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REDD+
Results-based Finance
A Private Sector Perspective

Bonn, UNFCCC, August 2013

Iain Henderson, UNEP FI

UNEP Finance Initiative (UNEP FI)

• UNEP FI is a 20 year old strategic partnership between UNEP and more than 220 global financial institutions. These include banks, insurers and investors.

•Moved into the 'REDD+ space' in 2011 with the 'REDDy Set Grow' series

- Inform and convene FIs on the opportunities, risks and roles in REDD+ and sustainable land use
- Work with policy-makers to develop a favorable policy framework that stimulates private sector engagement and investment in forest-based mitigation and leads to shifts in land use behavior by the private sector.

•UNEP FI is the key delivery partner for the UN-REDD Programme on Private Sector Engagement

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Setting the scene: Private sector perspective on results-based finance

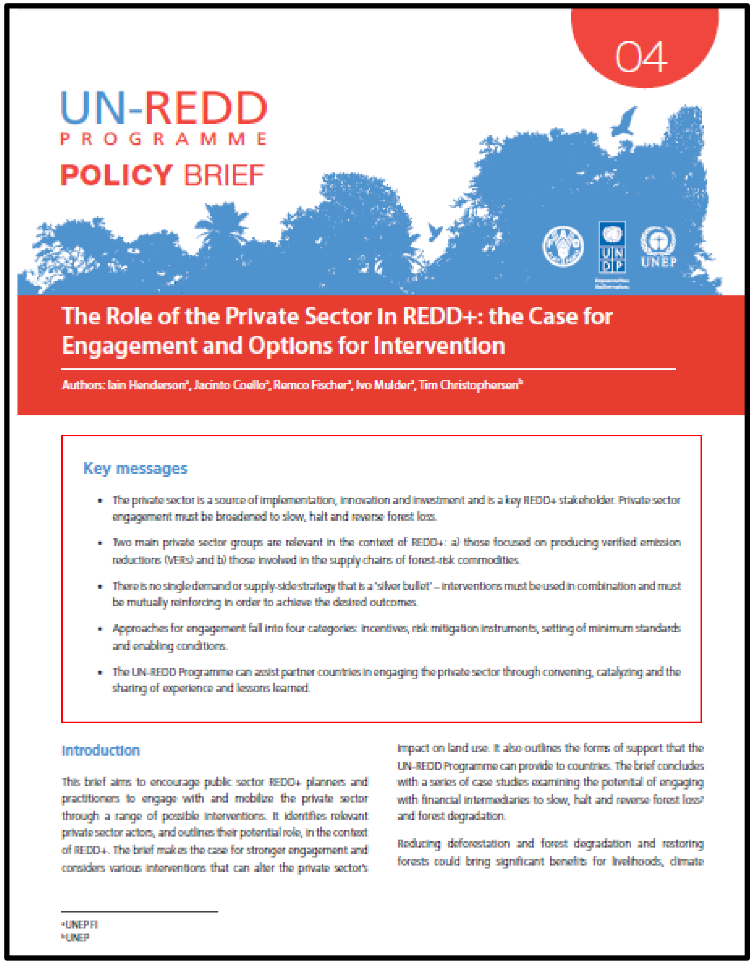
1. Topics addressed in this presentation:

•Key private sector lessons on results-based finance

•What should REDD+ results-based finance look like?

•Conditions needed by the private sector to scale up?

2. More on the private sector on the UN-REDD Programme website (www.un-redd.org)



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UN-REDD
PROGRAMME
POLICY BRIEF

The Role of the Private Sector in REDD+: the Case for Engagement and Options for Intervention

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Key messages

- The private sector is a source of implementation, innovation and investment and is a key REDD+ stakeholder. Private sector engagement must be broadened to slow, halt and reverse forest loss.
- Two main private sector groups are relevant in the context of REDD+: a) those focused on producing verified emission reductions (VERs) and b) those involved in the supply chains of forest-risk commodities.
- There is no single demand or supply-side strategy that is a 'silver bullet' – interventions must be used in combination and must be mutually reinforcing in order to achieve the desired outcomes.
- Approaches for engagement fall into four categories: incentives, risk mitigation instruments, setting of minimum standards and enabling conditions.
- The UN-REDD Programme can assist partner countries in engaging the private sector through convening, catalyzing and the sharing of experience and lessons learned.

Introduction

This brief aims to encourage public sector REDD+ planners and practitioners to engage with and mobilize the private sector through a range of possible interventions. It identifies relevant private sector actors, and outlines their potential role, in the context of REDD+. The brief makes the case for stronger engagement and considers various interventions that can alter the private sector's impact on land use. It also outlines the forms of support that the UN-REDD Programme can provide to countries. The brief concludes with a series of case studies examining the potential of engaging with financial intermediaries to slow, halt and reverse forest loss? and forest degradation.

