DRAFT DISCUSSION PAPER

FINANCING FLOWS: Needs, Gaps and an Approach for Addressing Country-Level Financing Challenges for SFM

This Draft Discussion Paper is jointly presented by NFP-Facility and the Program on Forests (PROFOR)

Introduction

Sustainable forest management (SFM) is the stewardship and use of forests and forest lands in a way that maintains their biodiversity, productivity, regeneration capacity, vitality and their potential to fulfill—now and in the future—relevant ecological, economic and social functions, at local, national, and global levels without causing damage to other ecosystems. In simpler terms, the concept can be described as the attainment of balance: balance between society's increasing demands for forest products and benefits, and the preservation of forest health and diversity. This balance is critical to the survival of forests, and to the prosperity of forest-dependent communities.

Financing of SFM has proved to be a complex issue because of the dual nature of forest management. Forest management can generate both global and national/local public goods and private profit at the same time (the former from forest-based services such as biodiversity or climate change mitigation and the latter from timber and non-timber forest products). This duality is both a challenge and an opportunity for financing of SFM.

This discussion paper is based on 1) the PROFOR-funded study *Financing Flows and Needs to Implement the Non-Legally Binding Instrument on All Types of Forests*-2008, by Markku Simula,.and prepared for the Advisory Group on Finance of the Collaborative Partnership on Forests; and 2) *Cultivating leadership, participation and inter-sectoral dialogue through the development of national forest financing strategies: emerging lessons-2009 Draft,* by Marco Boscolo, Jhony Zapata, Kees van Dijk, and Herman Savenije of FAO.

This note presents a brief overview of funding sources and gaps in forestry and details an approach piloted by the National Forest Programme Facility (NFP Facility) at the country level to support the development of forest financing strategies and instruments. The aim of this note is to inform dialogue on the fourth Global Objective on Forests (GOF4) which calls for reversing the decline in official development assistance for SFM and mobilizing increased new financial resources for its implementation.

Sources of Forest Financing

Forest financing sources are classified into public and private, national and international. Domestic public funding may come from general government revenue and revenue from state-owned forests. Private sources consist of forest owners, communities and forest industry, philanthropic funds and donors, as well as non-governmental organizations (NGOs) of various types. In the case of many NGOs, funds are raised from external sources. International public sources include bilateral aid agencies and multilateral financing institutions. Private sources are diversified, consisting of institutional and individual investors, the forest industry, various NGOs, etc. Foreign private financing can be direct or portfolio investment and loans or credits.

Demand for Forest ODA in Recipient Countries

Overall, country demand for forest ODA is found to be relatively weak: only two-thirds of the surveyed 43 countries mention forests in their poverty reduction strategies (PRSs), and only 28 percent include a coherent national strategy for forests. Supported actions are typically strategic areas identified by the recipient country within the donor's own strategic priorities. In the case of multilateral financing institutions, the situation is somewhat different because 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 (nfps) and associated financing strategies can be incorporated in the national development plans and policies. This has become increasingly important because 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 that have developed comprehensive forest financing strategies (e.g., Guyana, Tanzania, and Vietnam) have strongly relied on measures to increase revenue generation from the forest sector as a central element to raising 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 small and medium-size enterprises (SMEs).

Existing External Sources of Forest Financing

The current annual bilateral and multilateral flows to forests are estimated at about US$1.9 billion and the foreign direct investment (FDI) to forest industries at about US$0.5 billion. The ODA to forests includes about US$700 million for forest conservation. In addition, the conservation NGOs and philanthropy sector focuses on this thematic area.

In 2000–2007, the combined bilateral and multilateral financing flows have increased by almost 50 percent, which has partly been a result of increasing engagement of the multilateral sources as their share of the total external public financing to forests increased from 26 percent to 42 percent during the study period. The multilateral sources accounted for three-quarters of the total absolute increase in the total. However, bilateral ODA has also increased, albeit at a slower rate (15 percent in 2000–2007)[1].

Since 2000, two-thirds of the cumulative forestry ODA has been allocated to Asia, and only 20 percent to Africa and 11 percent to Latin America. Asia's share peaked in 2003, when it reached almost 80 percent of the total. In terms of income level, the least developed countries received 18 percent of the total, and the other low-income group received another

[1] The figures cited should be used with care because the data on external forest financing are incomplete and partly inconsistent.

39 percent. The rest (43 percent) was channeled to middle-income countries.

