



REDDy SET GROW

Executive Summary

Part 2

Private sector suggestions for international climate change negotiators

Designing an effective regime for financing forest-based climate change mitigation

A study by UNEP Finance Initiative's Biodiversity and Ecosystems Workstream (BEWS) and Climate Change Working Group (CCWG)

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UNEP Finance Initiative
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1. Executive summary

I. Private finance and investment: why?

Forests are chronically undervalued in today's economies, even though they underpin a wide range of complex and varied ecosystem services that one billion people immediately rely on for their livelihoods and that are central to economic progress and human welfare at a global scale. The nature of the problem is economic: the absence of a 'positive' price signal to protect and sustainably use forests lies at the heart of the current level of deforestation and makes the clearing of forests financially more attractive than preserving them. This notion applies equally to industrial-type deforestation – such as for the Brazilian soy and the Indonesian palm oil industries – and deforestation for subsistence farming in the Congo Basin and other regions.

Even if only the climate-related services and benefits of forests are considered, the case for systematically addressing, slowing, halting and ultimately reversing deforestation and forest degradation is overwhelming, for economic reasons alone: on a business-as-usual path, the costs of deforestation-related impacts of climate change on the world economy could reach USD 1 trillion per year by 2100 (Eliasch, 2008)¹. Stopping tropical deforestation and forest degradation and planting new forests could provide climate benefits equivalent to doubling current global nuclear energy capacity, or the construction of two million new wind turbines (Socolow and Pacala, 2004). If the other benefits that forests provide, such as water retention, habitat for wildlife, and regulation of local and regional climates, are considered, the benefits are far greater.

A 50 per cent reduction in deforestation rates is needed by 2020 if the forestry sector is to support global efforts aimed at holding global temperature rise to below 2 degrees Celsius, the global climate target that the world's governments have set in international climate change agreements. This will require a combination of: **(i)** weakening or reversing the current drivers of deforestation, particularly through shifts in land use for the production of agricultural commodities, **(ii)** mobilising investment in the active protection of standing forests, as well as **(iii)** mobilising investment in the creation of new, sustainably managed forests. Realising the climate change mitigation potential of forests will require up-front investment of approximately **USD 17-40 billion per year** (Eliasch, 2008) (UNEP, 2011).

Investment at this scale is **highly unlikely to come from governments alone**. To put the figure above into context, cumulatively available public funds from donor countries to date stand at approximately USD 7 billion (the annualised figures are much lower). Hence, investment from, and engagement of, the private sector – including financial institutions (FIs) and financial intermediaries – is essential, particularly for implementation activities.

Aside from the scale and speed at which investment needs to flow, a critical reason why any future international regime to reduce emissions from deforestation and forest degradation (REDD+)² must mobilise the private sector is that the drivers and roots of deforestation need to be addressed. This includes changing current behaviour patterns in the private sector itself which can happen in an effective way only if commercial actors and (subsistence) farmers are offered financially competitive alternatives to current land-use and deforestation patterns. In other words, only if investing in forest protection, conservation and enhancement can offer revenue streams competitive with those from the production of timber and agricultural commodities such as soybeans, palm oil and beef will the private sector truly shift behaviour patterns and unlock the skills and resources needed to achieve the deforestation targets.

Mobilising the private sector will depend on **(i)** the international community and governments offering avenues and formats for the private sector to invest and engage in the protection, rehabilitation and creation of natural forests as well as on **(ii)** making such investment opportunities competitive with alternative land-use options. Failing this, REDD+ and other instruments for forest-based climate change mitigation

¹ Please note that this is an estimate of the forestry-related impacts of climate change, additional to the climate change impacts of other industrial emissions of greenhouse gases.

² REDD+: Reducing deforestation and forest degradation + conservation and enhancement of forest carbon stocks and sustainable management of forests.

and sustainable forest management (SFM) are unlikely to achieve their potential of transforming the way forests are used and perceived. The private sector's participation in the transformation process is essential to the success of such initiatives.