Reducing deforestation and forest degradation and restoring forests could bring significant benefits for livelihoods, climate

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[b]UNEP

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Key Private Sector Lessons

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Some fundamentals…differentiating between:

The public and private sector often use different terminology in REDD+. We need to be aware of this **'perception gap'** if we are to engage meaningfully with key stakeholders. Technically, the private sector uses the following distinction between funding and finance:

- **Funding:** the generation of money- or more precisely the generation of the incentive to invest money- for a particular activity. This will help to make an investment commercially viable, and/or competitive to conventional investment alternatives. <u>This is not normally repaid</u> and there is generally no financial return. This is often a future payment
- **Financing:** often means making money available upfront, or ex-ante, for investment. The money is <u>typically repaid</u> from the on-going or ex-post operations and cash-flows of the investment. The two main types of finance are debt (often loans) and equity investments.

- Funding is the **incentive**, and finance is the **means** to undertake (in this case) REDD+ activities

Lesson 1: If the incentive structure is well designed- private sector capital will flow at scale

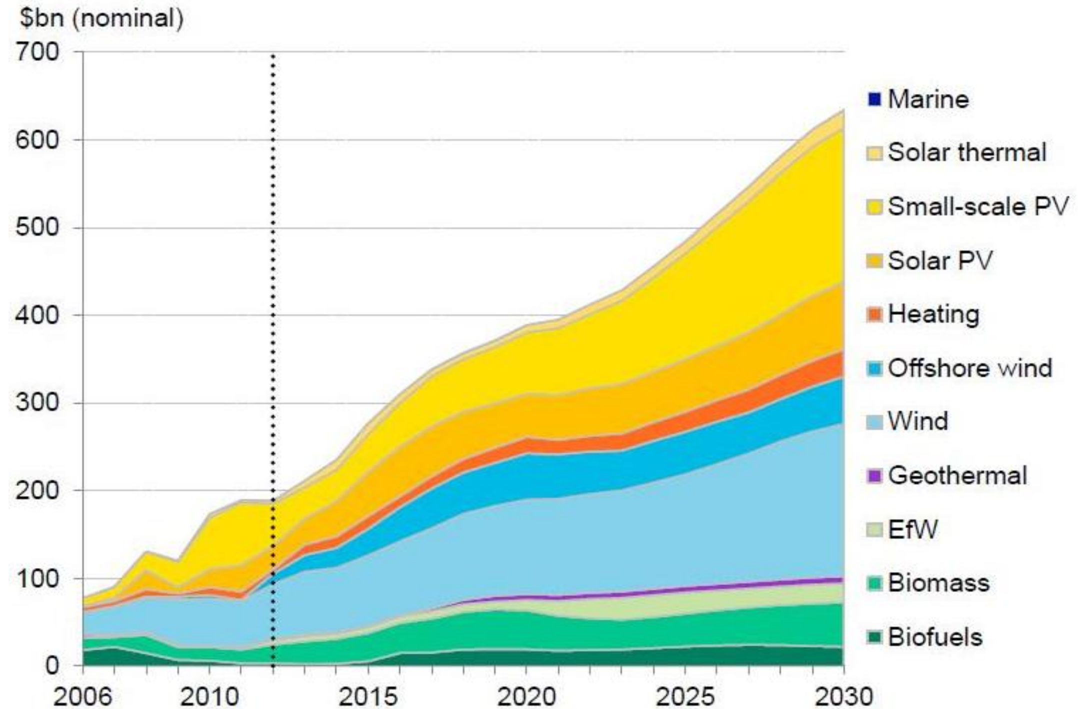
• Even with a more cautious banking sector following successive global financial crises and new capital requirements (Basel III), private sector capital will flow at scale into green investments if the ‘business case’ exists.

• Evidence from the renewable sector shows significant financial flows into renewables with the right conditions in place.

• Capital also is very sensitive to unfavourable changes in policy (e.g. Spanish feed-in tariffs)

BUT…will this transfer to the developing world?

AND…what are ‘favourable conditions’?