Bilateral ODA to forests has mainly come from relatively few sources: 95 percent is provided by nine donors (Germany, Japan, the Netherlands, Switzerland, the United Kingdom, and the United States). Japan's share is overwhelming, accounting for 48 percent of the total.

Multilateral financing to forests is estimated at US$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 percent to 73 percent in 2000–2007. More than a half (55 percent) of the World Bank's financing to forests has come from the International Finance Corporation (IFC) in the form of equity and credit to private sector enterprises. The Global Environment Facility's (GEF's) share has been declining from 31 percent to 14 percent during the last six years. Among the regional development banks, the African Development Bank (AfDB) has been the largest source of forest funding (9 percent of the total multilateral flows). The Asian Development Bank (AsDB) and the Inter-American Development Bank (IADB) have been marginal sources during this decade, although their role was more substantial in the 1990s. The International Tropical Timber Organization's (ITTO's) contribution was 5 percent in 2001, but it has dropped to 2 percent.

The other multilateral sources have a volume wise limited—but strategically important—role for contributing to financing of SFM. The Food and Agriculture Organization's (FAO's) programs amount to about US$48 million per year, including the National Forest Programme Facility. Since its inception in 2002, the Facility has supported stakeholders in 42 countries, with grants totaling US$6 million. The Global Mechanism (GM) of the United Nations Convention to Combat Desertification (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.

The total foreign-induced investment is substantially higher than the recorded foreign direct investment (FDI) flows (US$0.5 billion per year in 2003–2005) because 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 US$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 organisations (TIMOs) as their risk-averse institutional investors have started to appreciate high expected returns and improved country-level investment climates.

Timberland and other private investors can make a significant contribution to national measures in enhancing production of forest goods and services and associated trade. They can also have a positive impact on technology transfer and research, governance, and development of human resources. However, only relatively few countries can offer attractive timber-growing conditions, suitable land availability, and adequate investment climate to enable foreign investment to take place.

Appropriate regulation and voluntary measures such as forest certification are needed to mitigate possible negative impacts and to integrate these new actors into the national and local socio-economic framework to maximize mutual benefits.

Emerging Instruments and Mechanisms for Forest Financing

Great expectations have been put forward concerning the development of payments for environmental services as a possible complementary source of funding for SFM. However, these expectations have not yet materialized because the experience in developing countries continues to be limited (mainly in Latin America). From the international perspective, the PES schemes of global public goods from forests (e.g., climate change mitigation and biodiversity) have been seen as the most promising way to raise additional financial flows to SFM in developing countries.

Carbon Offset Markets. The main mandatory market for carbon offsets, the Kyoto Protocol's Clean Development Mechanism (CDM), has endorsed only one forest project for the time being. The current forest carbon portfolio under CDM includes a total of 27 projects with a total amount of credits of about 2 million tons of carbon dioxide (CO_2), suggesting substantial potential demand and supply that has not yet been realized. The voluntary market for carbon credits was US$331 million in 2007, or more than threefold the 2006 level. One-sixth of this market was generated by reforestation and forest conservation projects. In spite of small volumes, there is a significant forest carbon offset demand that cannot be channeled through the regulated market. In the short run, this unregulated market is likely to play a critical role in developing new ways of implementation for forest carbon trading.

Reduced Emissions from Deforestation and Forest Degradation (REDD) Avoiding deforestation would be among the lowest cost mitigation options to avoid increasing CO_2 emissions and possibly also increasing carbon sinks. At the same time, other benefits like biodiversity conservation, poverty reduction, and climate change adaptation could also be enhanced. For tropical country governments, REDD can represent an opening of a new source of financing for national priorities; for donor countries, it can be a low-cost option for carbon offsets; for environmental NGOs, REDD can generate additional resources for biodiversity conservation; for the rural poor, it can mean badly needed income and financial support to community development, as well as a means to improve their forest tenure rights; for the private sector, REDD can be an additional source of funding to make SFM financially viable; for political elites, it's yet another opportunity of income; for multilateral development banks, REDD can open up new ways of doing business in the context of maintenance of global public goods; and for intergovernmental organizations, it offers a new area of intervention in technical assistance and a new funding source.

Meeting such a broad range of varied interests in REDD schemes will be difficult, and several issues need clarification. Some of the issues can be addressed through international regulation, and some through appropriate measures in national REDD strategies. Many concerns are cross-cutting and need to be considered holistically (e.g., in the context of national forest programmes or similar broader strategies). Independently from which approach is applied, there are additional needs for co-financing of complementary activities to ensure that REDD benefits are created in practice, particularly building up country capacity to implement necessary measures to reduce deforestation.