II. Private finance and investment: how?

The international community has achieved considerable progress on the issue of REDD+ in recent years, culminating in a set of far-reaching resolutions at the UN Conference of the Parties in Cancun in 2010 (COP 16)³. However, the critical questions of how the implementation of REDD+ activities will be funded, and what the role of the private sector and private investment will be, have remained unanswered, and related negotiations are ongoing. This report aims to bring to the attention of governments and international climate negotiators **(i)** the views of financial institutions organised under the United Nations Environment Programme Finance Initiative (UNEP FI), **(ii)** the imperative of mobilising private investment and private sector engagement in the implementation of REDD+ activities (*Section 3.1*), **(iii)** the risks and challenges of private sector involvement in REDD+ and approaches to deal with these (*Section 3.2*) and, most important, **(iv)** the policy scenarios that are most likely to rapidly mobilise capital from the private sector at the required scale while actively addressing the concerns and risks of private sector participation (*Section 5.2*). The report highlights – on the basis of scenario analysis – how any future mechanism should combine different features to increase its effectiveness and efficiency.

The effectiveness of a future REDD+ funding mechanism depends on suitable answers to the following questions:

- 1. Will there be an overall deal?** Despite recent progress in the international REDD+ negotiations, it is unlikely that a global REDD+ mechanism will become truly operational unless a broader, global agreement on climate change under the United Nations Framework Convention on Climate Change UNFCCC is reached.
- 2. Who will make performance-based payments in Phase 3⁴ of REDD+?** Will performance-based payments come from **(i)** credit buyers via a crediting mechanism and international carbon markets (for eventual REDD+ credits abroad) or **(ii)** bilateral/multilateral funding vehicles equipped with international climate finance (ultimately from taxpayers in donor countries)?

Possible answers:

Carbon credits and decentralised markets
(polluters in developed countries pay)

Centralised public funding vehicle(s)
(taxpayers in developed countries pay)

- 3. Who can receive performance-based payments in Phase 3?** Can performance-based payments in Phase 3 be received by **(i)** national governments only, **(ii)** by activity implementers at the subnational level only or **(iii)** by entities at national and subnational levels, including particularly private bodies such as agricultural cooperatives, forest concessionaries and project developers?

Possible answers:

National governments only

Subnational implementing
entities only, including
private actors

Both

- 4. Who can design and implement REDD+ activities on the ground?** Are REDD+ activities on the ground open to private sector participation, or can such efforts only be initiated and implemented by public authorities and agencies?

³ <http://unfccc.int/resource/docs/2010/cop16/eng/07a01.pdf#page=2>

⁴ Among other resolutions on REDD+, the Cancun Agreements establish a phased approach to funding REDD+ in developing countries: **Phase 1** entails funding for public planning, organization and initial capacity-building; **Phase 2** entails funding for the implementation of national REDD+ strategies by governments; and **Phase 3** entails 'performance-based' funding for the implementation of concrete REDD+ projects and programmes on the ground. While there is agreement that Phases 1 and 2 can only be funded with public finance (and private sector stakeholders agree with that), there are diverging views on how Phase 3 activities (which will require the bulk of the total, cumulative REDD+ funding) should be financed. Therefore, the private sector suggestions in this report focus exclusively on the funding of Phase 3 activities.

Table 1 below provides an overview of different viable scenarios for a future REDD+ funding mechanism. These are based on different combinations of the answers to the questions listed above. The table also provides an assessment, by financial institution members of UNEP FI, of the likeliness and effectiveness of each REDD+ funding scenario to mobilise private investment at the required scale and speed, as well as to address the drivers of deforestation by changing behaviour in the private sector (*Section 5*).