Source: Bloomberg New Energy Finance

Lesson 2: What are well designed incentives? Policy that is: Long, Loud, Legal and Light

Investment in the green sector is to a large extent driven by government policy

Long-term and predictable policy that conforms to the four 'L's - **L**ong, **L**oud, **L**egal and **L**ight- will provide the framework for investors to mobilise capital at scale

•**Long**- investment timescales and policy timescales must align and need to be predictable (10 years in the GAVI pneumococcal AMC and 10-25 years in the renewables space for example)

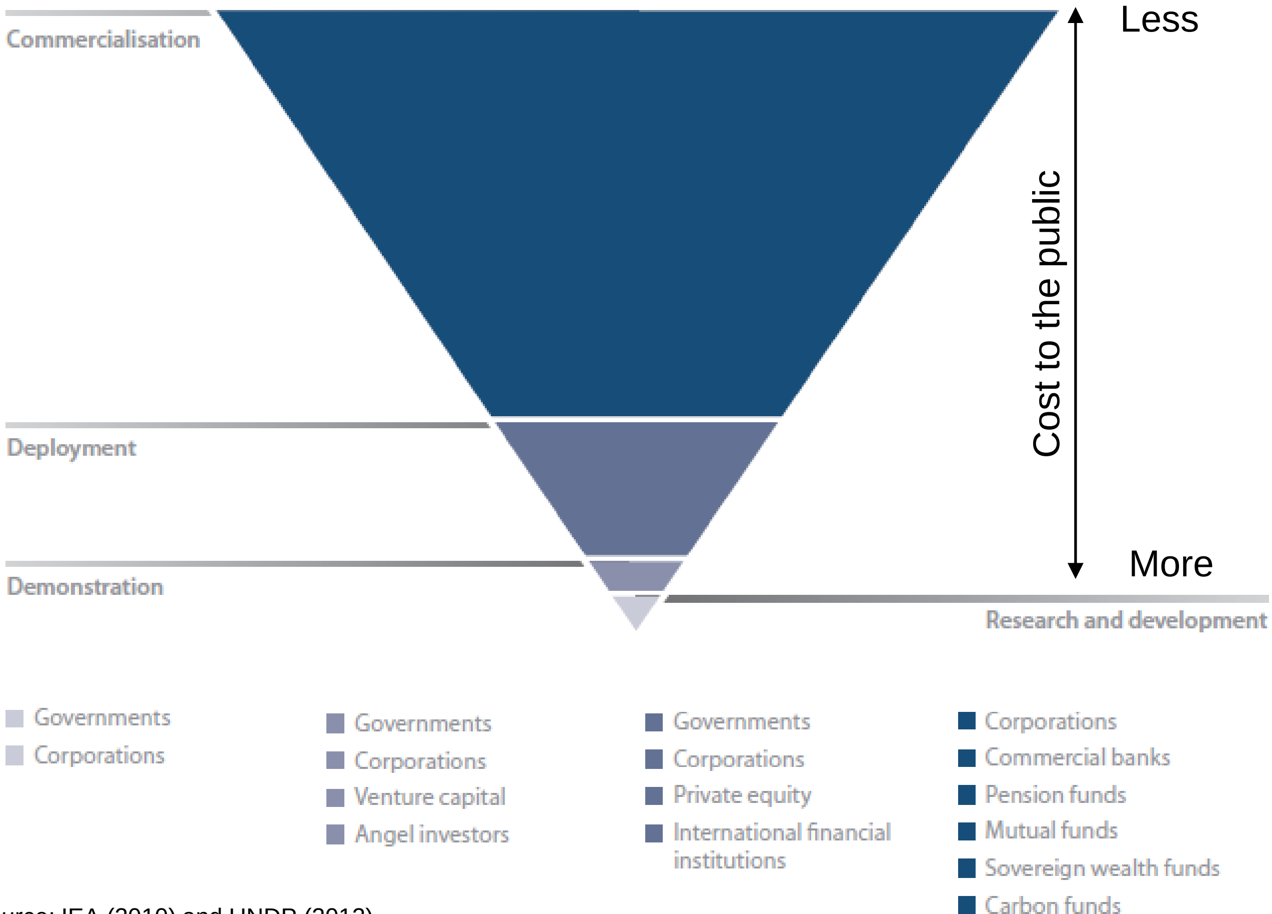
•**Loud**- policy must make targeted activities more commercially attractive than business as usual activities (BAU)

•**Legal**- a clear, legally binding framework must be in place that is the basis for long term, large scale, contractually-binding agreements

•**Light**- policy must be relatively easy and cheap to understand/adhere to

Lesson 3: Once suitable incentives are in place, finance needs to be raised and many green activities have higher 'upfront' finance requirements vs. BAU

- Green investments often have **higher upfront costs** than many BAU investments and there can be a 'first mover' disadvantage
- The renewables sector has experienced an early stage finance bottleneck (<1% of public sector finance in the developing world renewable space is for early stage investment)
- Lesson for REDD+: results-based payments are key but **access to finance** is vital too



Source: IEA (2010) and UNDP (2012)