International Climate-Related Forest Initiatives. Several initiatives have been undertaken to advance the implementation of REDD-related activities: The Forest Carbon Partnership Facility (FCPF) of the World Bank will assist developing countries in their efforts to reduce emissions from deforestation and degradation and building capacity for REDD activities. FAO, the United Nations Development Programme (UNDP), and the United Nations Environment Programme (UNEP) have launched a joint UN REDD Programme as a collaborative effort to provide coordinated technical assistance in REDD capacity building to developing countries.

The World Bank Strategic Climate Fund (SCF) will promote international cooperation through new and additional financing for addressing climate change through targeted programs. SCF has a holistic approach to climate change mitigation and adaptation that is particularly relevant in the forestry sector because of its diverse opportunities to contribute to the climate objectives. As a measure to start implementing SCF within a broad approach to mitigation of forest based emissions, enhancement of forest carbon sequestration, and adaptive capacity, the World Bank is currently developing a Forest Investment Program (FIP), which could address the key gaps of SFM financing in the existing and emerging instruments such as REDD schemes. The World Bank Clean Technology Fund (CTF) is promoting scaled-up deployment, diffusion, and transfer of clean technologies. In regard to the forestry sector, investments in bioenergy and improvement of the forest industry's energy efficiency and management fall under the CTF.

The Collaborative Partnership on Forests (CPF) initiative will elaborate a strategic framework for engaging all the key CPF members for improved cooperation and coordination. The International Tropical Timber Organization (ITTO) is planning to develop a thematic program on tropical forests and climate change

Many other international organizations have developed their own responses to climate change mitigation and adaptation through forest measures (e.g., the Center for International Forestry Research [CIFOR] and the International Union of Forest Research Organizations [IUFRO]).

Other Existing and Emerging Instruments of Forest Financing

Climate Related Regional and Country Initiatives The progress made in recognition of the role of avoided deforestation and forest degradation under the UNFCCC has given rise to several donor initiatives and some developing-country governments to provide funding for tropical forest conservation. Examples include the Congo Basin Forest Fund (CBFF) and the Amazon Fund in Brazil. In the developed countries, Australia and Norway (for example) have launched new financing initiatives targeted at REDD and forest conservation. These initiatives, together with the readiness of donors to mobilize new resources for forest financing, and various market-based or fund-based financing schemes, have potential to at least double the current financial flows from the international community to forests in developing countries.

There is a risk that funding will be driven by the sources and not by demand. Overlapping mandates between initiatives are likely to emerge. There is a need for harnessing synergies between new and emerging financing mechanisms addressing forest-related global concerns, particularly those related to climate change. Although harmonization between independent initiatives as an objective may not be realistic and not even appropriate, improved cooperation and coordination are needed, based on comparative advantages and available financial and human resources.

Payments for Forest Environmental Services Other than Carbon Various regulatory, market-based, and other voluntary payment mechanisms for forest environmental services have been introduced over the last decade. They are already a major source of funding in many developed countries for conservation of watershed conservation and biodiversity, but their greatest potential is in developing countries—particularly in climate change mitigation and adaptation. The actual development of market-based PES mechanisms in developing countries has, however, been slow for several reasons; 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.

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.

Financing Needs and Gap Analysis

Because of 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 (Table 1)[2]:

Table 1

	USD billions/year
opportunity costs for REDD	12.2
sustainable forest management costs	8.2
afforestation/reforestation costs	0.1–0.4
Total	**21.0**

Geographic Gap Analysis Most developing countries have some ODA flows to forests, but there are 30 countries where no source has been reported. The highest donor presence is found in South and Southeast Asia. Also Central and South America are relatively well covered by donor participation. Africa as a whole and Western and Central Asia have low levels of country presence by external financing sources. Many low-forest-cover countries do not receive substantial external support in managing and conserving their forests or tree resources. Many small or medium-size countries with still relatively large forests have only limited external support. A number of developing countries with high deforestation rates (above 1 percent per year) have significant

[2] The estimate for afforestation and reforestation (A/R) in Table 1 does not reflect the entire potential of this measure in developing countries because it refers only to lands that are eligible for the CDM (i.e., that were not forest in 1990). The total A/R potential is significantly higher. Notwithstanding the problems related to estimation of financing needs for REDD and SFM, a comparison with the existing financial flows reveals a vast gap in all areas. In addition, the estimates in Table 1 do not consider investments in capacity building of governments, smallholders, communities, and other stakeholders and other upfront investment costs that would be needed to make forest carbon payments work in practice. Furthermore, climate change adaptation in forests would also require additional financing.