Table 1: **Overview and assessment of REDD+ funding scenarios**

Scenario for the REDD+ funding mechanism	Will there be an overall deal?	Who can receive performance-based payments?	Who will make performance-based payments?	Who can design and implement REDD+ activities?	Effectiveness in private capital mobilisation and in changing private sector behaviour
Scenario 1 National crediting under a UNFCCC agreement	✓	National governments	Polluters in industrialised countries: via carbon credits/decentralised markets	Public and private entities	-- Minimal scope for and likelihood of mobilising funding for REDD+ implementation in Phase 3 at the required scale.
Scenario 2 Subnational or project crediting under a UNFCCC agreement	✓	Subnational entities (including private sector)	Polluters in industrialised countries: via carbon credits/decentralised markets	Public and private entities	+ Promising scope for and likelihood of private sector involvement in the implementation and financing of REDD+ in Phase 3, as long as private entities at the subnational level are eligible for crediting.
Scenario 3 The nested approach as a hybrid solution between the options in Scenarios 1 and 2: crediting at the activity level is combined with strong reference and accounting systems at the national level	✓	Both national governments and subnational entities, including private entities	Polluters in industrialised countries: via carbon credits/decentralised markets	Public and private entities	++ Highest scope for and likelihood of private sector involvement in REDD+ activity implementation and financing under Phase 3, as long as private entities at the subnational level are eligible for crediting.
Scenario 4 International fund with national-level incentive payments	✓	National governments and subnational entities	Taxpayers in industrialised countries: through public international finance	Public and private entities	-- Minimal scope for and likelihood of mobilising funding for REDD+ implementation in Phase 3 at the required scale.
Scenario 5 Voluntary markets only (no global REDD agreement under the UNFCCC)	✗	National governments and subnational entities	Polluters in industrialised countries: via carbon credits/decentralised markets	Public and private entities	+/- Promising likelihood of mobilising private involvement and investment for REDD+ implementation, but very small size and insufficient scope to mobilise investment at the required scale.

Summary

Scenario 1	<ul style="list-style-type: none"> Country and regulatory risk, which are considerable in developing countries anyway, are intensified, which significantly deters private actors, financiers and investors from facilitating REDD+ implementation projects on the ground. Successful REDD+ activities at the subnational level (as measured against either a national or subnational baseline) are not rewarded unless the entire national REDD+ scheme is successful (measured against a national baseline). This type of 'performance risk' will hardly be acceptable to private sector actors or investors operating at the activity level. The drivers of deforestation are not addressed, as there is no shift in price/market signals; the land-use behaviour of the private sector remains unaltered. Scarce public funding from international donors would have to be used for Phase 3 in addition to Phases 1 and 2.
Scenario 2	<ul style="list-style-type: none"> Performance-based remuneration contracts are entered into with subnational entities – particularly private bodies such as cooperatives and forest concessionaries; the results are less political risk and better enforcement mechanisms. Weak public governance in less advanced developing countries does not affect activities directly, which makes investments less risky. This mechanism creates a price signal for private actors that makes the protection of forests financially competitive with conventional land-use options that lead to deforestation and forest degradation. The environmental integrity of REDD+ efforts is weak, as leakage cannot effectively be managed, with negative implications for the marketability of and demand for REDD+ carbon credits on international carbon markets.
Scenario 3	<p>Combines all the advantages and strengths of Scenarios 1 and 2 into one framework:</p> <ul style="list-style-type: none"> Allows crediting to and, hence, direct receiving of performance-based payments by operational entities such as municipalities, cooperatives and forest concessionaries, which in turn can secure private finance and investment to run activities. Environmental integrity is ensured through reference levels and MRV (measuring, reporting and verifying) at the national level. Reference levels and MRV at the subnational and regional levels can logically be embedded into national structures. The reduced risk of intra-country leakage gives comfort to buyers on carbon markets, increases prices for REDD+ credits and makes REDD+ investments more attractive. Leakage is managed through a harmonised system of subnational baselines and an all-encompassing national baseline as decided in the Cancun Agreements. This mechanism creates a price signal for private actors that makes the protection of forests financially competitive with conventional land-use options that lead to deforestation and forest degradation.
Scenario 4	<ul style="list-style-type: none"> Private investment can be mobilised in this scenario to participate in an international REDD+ funding vehicle. However, the bulk of funds mobilised by such a vehicle can only come from public sources; it would take much time and effort and a well-established track record before private investors felt comfortable investing in a multilateral public investment structure of this nature at the required scale. A more fundamental question is how (i.e., from where) investors would be repaid their capital and any expected return on investment, in the absence of a market for REDD+ credits: from which revenue streams would host governments, municipalities, cooperatives and forest concessionaries in developing countries repay debt and service dividends after the successful implementation of REDD+ activities? The drivers of deforestation are not addressed, as there is no shift in price/market signals; the land-use behaviour of the private sector remains unaltered. Scarce public finance has to be used for Phase 3, in addition to its use in Phases 1 and 2.
Scenario 5	<ul style="list-style-type: none"> Market players should prepare to make use of current opportunities within the voluntary market or dedicated national cap and trade schemes that allow for REDD+ offsets (e.g., AB 32 or the EU ETS Phase 3). Though this scenario is not unfriendly from a private sector perspective, the scope and size of voluntary or national regulatory markets will remain far too limited to mobilise investment at the scale required to meaningfully address deforestation and forest degradation in developing countries.