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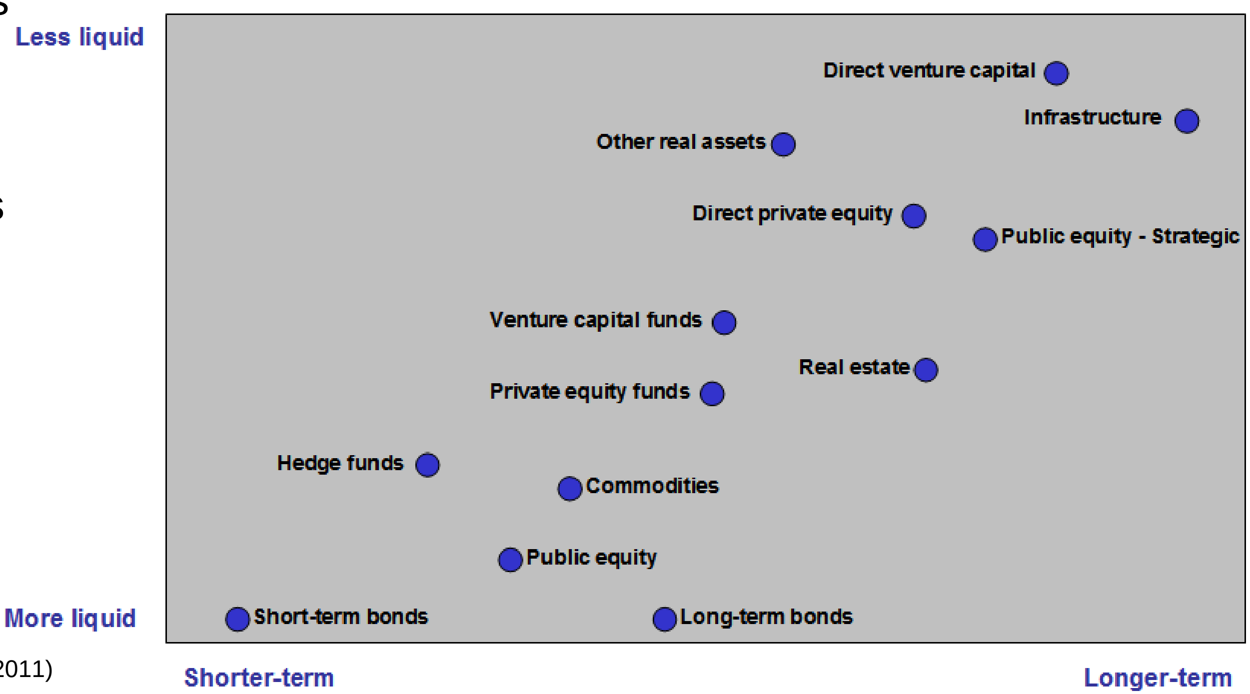
Lesson 4: The supply of finance is important

• Even if the incentive structure is well constructed, we need to think about who will supply finance as the **‘supply chain’ of finance is very varied**

• A key lesson from the renewable world is that much of the investment has been into private equity and private debt vehicles- BUT many large investors can’t invest into these vehicles

• There are large amounts of private sector capital but we need to think carefully about how REDD+ actors will access it- new financial instruments or mechanisms might be required if we want to **connect the capital to activities** (‘REITs’ are an example from the real estate world)

Asset class liquidity vs. time horizon



Source: Adapted from World Economic Forum (2011)