donor presence, but there are a number of them where external support is absent or limited (e.g., the Comoros, El Salvador, Mauritania, and Myanmar). Many countries with high or medium forest cover (above 40 percent) have only limited presence of external financing agencies (e.g., Angola, Republic of Congo, Equatorial Guinea, The Gambia, Guinea-Bissau, the Democratic People's Republic of Korea, Timor-Leste, and Trinidad and 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. On the other hand, there are a number of countries where external funding sources have a particularly strong presence, such as Indonesia, Brazil, Ethiopia, Kenya, and Vietnam. 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 in forest- rich areas in the Congo Basin, the Amazon Basin, and Southeast Asia. Foreign-owned industrial capacity is more broadly invested across countries in Asia and Latin America, but Africa is clearly lagging behind.

Thematic Areas A considerable share of forest ODA is allocated to forest conservation that is compatible with the principle of supporting enhancement of global public goods. In relative terms, SFM outside protected areas appears to be substantially less supported by external funding. However, these forests also generate important public goods, but their maintenance is not compensated to forest managers. New PES mechanisms, particularly REDD, have a major potential in providing financing for SFM, particularly forest conservation.

Financing of forest restoration is likely to remain a major gap, particularly in arid and semi-arid regions because of their low competitiveness for production of wood and non-timber forest products (NTFPs) and for PES schemes because of low carbon intensity, but their potential contribution to co-benefits (other aspects of SFM) is often substantial. The upstream investment in policy reforms, capacity building, and other national measures of the NLBI appears grossly insufficient. PES schemes will not remove this constraint because their focus is on payment upon performance of the environmental service.

Private sector financing will be able to take care of most of the investment needs of productive fast growing plantation development in those countries that have a comparative advantage and adequate investment climate. Trade-related initiatives like forest certification and the EU Forest Law Enforcement, Governance, and Trade (FLEGT) will assist producers to internalise SFM costs in product prices, but this process will take time as long as low-cost competition continues from illegally and unsustainably produced products and the market share of certified products remains limited. A whole range of activities are needed to achieve sustained financing of forest management for environmental services and various forest products and services. The long-term scenario should be that these two main income-earning sources could be able to ensure that SFM becomes gradually self-financing. 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 (for example):

- Implementation of measures to shift agribusiness companies and landowners away from clearing of rain forests toward

planting on non-forest lands, including improvement of agricultural productivity
- SFM-based production of timber and non-timber forest products
- Establishment and effective implement-tation of adequate forest ownership/use rights for communities, smallholders, and forest dwellers
- Land-use zoning and planning in forest areas
- Complementary investments in non-forest-sector programs (agriculture, trans-portation, mining, energy, etc.) to ensure adequate forest protection
- Building institutional, legal, and technical capacities of governments and private and communal forest stakeholders
- Improving forest governance and forest sector transparency and control
- Restoration of degraded forest ecosystems and plantations
- Improvement and restructuring of forest-based industries
- Rural development, social services, infrastructure, and administration and management skills of forest communities
- Development of innovations and research
- Implementation of market-based and other voluntary mechanisms
- Protection of forests against fires, pests, diseases, and other external threats.

Country-Level Support to the Development of Forest Financing Strategies and Instruments

Environmental awareness, international conventions and globalization of markets are prompting most countries to manage their forests more sustainably than they have in the past. However, progress is hindered by a lack of suitable financing. Many countries recognize that to address this challenge it is necessary to examine ways to tap into new sources of finance, increase the effectiveness of existing financing mechanisms, and develop innovative ones. The acknowledgement of the role that forests can play in climate change mitigation is also providing new opportunities to finance sustainable forest management.

For several years, FAO, the national forest program Facility and their partners have worked on forest finance at a number of levels. This work has been briefly summarized in Vahanen and Boscolo3. At the national level, one of these activities has been to support countries in the development of national forest financing strategies. Some observations that emerged from a knowledge sharing initiative that encompassed 19 countries in Latin America, provided the basis for the design and implementation of a capacity building process that has been piloted and applied in 6 countries since 2007. The process of supporting countries in the development of forest financing strategies, its initial achievements, and the lessons that are emerging are then described.

