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REDDy SET GROW

Executive Summary

Part 1

A briefing for financial institutions

Opportunities and roles for financial institutions in forest carbon markets

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

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1 Executive summary

A 50% reduction in deforestation is needed by 2020 if the forestry sector is to support, rather than undermine, global efforts aimed at holding global temperature rise below 2 degrees Celsius, the global climate target that the world's governments have set themselves in the international climate change agreements of the UNFCCC[1].

Previous research suggests that slowing down, and ultimately even reversing, emissions from forestry activities requires a combination of three distinct approaches: **(i)** withdrawing the current drivers of deforestation, particularly through shifts in the production of agricultural commodities, **(ii)** mobilising investment into the pro-active protection of standing forests, **(iii)** mobilising investment into the creation of new, sustainably-managed forests. The focus of this study is on areas **(ii)** and **(iii)**.

In these two areas, considerable investment is needed to realise the climate change mitigation potential of forests: roughly USD 17-33 billion per year are needed to halve emissions from deforestation by 2030 (Eliasch, 2008); UNEP's Green Economy Initiative comes to the conclusion that annual investment in the order of USD 40 billion is needed to both halve global deforestation by 2030 as well as to increase reforestation and afforestation by 140% by 2050 relative to business as usual. Investment is needed both up-front for capacity building and preparatory work as well as on an ongoing basis for implementation, which entails compensation for opportunity costs as well as the costs of forest protection.

Investment at this scale is unlikely to come from governments alone. Hence active investment from private sector investors is essential, including financial institutions (FIs) and intermediaries of different kinds, particularly for implementation activities. This will depend on making the protection and enhancement of natural forests, and the creation of new forests, a competitive investment opportunity.

The international carbon market offers an avenue for increasing the financial competitiveness of forest protection and creation. While investment in forest-carbon has been limited to date – with an estimate market value of only USD 37 million in 2008 in the regulatory and voluntary markets combined – future investment opportunities in forest-carbon promise to be of great interest to the private sector in general, in particular investors and other financial intermediaries, for a variety of reasons:

1. **Profit:** Aside from traditional forest gains, such as through timber and non-timber forest products, new profits can be made in the sector through the generation and export of carbon credits. In the forest sector this is at present largely limited to voluntary carbon markets which are small in size and weak in prices. The potential is expected to significantly increase, however, if carbon credits from avoided deforestation are recognised in regulatory markets post-2012. At present, only such credits from the creation of new forests (afforestation and reforestation) are tradable on official, regulatory markets.

2. **Diversification:** Forest-based climate mitigation investments can constitute a viable opportunity for risk management by diversifying investors' portfolios, including such portfolios with an exposure to the forestry sector. Forest carbon prices are unlikely to be highly correlated with (for example) pulp or timber prices (at least initially – as there is more competition for limited resources, prices could become increasingly correlated).

3. **Compliance:** Financial institutions or their clients may have emission reduction targets that they need to meet (for example in Kyoto Protocol Annex I countries), or they may expect such targets to be imposed in the future (for example in the case of a number of states in the USA). Investing in forestry can help meet such targets.

4. **Corporate social responsibility (CSR):** Financial institutions or their clients may be interested in demonstrating CSR through a financially competitive investment which, in addition, yields environmental and social returns. Such non-financial returns can be capitalised on via marketing and

1 This target was recently confirmed in the Cancun Agreements 2010

institutional positioning. Forestry projects can have especially interesting characteristics as they often result in a wide variety of significant sustainability benefits alongside reductions in greenhouse gas emissions.

5. **Broader sustainability:** Forestry investments can indirectly lead to the provision of a variety of ecosystem services and sustainability benefits next to emissions reductions. These include enhanced water-cycle management, the retention of valuable soil, and landscape protection. Despite the current lack of systems of payments for ecosystem services and resulting revenue streams, these could lead to additional returns in the future, once such systems are established. The overall market value of payments for water-related ecosystem services and other ecosystem services were estimated at USD 5.2 and USD 3 billion in 2008, respectively (TEEB, 2010).