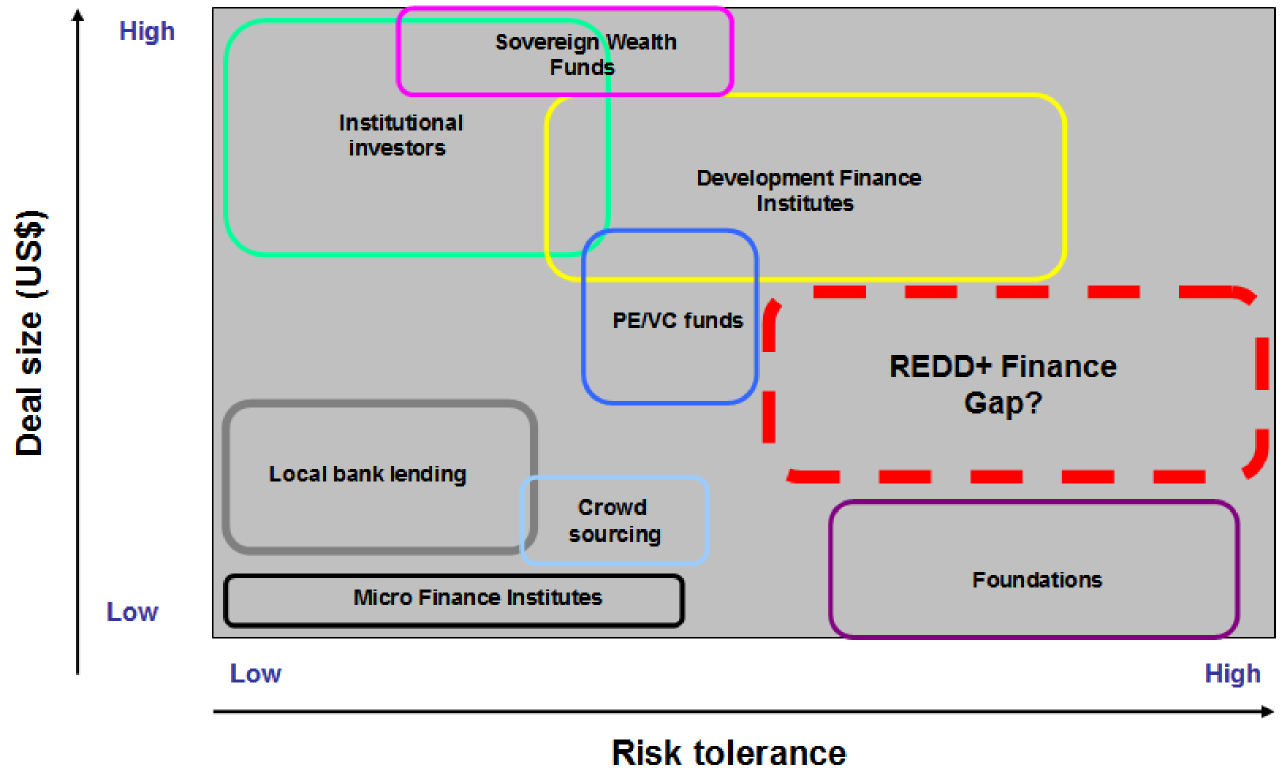
Lesson 5: The demand for finance is important too

- Even with a well designed incentive scheme, we need to consider who needs finance
- Different lenders have different objectives in terms of who they provide finance to, deal size and risk appetite

- Many forest enterprises are **Small and Medium sized Enterprises (SMEs).** They can be too big for local finance sources but too small for international financial sources of finance

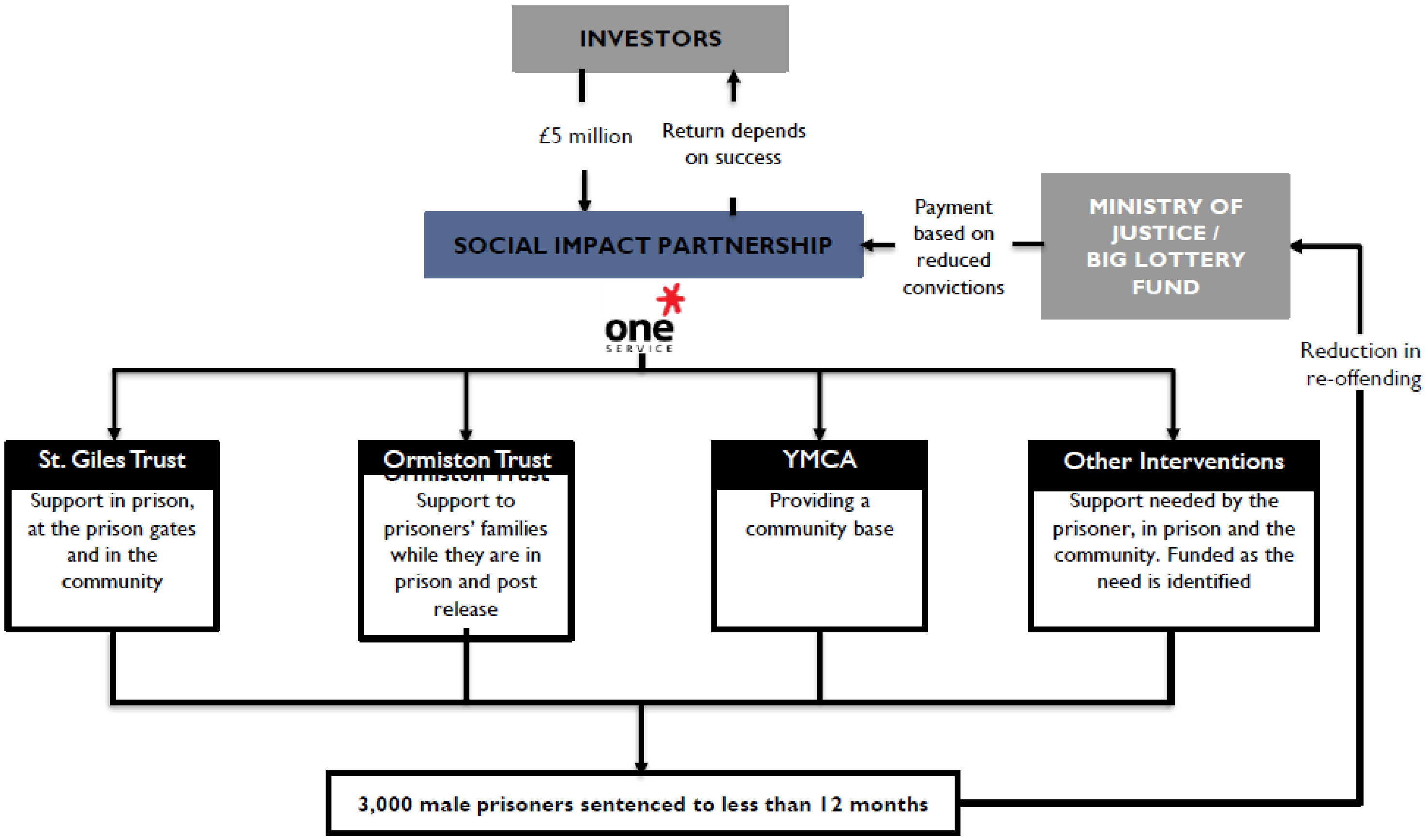
- Looking at ways to aggregate and keeping transaction costs low is/will be important