Background on country level assessments

Between 2005 and 2007, FAO and the nfp-Facility, in partnership with IUCN-ORMA, CCAD (Central American Commission for Environment and Development), OTCA/ DGIS/GTZ-BMZ, and with support from the Ministry of Agriculture, Nature, and Food Quality of the Netherlands and the German Government carried out a knowledge management and sharing initiative aimed at: (a) producing a comprehensive assessment of the Latin America experience with financing mechanisms, and (b) increasing the capacity of national forest programmes for the participatory development of national strategies

[3] Vahanen T. and M. Boscolo. 2008. FAO support of SFM financing. Pp. 20-24 in Holopainen, J. and W. Marieke (Eds), Financing Sustainable Forest Management. Tropenbos International, Wageningen, The Netherlands.

of forest financing. Latin America was initially chosen for the leadership role it has played in the past decades in the experimentation with innovative financing mechanisms for SFM. The initiative produced a total of 19 country assessments, sub-regional and regional syntheses and numerous workshops. An overall synthesis has been prepared by van Dijk & Savenije (2008)4 whose main findings are summarized in a FAO policy brief5. Some relevant observations are discussed below.

Variability needs diversification. There is much variability among countries in the types of mechanisms adopted or experimented with to support SFM, with some countries emphasizing financing for productive purposes with others focusing on conservation purposes. Overall, diversification in sources and mechanisms was considered desirable and effective to address the variety of situations, purposes and actors that are found within SFM.

Enabling environment is key. Improvements in the enabling environment are a necessary condition to increase financing and its effectiveness. Some challenges are:

- Forest policies exist but often lack visibility and support at the highest government level
- Forest legislation exists but sometimes it restricts the use of new mechanisms such as payments for environmental services
- Institutional structures are often an impediment to the effective use of existing financing (e.g., overlapping and confusing jurisdictions).

The countries that appear to have been more successful at financing certain aspects of SFM are typically characterized by a supportive policy and institutional environment (including clarity of land tenure), alignment with long-term national priorities and commitments; and synergistic incentive packages that combine financing with favorable investment, credit and trade policies. Good governance is essential to an enabling environment. Whether the mechanism is direct payments for environmental services, funds to promote forest conservation and management, or investments, initiatives that are governed by credible and legitimate bodies and decision making processes are generally more effective in achieving the intended results than initiatives that depend on institutions with limited credibility and legitimacy.

Capacity building and knowledge sharing is needed. The need for capacity building remains high. Much of this capacity can be built by facilitating exchanges both within countries (e.g., facilitating dialogue between the forest and financial sector) and across countries. The initiative also identified the need to facilitate consensus building for regional mechanisms, and for selecting priorities for a coordinated implementation of national agendas. It acknowledges the importance of a participatory process approach and the establishment of national and regional communities of practice for knowledge sharing and solutions design

Need for a comprehensive national financing strategies and dialogue. Numerous innovative and traditional mechanisms exist to finance sustainable forest management. Yet, there exists limited systematization and coordination among them. Hence, positive synergies could be created by harmonizing the use of traditional and

[4] Dijk, Kees van & Herman Savenije. 2008. *Hacia estrategias nacionales de financiamiento para el manejo forestal sostenible en América Latina:* Síntesis del estado actual y experiencias de algunos países. Documento de Trabajo sobre Política e Instituciones No. 21. FAO, Roma. Document available in Spanish with English translation forthcoming.

[5] FAO. 2009. *Financing Sustainable Forest Management*.

innovative mechanisms in integrated and broadly supported strategies. Positive synergies can also be created by facilitating an open and creative dialogue between the financing and forest sector to advance SFM and forest sector development. For this to occur, an adequate space needs to be created to promote mutual understanding, prepare joint analysis of the situation, create a shared vision and solve the problem collectively.

