FINANCING FLOWS AND NEEDS TO IMPLEMENT THE NON-LEGALLY BINDING INSTRUMENT

ON ALL TYPES OF FORESTS

prepared for

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EXECUTIVE SUMMARY

The eighth session of the United Nations Forum on Forests (UNFF) will consider “Means of Implementation (MoI) for sustainable forest management.” Given the critical importance of the funding issue for the effective implementation of the Non-Legally Binding Instrument on All Types of Forests (NLBI), the Collaborative Partnership on Forests (CPF), through its Advisory Group on Finance, decided to support substantive preparations for the Ad Hoc Expert Group on finance and UNFF8 through an analytical mapping of needs and available sources and mechanisms for funding, taking into account the recent developments, including in the climate change regime.

ivu41-2.6(2es an.-6)4edndataba.7(4es5.5(4u), .-6)4u9(bsw: Tyaan.-6)ngo4 donor's own strategic priorities. In the case of multilateral financing institutions, the situation is somewhat different as they tend to be more demand-driven than bilateral donors. However, multilateral institutions are also influencing the demand by means of analytical work, awareness-raising among their clients, and development of new services (e.g., financing of global public goods).

ODA's role has proved to be mainly catalytic, and it will critically depend on to what extent national forest programmes (nfp) and associated financing strategies can be incorporated in the national development plans and policies. This has become increasingly important as bilateral donors are presently channeling a significant part of their assistance through budget support and domestic systems and procedures. Stakeholders in the forest sector in the recipient countries have to meet the challenge of clarifying and raising awareness of the potential of forests in the achievement of the national development goals. Only a few countries have apparently been able to do this.

A number of countries which have developed comprehensive forest financing strategies (e.g., Tanzania, Guyana, and Viet Nam) have strongly relied on measures to increase revenue generation from the forest sector as a central element to raise funding for SFM. In national strategies in Latin America, the emphasis is generally given to creation of enabling conditions for private investment and developing new innovative instruments, including payment for environmental services (PES) and specialized funds and credit instruments. Less attention has been paid to smallholders, community forests and SMEs.

Existing External Sources of Forest Financing

The current annual bilateral and multilateral flows to forests are estimated at about USD 1.9 billion and the foreign direct investment (FDI) to forest industries at about USD 0.5 billion. Information on private investment by institutional investors, commercial banks and export credit agencies is not available and neither is it known how much the NGO and philanthropy sector contributes to forest financing. The ODA to forests includes about USD 700 million for forest conservation. In addition, the conservation NGOs and philanthropy focus on this thematic area.

In 2000-2007 the combined bilateral and multilateral financing flows have increased by almost 50%, which has partly been a result of increasing engagement of the multilateral sources, as their s,1r other low income group received another 39%. The rest (43%) was channeled to middle income countries.

Bilateral ODA is also concentrated among recipient countries. In 2006, India absorbed 22% of the total forestry ODA, followed by China (13%) and Viet Nam (12%). Together with Indonesia, Cameroon, Tanzania, Bolivia, Brazil, Colombia and Honduras, these ten countries received two thirds of the total forestry ODA, which is therefore fairly highly concentrated.

Although the traditional forestry ODA in the future might not significantly increase or could even decline in some donor countries, funding through new instruments and various international and regional initiatives is likely to increase in the future, probably significantly. A higher proportion of the ODA may also be channeled through multilateral institutions in line with the recent trend. The increased funding will most likely be linked to the broader climate change and conservation agenda. Funding flows through new instruments and approaches are likely to benefit middle income countries more than low income countries. Maintenance of the focus on the least developed countries will therefore be a challenge as many of them are lacking preconditions for effective aid and other external financial flows.