Mapping of investors based on risk tolerance and deal size



Source: Adapted from Dalberg (2013)

Lesson 6: Results-based payments are generating considerable interest in other fields of finance, like in social finance with the Social Impact Bond

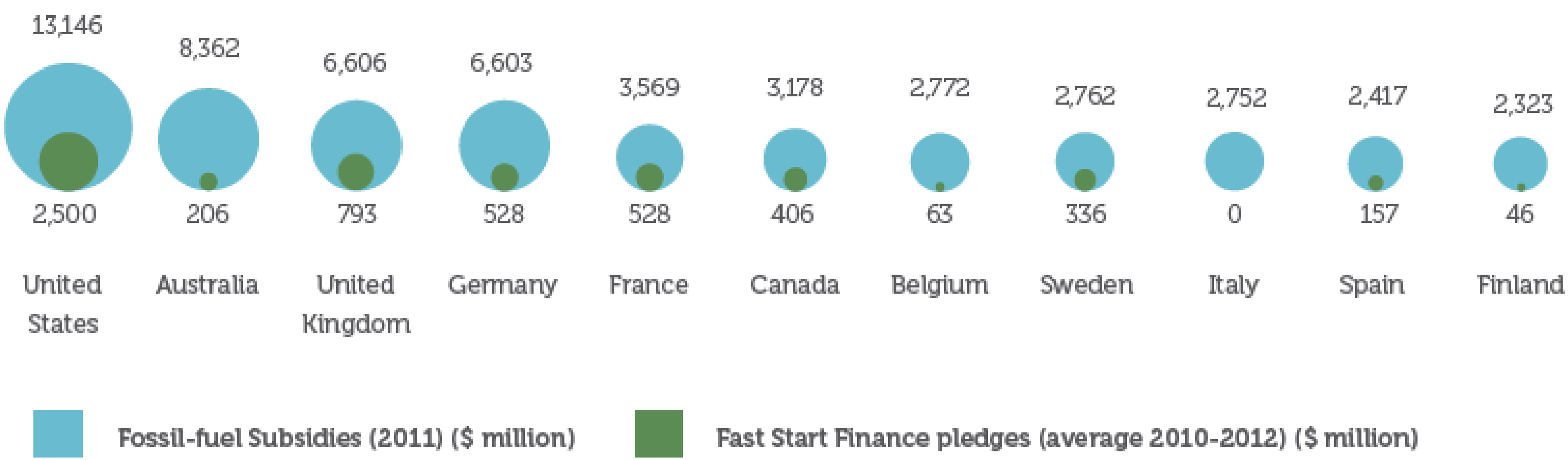


Source: Social Finance UK

Lesson 7: Results-based payments are very important, but we must not lose sight of the 'big picture'

- Even if the incentive structure is well constructed for REDD+ investments, we need think about factors **driving finance and investments into business-as-usual activities**
- What is driving finance & investment into the drivers of the deforestation? Are there perverse subsidies we need to be aware of and are these preventing a 'level playing field' for REDD+ investments? Could these be redirected and used as a 'double dividend' for REDD+ funding?