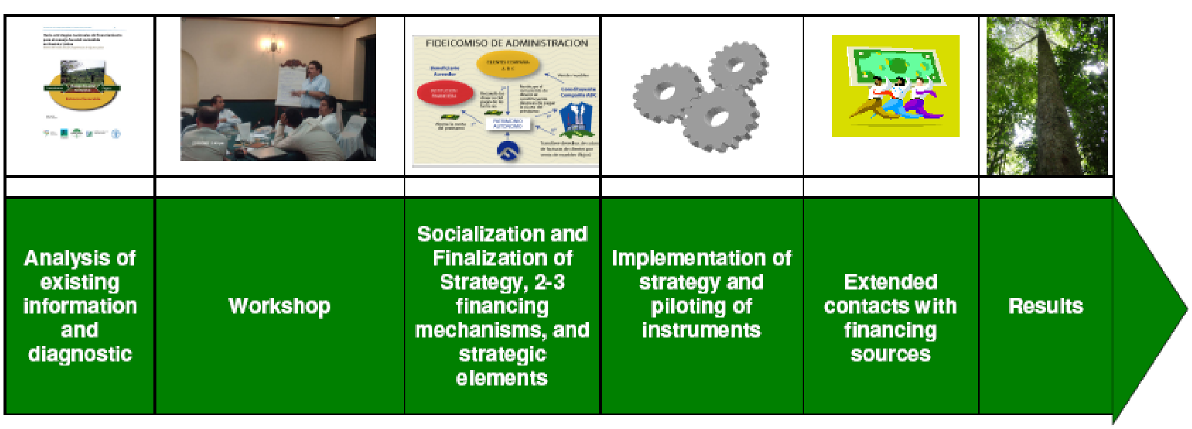
Facilitating Country-Level Leadership, Participation and Inter-Sectoral Dialogue through the Development of Forest Financing Strategies

The observations summarized above have been consolidated into a capacity-building process to support countries in developing and implementing their forest financing strategy and mechanisms. As illustrated in Figure 1, the capacity-building process represents an integrated approach to financing that includes the development of diagnostic assessments, the building of partnerships between the forest and finance sectors, the delivery of capacity-building workshops, the facilitation of follow-up activities, and technical advice in developing new financing instruments.

These processes are bringing together representatives of the forest and financing sector and helped to: (1) Share concepts on sources of financing, investment and market based mechanisms, and the factors/importance of an enabling environment; (2) Illustrate concepts with examples and case studies; (3) Increase mutual understanding among two groups, the forest sector and the financing sector, that have limited knowledge about each other (through sharing of perspectives, views, concerns, hopes); (4) Provide joint problem analysis and solving (how to prioritize, create consensus on strategic elements, create broad based support, etc.) and (5) Initiate a stakeholder process for the development of a forest financing strategy and the development of a few number of financing mechanisms.

Since July 2007, FAO, the nfp Facility, and their partners have used this process to support the development of national forest financing strategies in Namibia, Guatemala, Suriname, El Salvador, Peru and Paraguay. This support has been provided within the framework of national forest programs and tailored to the needs of the countries.

Figure 1. The Capacity Building Process



Selected Country Experiences and Initial Achievements

Guatemala

In Guatemala, a national workshop on forest financing was held in November 2007. The workshop was attended by representatives of the public sector as well as numerous representatives of the private sector, both of the forest industry and of the financial sector (stock exchange, private and public banks).

Participants identified two possible capital market instruments with potential for development in Guatemala: (1) Securitization of forest based cash flows; and (2) Warrants (certificates of deposit). CABI, a local business intelligence organization recently agreed to explore the implementation of an innovative financing instrument in Guatemala as a pilot case and to be compensated only if implementation leads to actual investment.

Participants identified critical bottlenecks in the development of capital market instruments in Guatemala. One such constraint is the availability of economic-financial information needed to properly estimate the value of forest assets and of future forest earnings. Another constraint is the lack of known methodologies in Guatemala to rigorously assess forest investment risks. In April-May 2009, proposals will be evaluated regarding the creation of a Forest Finance Intelligence Unit (*Unidad de Inteligencia Financiera Forestal*) and the hiring of a person in charge of the unit. The unit will provide forest finance information, capacity building opportunities for foresters and finance professionals and facilitate the development of pre-investment initiatives (business cases).

The process also highlighted the fact that key forest stakeholders have negligible influence on important decisions that relate to sector financing (e.g., international financing mechanisms like the Forest Carbon Partnership Facility for which Guatemala is in the process to develop a proposal or r-plan, national government programs like PINFOR, PINPEP and PPAFD that are in the process of being discussed and reformulated, and private instruments). Through an initiative known as the Growing Forest Partnerships (GFP), which was recently launched in Guatemala, working relationships have been strengthened between the national forest programme and the International Union for Conservation of Nature (IUCN), The National Protected Areas Council (CONAP), The Ministry of the Environment (MARN), indigenous organizations (ACOFOP, Utz Che), and others.

Currently, there are three task force groups operating in the country:

(1) Governance and participation group, that is developing concrete proposals to ensure greater participation and influence by forest dependent communities on forest policy issues that relate to financing;
(2) Financing mechanisms group, charged with the task to discuss the design of international and national financing mechanisms; and an
(3) Information and capacity-building group, with the task to ensure that participation by forest dependent community is informed.