Multilateral Sources

Multilateral financing to forests is estimated at USD 0.8 billion per year in 2005-2007. The main source is the World Bank (WB) Group, and its share in the total has increased from 51% to 73% in 2000-2007. More than half (55%) of the Bank's financing to forests has come from the International Finance Corporation (IFC) in the form of equity and credit to private sector enterprises. GEF's share has been declining, from 31% to 14% during the last six years. Among the regional development banks, the African Development Bank (AfDB) has been the largest source of forest funding (9% of the total multilateral flows). The Asian Development Bank (AsDB) and the Inter-American Development Bank (IADB) have been marginal sources during this decade, while in the 1990s their role was more substantial. ITTO's contribution was 5% in 2001 but it has dropped to 2%.

The other multilateral sources have a volume-wise limited but strategically important role for contributing to financing of SFM. FAO's programmes amount to about USD 48 million/year, including the National Forest Programme Facility. Since its inception in 2002, the Facility has supported stakeholders in 42 countries with grants totaling USD 6 million. The Global Mechanism (GM) of the UNCCD attempts to mobilize funding for sustainable land management in which forest interventions can be important.

Private Sector Investments

There is no systematic information available on the domestic or private foreign direct investment in the forestry sector in developing countries. There is, however, a common view that the bulk of forestry investment is from domestic sources by the formal private sector and by communities, landowners and farmers.

Foreign-induced investment is substantially higher than the recorded foreign direct investment (FDI) flows (USD 0.5 billion per year in 2003-05), as local financing of foreign-owned investment projects is common. The FDI stocks in the wood and paper industries in developing countries have increased rapidly, reaching USD 17.8 billion in 2005. Another recent important trend is FDI made by developing country investors in other developing countries. A significant increase in foreign private financing in developing countries is foreseen in planted forests and downstream industrial processing. Plantation investments are partly made by Timberland Investment Management Organizations (TIMOs), as their risk-averse institutional investors have started to appreciate high expected returns and improved country-level investment climates.

The key issue in private sector financing is to ensure that investments are not made into illegal and unsustainable operations. A growing share of forest industry corporations exporting to environmentally sensitive mark biodiversity conservation, poverty reduction and climate change adaptation could also be enhanced. Through carbon revenue, prospects for the economic viability of SFM in developing countries are expected to substantially improve as at least part of the ecosystem services that forests provide could be remunerated.

REDD compensation as a win-win instrument is being increasingly supported by practically all stakeholders for a variety of reasons. For tropical country governments REDD can represent an mitigation and adaptation, which is particularly relevant in the forestry sector due to its diverse opportunities to contribute to the regulatory framework, market creation and promotion, engagement of suppliers, lack of technical and business management capacities among forest communities and landowners, etc. Payment schemes may therefore have to rely on domestic public sector funding and international support, but in the long run the prospects for market-based solutions appear bright if policy and legal issues can be addressed.

Support is needed to generate (i) realistic understanding of the possibilities of PES schemes, (ii) necessary preconditions for their effective implementation, and (iii) needs for financing of upfront investments in capacity building, information systems, and setting up of appropriate voluntary and regulatory payment mechanisms with intended equity impacts. There are also sovereignty issues to be addressed.

Other Emerging Instruments of Forest Financing

A range of new instruments is being developed to complement the menu of traditional lending and equity investment in the forest sector. These include (i) eco-securitization and forest-backed bonds, (ii) forest insurance and re-insurance, (iii) application of sustainability safeguards, and (iv) corporate-smallholder/community partnerships. These address some constraints, such as upfront financing of long-term forest investments (particularly plantations), and risk management against natural disasters. Eco-securitization and insurance are important strategic instruments which would greatly facilitate private sector investment in forestry but with a few exceptions; they are still at development stage and often need external support.