III. The nested approach – key features and advantages

The most promising policy option for private sector involvement in REDD+ is the nested approach as described in Scenario 3.

The nested approach is considered by a number of private sector actors and stakeholders to be the most likely as well as effective type of mechanism to develop under current conditions. An important question – and a core condition of the effectiveness of the nested approach in mobilising private sector skills and investment – is whether private sector entities, such as agricultural cooperatives and forest concessionaries, will also be eligible for REDD+ crediting, in addition to subnational governments. If not, the nested approach could lose much of its effectiveness given the regulatory and political risk profiles of many subnational governments similar to those of governments at the national level. There are a few critical design features of the nested approach that make it appealing from a private sector and investment mobilisation perspective (*for more information, go to Section 5.3*):

- 1. The effect of addressing the drivers of deforestation by changing behaviour in the private sector itself.** The fundamental reason for the unsustainable use of forests and for current trends in deforestation is that forests are worth more cleared than standing: the products derived from deforested lands – be they beef, soybeans or palm oil – offer financial revenue to landholders and economic opportunity to local communities and country governments, while standing forests do not. Systems are needed that – by opening avenues to generate financial revenues from the protection, rehabilitation or creation of natural forests – offer real and sustainable alternatives to conventional private sector practice. This is the key advantage of a market-based mechanism that formally confers monetary value on natural forests based on the real carbon sequestration services they provide (there are also disadvantages and risks, which are highlighted further below).
- 2. The possibility of making performance-based payments directly to the public and private implementers of REDD+ activities at the activity level.** This would help to mitigate the most significant investment risk category in the developing world, country and regulatory risk. This risk category is one of the main impediments to increased private investment in the developing world generally. It results from track records of political instability and corruption as well as regulatory and legal uncertainty in the countries concerned. This risk is already detrimental to private investment in ordinary market settings, but it would be considerably intensified, in a REDD+ context specifically, if all future REDD+ revenue streams, be they from carbon markets or from an international fund, were administered and distributed exclusively by public bodies and through government channels.
- 3. Subnational and regional baselines coexist with an all-encompassing national baseline; this combines environmental integrity with private investment mobilisation.** Enabling performance-based payments at the activity level, as described above, requires the ability to measure local performance accurately by making use of reference levels that are pertinent to the geographic areas concerned. This is not possible if REDD+ performance at the subnational or regional level is measured against national baselines. Rather, any baseline established at the national level, and communicated internationally (in line with the Cancun Agreements), can be disaggregated into a series of subnational baselines, which in turn can be disaggregated into regional baselines at the level of counties and/or municipalities. All these baselines need to be logically interlinked and, at any given point, sum up to the baseline at the national level. This can ensure the environmental integrity of the scheme and avoid leakage while enabling the set-up of subnational baselines that are required for subnational crediting.
- 4. A crediting mechanism beats an international fund: make carbon emitters, not taxpayers, pay for REDD+ implementation.** The bulk of the USD 17 - 40 billion estimates of needed REDD+ investment per year comprises, in essence, opportunity costs related to the conservation or enhancement, rather than the destruction or degradation, of forests. This is a cost that will have to be assumed by somebody, and there are ultimately only two options for how this might happen: **(i)** developed-country emitters of greenhouse gases take on the cost, or **(ii)** developed-country taxpayers do so. Even if an international public funding vehicle for REDD+ were mandated to mobilise private investment, such as from institutional investors

like pension funds, a fundamental question remains unanswered: how, or from which underlying revenue streams, would private investors be repaid their capital (as well as any expected return on investment), in the absence of a market for REDD+ credits? From which revenue streams would host governments, municipalities, cooperatives and forest concessionaries in developing countries repay debt, service interests and dividends after the successful implementation of REDD+ activities? The only answer that can be provided at this stage is: from the generation of carbon credits sold on international carbon markets.