Despite the commercial promise of these benefits, activities and investment in forest-based climate change mitigation have to date been slow and modest, especially when compared to other types of emissions reduction efforts. A variety of reasons for this can be identified:

- There is at present no mechanism under the formal international climate change architecture to capitalise on emissions reductions from avoided deforestation. Such activities are possible only on voluntary carbon markets. There is at present no guarantee that such a mechanism will be put in place in the future; although the current UNFCCC agreements specify the set-up of an international REDD+ mechanism, it remains undecided how the implementation of concrete REDD+ activities will be financed and whether the mechanism will be based on a system of tradable credits. Part 2 of this two part series, will make suggestions on such design options of the future international REDD mechanism that will ensure effectiveness in mobilising private finance and investment.
- Despite the fact that the generation and trade of carbon credits from reforestation/afforestation projects is possible under the Clean Development Mechanism (CDM) of the Kyoto Protocol, such projects remain far from being competitive with other types of CDM projects. The carbon sequestered by new forests is not captured permanently as, at some point in the future, forests will cease to exist and will release the carbon back into the atmosphere. The modalities of the CDM address this issue by allowing reforestation and afforestation projects to generate only such carbon credits which are 'temporary' and which need to be replaced by additional credits at predefined points in time. The temporary nature of forestry credits is a clear disadvantage when compared with conventional CDM credits, and the result is a price discount as well as only marginal demand on international carbon markets.
- Trade with forestry credits is banned from the European Emissions Trading Scheme (EU ETS) and other domestic carbon markets, which ultimately alienates reforestation and afforestation projects from the main sources of global demand for CDM-derived offsets.
- Voluntary carbon markets allow activities in the area of avoided deforestation to generate tradable carbon credits, and also address the issue of 'non-permanence' through a system of buffers and insurance rather than through a solution of temporary credits; this makes forestry credits equivalent to and competitive with other types of offsets. The result is that on the voluntary carbon markets forestry credits play a much greater role, relative to other emissions reduction efforts, than in the regulatory markets. Voluntary markets are, however, limited in demand and size and have therefore only mobilised relatively modest volumes of investment into emission reduction activities.
- There has to date been only limited effort in informing and educating relevant commercial actors with potentially important roles in these markets. This Briefing and subsequent activities by UNEP FI address this barrier.
- In addition to broader barriers, investments for both the creation of new forests, and especially the protection of standing forests, are exposed to a variety of distinct and very unique risks; these exacerbate the already challenging risk landscape inherent to such developing countries and emerging economies where most, if not all, opportunities in forest-based mitigation are found.
    - In the domain of policy and political risk, for instance, overall governance risks at the domestic level as well as the general lack of law enforcement, are compounded by the risk that a specific country might not be eligible for the participation in official conservation projects and for the generation of forestry credits. Furthermore, a country may be formally eligible but de facto unable to put in place the operational

frameworks and systems needed, such as credible deforestation baselines and reliable monitoring systems. The most notable international policy risk is underpinned by the uncertainty of whether or not a global agreement on climate change is achieved and a corresponding architecture put in place in time.

- Market risks are significant given the reliance of demand and supply in any regulatory carbon market on public decision-making and intervention. Ad-hoc and unexpected government measures can lead to sudden shifts in demand and supply which are difficult, if not impossible, to hedge against. The result can, especially, consist of a strong downward pressure on forestry credits. In addition to risks that are common to all carbon market activity, there are risk categories which are more specific to projects in the area of reduced deforestation. Projects and efforts in this area may, for instance, perform well at the local level but be unable to generate revenue as a result of failure in the reduction of deforestation levels at regional or even national levels. Other specific risks in the area of reduced deforestation might be associated with the rules for establishing (and possibly updating) national, regional or project-level baselines, the rules for measurement, reporting and verification, international rules for the transfer or use of credits and liabilities for error, fraud or other factors after transfer of credits. There are a wide variety of instruments and approaches that can be considered in order to manage and mitigate different classes risk.

Despite the variety of barriers and risks, and in light especially of the promising business potentials, different types of financial actors around the world - ranging from local commercial lenders, over large diversified financial conglomerates, to mainstream capital market actors and niche insurers - have already started with the commercial implementation of pilot projects in financing, brokering and insuring of forest-based climate change mitigation projects. These are presented in this Briefing and used to portray the variety of generic roles that investors and financial institutions can play in combining financial returns with a wide variety of environmental and social benefits.

REDDy - Set - Grow explained

Part 1: A briefing for financial institutions

This part of the report 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. This will also be useful for policy makers in understanding the approach and needs of financial institutions.

Part 1 will address the following questions:

- **What is 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 been made by financial actors when establishing operations in this space?**
- **What are the risks and barriers that private actors face?**

Part 2: Policy makers

This part of the report provides an assessment of current international regulation and recommendations to national and international policy makers on what the international regime under the United Nations Framework Convention on Climate Change (UNFCCC) needs to deliver to effectively mobilise private finance and investment for forest-based climate change mitigation. This will also be useful for financial institutions in understanding policy design and implementation.

Part 2 will address the following questions:

- **What policy options are most conducive towards effectively financing forest-based climate change mitigation?**
- **How does policy design and implementation reflect on the risks, barriers and issues of forest-based mitigation opportunities as perceived by the private sector?**

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United Nations Environment Programme Finance Initiative (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 organisations, to develop and promote linkages between 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 practice at all levels of financial institution operations.

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