and well-managed initiatives, only a relatively small percentage of allocated funds will likely need to be disbursed, offering the potential for considerable leverage of private sector capital.

- Ideally, loan guarantees should be focused on specific jurisdictions or sectors, targeting areas embedded in national strategies or action plans.

- This mechanism does not attempt to stimulate demand for REDD+ emission reductions directly. Instead, it facilitates greater access to capital for REDD+ initiatives, making a wider range of REDD+ initiatives commercially viable and sending an important political signal about REDD+ in the post-2020 framework.

## Options and examples

- Loan guarantees may be applied at the level of individual loans, or to an institution to guarantee against losses of a loan portfolio. A number of developed and developing countries have previously used loan guarantee mechanisms to support development of agriculture and rural enterprise, through guaranteeing lending to individual enterprises or cooperatives. The Alliance for Green Revolution in Africa (AGRA) has also used this type of support across five African countries. The United Nations Development Programme and GEF operate Proyecto Cambio across Central America, which offers loan guarantees to rural and agri-businesses that aim to conserve biodiversity. There may be scope to expand existing facilities or replicate them to help aid the transition to sustainable land use.

- The European Investment Fund offers loan guarantees to institutions with a portfolio of loans to small and medium enterprises (SMEs) to provide cover across the portfolio.

- USAID Development Credit Authority & Althelia Climate Fund: This loan guarantee, announced in May 2014, covers loans up to USD 133.8 million to be issued by Althelia for up to 50% losses at portfolio level. Althelia will make commercial loans to a range of sustainable agriculture and REDD+ initiatives worldwide. It will then help these projects sell the carbon credits generated by their activities, creating a revenue stream that allows repayment of loans. A bond is being issued to raise capital for the loans.

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## The Investment Case

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