Paraguay

A national workshop on forest financing was held in Paraguay in February 2009. Co-organized by 11 different organizations, the workshop was attended by over 100 representatives of the public and private sector, both of the forest industry and of the financial sector. The capacity-building process was initiated against a backdrop of challenging issues (Paraguay has one of highest deforestation rates in South America) but also promising opportunities including a new leadership with INFONA (the National Forest Institute), a supportive private sector, and the fact of having being selected as a pilot country by both the Forest Carbon Partnership Facility and UN-REDD. Paraguay has also received valuable support from various donors to improve its investment climate, most recently by the IADB and the Spanish Government.

The workshop received attention of national level representatives of both public and private sector (two ministers attended the first and last day, along with key decision makers and private sector CEOs), received good media coverage, and offered various presentations on innovative instruments, drawing on both domestic and international experiences.

Some initial achievements include:

- Three financing instruments were identified for development
  - A trust fund (Fideicomiso) that is attractive for private and institutional investors (e.g., pension funds)
  - A capital market instrument (e.g., securitization) to be developed with the Asunción Stock and Commodity Exchange
  - An appropriate credit line through the *Agencia Financiera de Desarrollo* (AFD)
- Initial elements of a financing strategy were identified
- Four task force groups were formed to address information gaps
  - Finance (economics)
  - Legal
  - Technical information
  - Marketing
- A declaration was signed by ministers and key private sector representatives
- A proposal was made to UN-REDD to have two national focal points: the Ministry of the Environment (SEAM) and the National Forest Institute (INFONA)
- A proposal was made to create strong linkages between the UN-REDD Steering Committee (to be formed) and the Steering Committee of the national forest program.

El Salvador

The forest sector of El Salvador has undergone positive changes during the last few years. In 2006 the country elaborated the National Forest Strategy (EFSA) and in 2007, when El Salvador became an nfp Facility partner, support was provided to encourage the active participation of several stakeholders in the implementation of the nfp.

In September 2008, the Facility, together with FAO and other partners, organised a workshop to discuss the national forest financing strategy. The participants, representing the forest and financial sector, identified and agreed upon following priority actions to be undertaken: (i) strengthen the Forestry Commission, which is the advisory board of the Minister of Agriculture in forestry issues, and (ii) develop the national forest financing strategy and three financial instruments (forest bonds, forest trust fund and a forest instrument for the stock market).

The result of this consultation is that the composition of the new Forestry Commission was agreed upon by the main stakeholders and an official request to the governmental authorities for the endorsement of the proposal was done. Furthermore a National Program of Forest Incentives was elaborated with the purpose to strengthen the technical capacities of the forestry department, to provide technical assistance to stakeholders and to reorganize the forest bond.

Several meetings were organized with the management of the stock market of El

Salvador (BVES), the representatives of the financial sector, managers of some important forest enterprises and some farmers and coffee producer groups, resulting in an agreement to further develop a mechanism allowing the insertion of the forest trust fund into the forest mechanism of the stock market.

As another result of the consultation process was that the Minister of Agriculture decided to request US$3.5 million to support this initiative and to strengthen the capacities of forest stakeholders. The Ministry of Agriculture will strengthen the forestry department (DGFCR) with specialized personnel to elaborate financial mechanisms and a Development Plan for the Forestry Sector with the participation of key forest stakeholders, several banks and financial institutions.

Lessons learned

One of the key lessons learned from this country-level work has been the realization that public and/or private funding is often available to finance numerous forest activities. However, the forest sector is often ill-prepared to effectively access these sources of finance. A key limitation is institutional weakness along many dimensions: **Knowledge** of financing language, instruments, and processes; **isolation** from other sectors and from other key stakeholders within the sector; a legacy of **dependence** on public resources, both domestic and international with a focus on limited instruments; and failure to adequately improve the **climate** for investment and market development.

The approach has been to address these weaknesses by working with national forest programs to:

➢**Encourage a strategic approach to finance**. There is a need to help stakeholders think strategically about financing forestry activities through the use of a diversified set of financing sources and instruments to include public and private funds, investment and market mechanisms, and interventions to improve the climate for investment and market development. This strategic approach is helping to reduce excessive reliance on public government programs and overseas development aid.

➢**Facilitate leadership development**. A key approach has been to respond to countries' needs through clear requests for support, and make use of the countries' resources and opportunities first. In developing national forest financing strategies, one of our key approaches has been to capitalize on national stakeholders' resourcefulness, creativity, and ability to find solutions to the challenges they face. This has resulted in a greater sense of ownership, motivation and continuity.