IV. The risks and challenges of private sector participation in REDD+

While the systematic involvement of the private sector and the mobilisation of private finance are imperative both for the implementation and financing of REDD+ activities at scale and speed, as well as in effectively addressing the fundamental drivers of deforestation, it is also critical to take note of the resulting risks, disadvantages and potential challenges:

- 1. Fungibility.** A repeated concern with involving the private sector, in this case through a market-based REDD+ crediting mechanism that is fully integrated with the global carbon markets, is that the large volume of REDD+ credits potentially available will create downward pressure on prices and destabilise the markets. This in turn can incentivise industrialised countries with emissions-reduction commitments to increasingly meet targets through the import of credits rather than through domestic decarbonisation measures. However, the reality of this is contested. Preventive measures and controls are possible, such as limiting the fungibility of REDD+ credits; this can be supported by simultaneous commitments by countries to more ambitious emissions-reduction targets, which – coupled with flexible modalities around supplementarity⁵ – can avoid depressing carbon prices while keeping overall mitigation costs down despite more stringent emissions-reduction commitments. Qualitative restrictions allowing the import only of credits with strong sustainability features can also play an important role.
- 2. Environmental and social safeguards.** There is a legitimate concern that by allowing the private sector and private investors to play a central role in REDD+, projects and activities will be naturally biased towards maximising the carbon component of any forest ecosystem, at the possible expense of local communities, forest-dependent indigenous people, biodiversity and non-carbon forest ecosystem services. Environmental and social safeguards are, however, included in the latest REDD+ resolutions and are being further developed and specified to counterbalance this potential threat. Moreover, discussions with financial institution members of UNEP FI have led to an understanding that strong and clear safeguards can be enablers, rather than deterrents, of private sector involvement in REDD+. Safeguards, and compliance with them, can help avoid reputational and operational risk, clarify legal requirements that must be followed, as well as clearly set out the social and environmental requirements in what for many institutions will be a new area of business.
- 3. Land tenure and ownership rights.** Private sector involvement in REDD+ can lead to increased insecurity and diminish the prospect of forest-dependent communities having their tenure rights formalised; by conferring new value on forest lands, government actors and commercial entities can be incentivised to “actively deny or passively ignore” access and control of forest resources by local, forest-dependent communities.⁶ This problem can be addressed by establishing clear land tenure and ownership rights up front. This is not only important so that local communities can economically benefit from REDD+ activities but is in fact a key enabler, and a fundamental condition, of the involvement of the broader private sector and the mobilisation of private finance and investment in REDD+ activities: professional private sector actors such as project developers, forest concessionaries, lenders and investors will, as a core requirement in risk management, object to investing in REDD+ activities unless clear and undisputed ownership systems are in place.

⁵ The concept of ‘supplementarity’ relates to industrialised countries with emissions-reduction commitments only being able to use foreign carbon credits (such as from the Clean Development Mechanism or from a future REDD+ crediting mechanism) for compliance in a ‘supplemental’ way, therefore achieving the bulk of emissions-reduction commitments domestically. While the concept is central to the environmental integrity and effectiveness of any global climate regime, it can be argued that, if industrialised countries increased the ambition of their overall emissions-reduction targets, a large fraction of resulting cost increases could be compensated for by more relaxed supplementarity modalities, at least for specific types of carbon credits, such as REDD+ credits, for instance. This would translate into increased global ambition on climate change coupled with solid global demand for REDD+ credits, while keeping global mitigation costs down.

⁶ <http://www.forestsclimatechange.org/fileadmin/downloads/movingahead11.pdf>.

4. Geographic investment distribution, governance and corruption. A REDD+ funding mechanism that relies on private finance mobilisation needs to recognise the risk of an uneven distribution of investment and commercial REDD+ activity between more advanced emerging economies and less developed countries, especially in the short to medium term.⁷ Publicly funded risk-mitigation tools and other support mechanisms for private investment could play an important role in mobilising private REDD+ investment in potentially disadvantaged countries unattractive to private investors.⁸

Key to governance and human rights issues for communities affected by REDD+ are procedural rights and standards for consultation and involvement. Efforts to build REDD+ 'readiness' at the country level under Phase 1⁹ should, for this reason, also contribute to building capacity among local authorities and communities to participate in processes under the principle of 'free, prior and informed consent' in the context of REDD+.