<u>Financing Needs and Gap Analysis</u>

Due to great variation in local conditions, estimating financing needs for implementing sustainable forest management is difficult. The most comprehensive effort to assess financing needs for the forestry sector has probably been carried out by UNFCCC (2007) which concluded with the following indicative estimates for developing countries:

USD / billion/(ti31(s)-321sc0,s)67TD( )TTebo.9510.02 0 3.64fBTTm

Many low forest cover countries do not receive substantial external support in managing and conserving their forests or tree resources. Many small or medium-sized countries with still relatively large forests have only limited external support. A number of developing countries with high deforestation rates (above 1%/year) have significant donor presence, but there are a number of them where external support is absent or limited (e.g., Comoros, Mauritania, El Salvador, and Myanmar). Many countries with high or medium forest cover (above 40%) have only limited presence of external financing agencies (e.g., Angola, Congo Rep., Equatorial Guinea, the Democratic Republic of Korea, Gambia, Guinea-Bissau, East Timor, and Trinidad & Tobago). With a few exceptions, small island countries do not receive any support to forests, although their importance in maintenance of biodiversity, watershed protection and adaptation to climate change are often critical.

Some of these gaps are presumably partly explained by political reasons and partly by weak governance which does not allow effective participation of external bilateral and multilateral funding agencies in a complex natural resource sector like forestry, often characterized by strong vested interests resisting any pressures for policy and institutional reforms.

On the other hand, there are a number of countries where external funding sources have a particularly strong presence, such as Indonesia, Brazil, Viet Nam, Kenya and Ethiopia.

Private foreign financing through plantation investments has gone to a small number of countries in Latin America and Asia. Foreign investments in natural forest management are concentrated to gradually self-financing. In order to achieve this goal, new instruments require substantial initial upfront investment to develop and pilot suitable modalities in specific country conditions.

Required investments in areas that are central to SFM implementation (including new instruments like REDD and other PES schemes) include, e.g.:

(i) Implementation of measures to shift agribusiness companies and landowners away from clearing of rain forests towards planting on non-forest lands, including improvement of agricultural productivity
(ii) SFM-based production of timber and non-timber forest products
(iii) Establishment and effective implementation of adequate forest ownership/use rights for communities, smallholders and forest dwellers
(iv) Land-use zoning and planning in forest areas
(v) Complementary investments in non-forest sector programs (agriculture, transportation, mining, energy, etc.) to ensure adequate forest protection
(vi) Building institutional, legal and technical capacities of governments and private and communal forest stakeholders
(vii) Improving forest governance and forest sector transparency and control
(viii) Restoration of degraded forest ecosystems and plantations
(ix) Improvement and restructuring of forest-based industries
(x) Rural development, social services, and infrastructure, as well as administration and management skills of forest communities
(xi) Development of innovations and research
(xii) Implementation of market-based and other voluntary mechanisms
(xiii) Protection of forests against fires, pests, diseases, and other external threats

Investment Potential

A qualitative attempt to characterize investment potential in developing countries is given below**.**

sensitive, technically complex and resource-demanding. Implementation tends to be slow, even within an adequate legislation, if the relevant administration cannot be effectively mobilized to implement the will of legislators. This has be

Building up the necessary country capacity would also require additional investment which the current and emerging instruments are not yet sufficiently addressing. For forest actors and other stakeholders as recipients, access to funding sources and transaction costs are crucial. The currently available funding sources have not adequately considered this, as their design is usually driven by internal priorities and procedures.

There is an urgent need to improve transparency of external forest (and related) financing from all sources to developing countries. This has been long overdue and has contributed to the slow progress in reaching a consensus on options to mobilize “new and additional” financial resources for SFM.

Strengthening of International Financing for SFM

There exists a rapidly evolving forest-related financing architecture at the international level, which is partly specifically targeted at sustainable forest management and partly at enhancing the contribution of forests to climate change mitigation and conservation of biological diversity. The ‘portfolio approach’ for forest financing therefor built up to make full use of the increasingly diversified and complex external and internal funding instruments for forests.

The world's forests are a multi-functional natural resource which, when managed sustainably, can meet the various needs of society in spatial and temporal terms (i.e., local, national, global as well as present and future generations). To maintain and enhance the goods and services provided by forests, international, national and local level action to implement the global commitment to SFM as expressed in the NLBI is paramount. It is equally important that appropriate means of implementation, especially financial resources, for sustainable forest management and thus for the NLBI implementation are made available. Further clarity on how this can be achieved is urgently needed in order to make progress on the ground.