Developed country fossil fuel subsidies vs. climate finance



Source: ODI, adapted from Oil Change International (2012)

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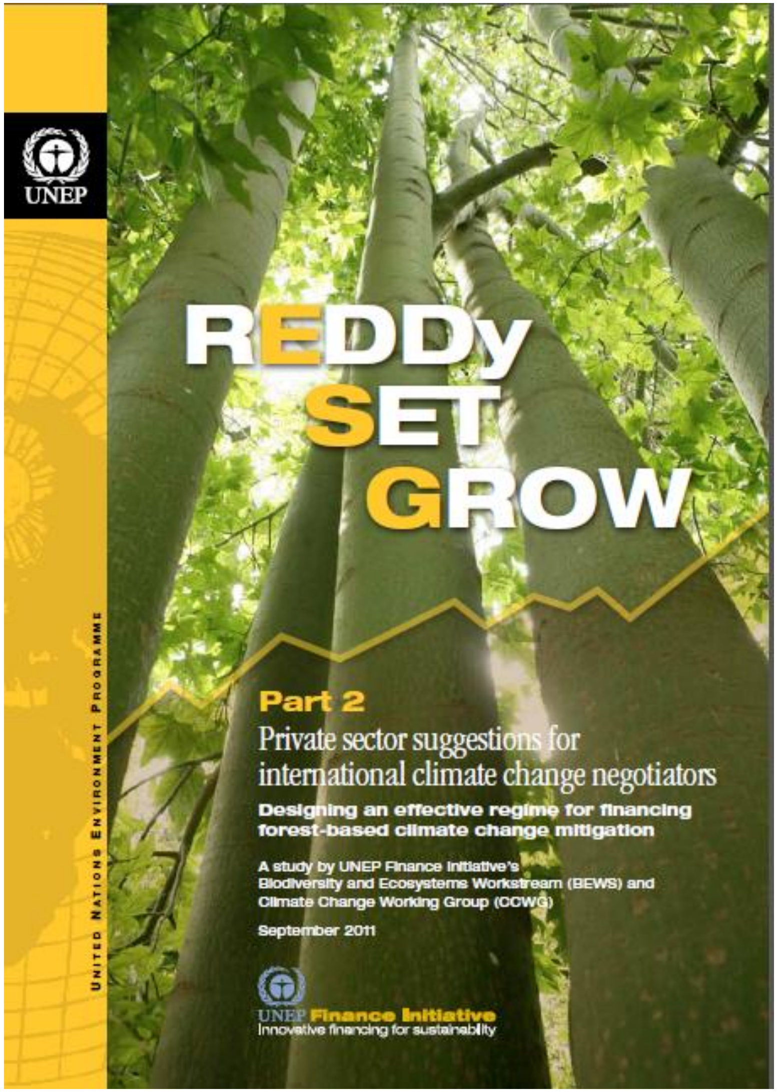
What Should Results-based Finance Look Like?

REDDy SET GROW Part 2

• UNEP Finance Initiative report from Sept 2011

• Produced for policy makers and negotiators to provide information on what REDD+ architecture needs to deliver to effectively mobilise private sector finance and investment at scale

• Extensive input from the finance sector (banks, insurers, investors), broader private sector as well as Development Finance Institutions



Key Findings: overview and assessment of REDD+ funding scenarios

Scenario	Who can receive payments?	Effectiveness in private capital mobilisation (based on private sector consultations)
1. National Crediting under UNFCCC	Public and private entities	- - Minimal scope and likelihood of mobilising private sector funding for REDD+
2. Sub-national or project crediting under a UNFCCC agreement	Public and private entities	+ Promising, as long as the private entities at the sub-national level are eligible
3. Nested approach- hybrid of 1 and 2	Public and private entities	++ Highest scope and likelihood of private sector involvement
4. International Fund with national-level incentive payments	Public and private entities	- - Minimal scope and likelihood of mobilising funding
5. Voluntary markets only	Public and private entities	+/- Promising likelihood of mobilising private sector capital but very small scale

Source: Adapted from UNEP FI REDDy SET GROW Part 2

Take away message

To deploy capital at scale, the private sector wants to:

- Invest at a scale where the risks and opportunities are clear and can be managed
- Have predictability of demand
- A clear, long 'price signal' that can be used to forecast revenues and calculate if a reasonable return on investment can be made ('competitive risk-adjusted returns')
- Transparent criteria and stable policy over the long term
- Have a high-level of social and environmental safeguards; management of reputational risk