There are justifiable concerns that the pricing of forests and the large new financial flows that this will create could fuel new conflict and result in new opportunities for corruption, at both regional and national levels. However, positive improvements and developments for human rights and governance can also be achieved through a well-designed framework for financing REDD+. Robust implementation and monitoring of safeguards and mechanisms for transparent and accountable financial transfers can be established, supported by enhanced international scrutiny of forest management.¹⁰

REDDy Set Grow explained

Part 1: A briefing for financial institutions

Part 1 provides private sector actors, particularly financial institutions, with an overview of the current and emerging business opportunities in forest-based climate change mitigation, including an assessment of the risks involved and possible measures to reduce them. It also outlines the types of roles that financial institutions can play in such activities and efforts. This briefing to financial institutions is likely to also be useful for policymakers in understanding the views, needs and priorities of financial institutions and private sector investors.

Part 1 of REDDy Set Grow addresses the following questions:

- What are the current shape and status of forest carbon markets?
- What are the emerging opportunities for, and potential roles of, investors and financial institutions?
- What experiences have financial actors had when establishing operations in this space?
- What are the risks and barriers that private actors face?

Part 2: A briefing for policymakers

Part 2 presents to policymakers who are involved in national REDD+ policy processes and international climate change negotiations in the UNFCCC **(i)** the imperative need to systematically mobilise private finance and investment for forest-based climate change mitigation, as well as **(ii)** concrete suggestions of how any future REDD+ funding mechanism could most effectively achieve that.

This analysis will also be useful for financial institutions in understanding the history and current proceedings in the international negotiations on REDD+ funding.

Part 2 addresses the critical question of what policy options, and what type of REDD+ funding mechanism, are most conducive towards effectively financing forest-based climate change mitigation (with a focus on Phase 3 of REDD+ implementation).

7 <http://www.forestclimatechange.org/fileadmin/downloads/movingahead5.pdf>;
<http://www.forestclimatechange.org/fileadmin/downloads/movingahead11.pdf>.

8 For previous work of UNEP FI on the issue of leveraging private climate finance through public finance mechanisms and risk-mitigation tools, please refer to the UNEP FI submission to the Transitional Committee of the Green Climate Fund (GCF), http://unfccc.int/files/cancun_agreements/green_climate_fund/application/pdf/unep_fi_submission_on_private_sector.pdf, as well as to the report at: http://www.unepfi.org/fileadmin/documents/catalysing_lowcarbon_growth.pdf.

9 Among other resolutions on REDD+, the Cancun Agreements establish a phased approach to funding REDD+ in developing countries: Phase 1 entails funding for public planning, organization and initial capacity-building; Phase 2 entails funding for the implementation of national REDD+ strategies by governments; and Phase 3 entails 'performance-based' funding for the implementation of concrete REDD+ projects and programmes on the ground. While there is agreement that Phases 1 and 2 can only be funded with public finance (and private sector stakeholders agree with that), there are diverging views on how Phase 3 activities (which will require the bulk of the total, cumulative REDD+ funding) should be financed. Therefore, the private sector suggestions in this report focus exclusively on the funding of Phase 3 activities.

10 <http://www.forestclimatechange.org/fileadmin/downloads/movingahead11.pdf>.

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About the UNEP FI

The United Nations Environment Programme Finance Initiative (UNEP FI) is a global partnership between the United Nations Environment Programme and the private financial sector. UNEP FI works closely with the nearly 200 financial institutions that are Signatories to the UNEP FI Statements, and a range of partner organizations, to develop and promote linkages among the environment, sustainability and financial performance. Through regional activities, a comprehensive work programme, training activities and research, UNEP FI carries out its mission to identify, promote and realise the adoption of best environmental and sustainability practices at all levels of financial institution operations.

About the Biodiversity and Ecosystems Workstream (BEWS)

The Biodiversity and Ecosystems Workstream is based on the need to engage the financial services sector in identifying and addressing the challenges arising from the loss of biodiversity and the degradation of ecosystem services.

About the Climate Change Working Group (CCWG)

The Climate Change Working Group is a global platform of financial institutions – lenders, investors and insurers – that collaborate to understand the implications of climate change on financial performance and the roles of the finance sector in addressing climate change, as well as to advance the integration of climate change factors – both risks and opportunities – into financial decision-making.

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