- This is not inconsistent with large-scale, national, or subnational REDD+ programmes. Crediting structure, risk management and accounting are key however

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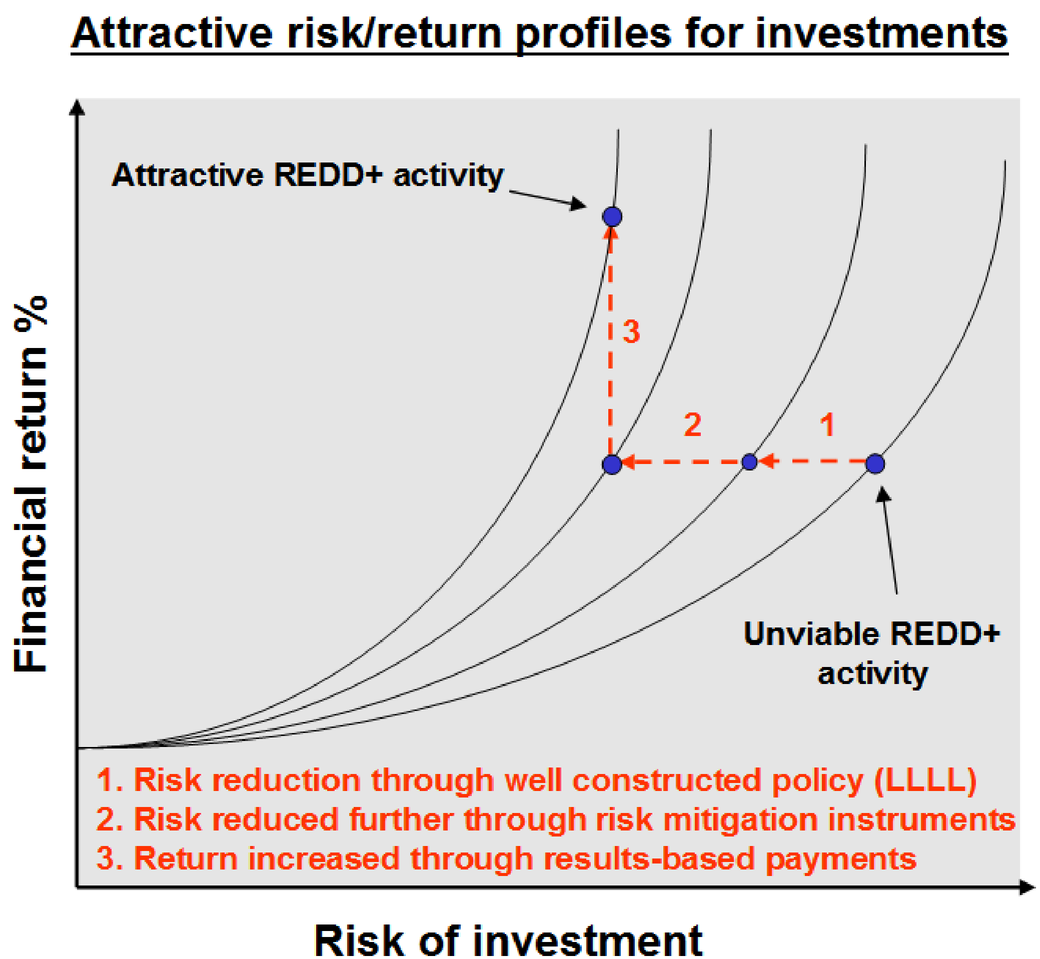
Conditions to Scale Up?

Create an attractive risk/reward profile for REDD+ investment

- The private sector think in terms of risk, return and tenor (length of investment). They will not deploy capital at scale unless they can calculate what this will be for REDD+

- The single most important factor to mobilise private sector capital at scale is to create a compelling **business case** for REDD+ through Long, Loud, Legal and Light policy and results-based payments

- More focus on the positives rather than the risks to private sector participation



Source: Adapted from UNEP FI/UNDP 2012

Possible next steps?

- Continue to narrow the ‘perception gap’ between REDD+ stakeholders to ensure efficiency and effectiveness
- Ensure REDD+ policy is Long, Loud, Legal and Light
- Advance Market Commitments (AMCs) have shown promise outside REDD+ in areas with similar barriers (large upfront costs, long ‘asset lives’, policy uncertainty, unclear market variables like price and demand)- a source of interim results-based demand?
- Develop a more robust business case for the private sector- what exactly is the value proposition?
- Generate a more detailed understanding of conditions required to attract REDD+ investment in forest countries, and what is driving business-as-usual investments in drivers of deforestation
- Ensure access to finance is considered while results-based payment mechanisms are being developed

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Thank You

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