➢**Support partnership building**. Previous experiences have shown that partnerships that go beyond traditional networks generate innovative solutions to forest financing. In the countries where we are working, efforts to attract and actively involve representatives of the financing sector translated into greater clarity of the communication barriers between the two sectors and of the different cultures, methodologies and requirements they operate under. This clarity is facilitating the identification of new ways in which these two sectors can work together effectively. It is also helping the forest sector to better integrate with other development activities and gain greater political and public visibility and recognition.

➢**Build capacity**. The need for capacity building remains high in many countries. Stakeholders need to improve their communication and negotiation skills especially when presenting the opportunities and challenges of forest sector activities to the finance sector. There is a strong learning potential that comes from improved communication across sectors (e.g., forest and financial). There is also a strong potential for developing countries to learn from each other. This potential is currently largely untapped. Flexibility, adaptability and innovation are necessary to take advantage of new opportunities such as carbon finance and new indirect investment and should be enhanced.

➢**Promote financial innovation**. Similarly to what is expressed above about capacity building, there is a large untapped potential for financial innovation that comes from sharing experiences both within and across countries. Payment for environmental services schemes and capital market instruments appear as particularly promising. Successful financing initiatives have benefited from domestic and international support in their start-up phases, both for payments for environmental services (e.g. support from the Global Environmental Facility in Costa Rica) and new investment products (e.g. the bond guarantees in Chile). This support if often needed even when activities are economically viable in the medium-term because the initial costs of developing and implementing these instruments can be high. International support can also aid in the provision of instruments like guarantees and in risk mitigation.

Overall Conclusions

An examination of the financing flows, needs and gaps at both the international and national level provide preliminary indications that there is a need for substantial new and additional funding from all sources to support SFM. There are national and international funding sources that are emerging to support SFM.

Although many new promising mechanisms and sources are emerging, so far there is no serious deliberation to define and develop a SFM-specific funding mechanism or instrument.

That said, the preliminary findings indicate the following:

➢**ODA should play a substantially stronger role** in future forest financing. Increased contributions, including to sectoral aid programmes and policy development lending, would be needed in future forest financing to ensure that the financing gap is not expanding further. National forest programmes provide a useful framework for donor harmonization and in-country coordination of external financial support to forestry.

➢**Market-based mechanisms have significant potential to generate financing** through payments for forest environmental services, but these mechanisms cannot work effectively without a regulatory framework and the government's promotional role. They also need significant upstream investment because their payments are made upon performance. This constraint should be addressed when PES schemes are developed.

➢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 mobilise 'new and additional' financial resources for SFM.

➢There is also a need to **harness synergies between various financing mechanisms** and instruments in climate change, biodiversity, land degradation, and sustainable forest management. In view of the independent nature of various financing bodies and sources and the fact that forests are often just one of the financing windows in many cases, it is unrealistic to assume that the various components of the forest financing 'portfolio' could be forged under a single management structure. However, the current cooperative arrangements should be strengthened.

Investment Needs for Supporting Country Level Financing

There are indications that more financing is likely to be available for those countries where there is effective demand for forest financing and where the national legal and policy framework and governance conditions enable investments by both the public and the private sectors. It is indeed the national-level conditions that will largely define how much external financing will be provided to SFM and associated downstream activities.

Success in raising necessary funding for SFM from private sources will largely depend on (i) the markets for forest goods and services and how forest owners and communities and the other actors in the private sector can be made to invest in sustainable operations and (ii) whether the competitiveness of forests as a land use can be ensured against alternative uses. To achieve this on a country level, there should be a conducive policy environment for SFM, and private sector actors (including smallholders and communities) should have access to adequate funding resources.

Without establishing secure land-tenure and forest-use rights, it is unrealistic to assume that the private sector, local communities, and smallholders will invest in SFM. Changing the investment climate to provide enabling conditions for both private and public investment as a means to fill part of the SFM financing gap requires addressing both extra-sectoral and forest sector constraints. There is a need to assess and monitor national forest sector investment climate to ensure systematic efforts for necessary improvements.

Building up the necessary country capacity would also require additional investment that 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 because their design is usually driven by internal priorities and procedures.

On a country level, enhanced coordination would require integrating instruments such as national forest financing strategies and exchange of information that could be arranged through appropriate arrangements led by governments.

Public and/or private funding is often available to finance numerous forest activities. However, the forest sector is often ill-prepared to effectively access these sources of finance. A key limitation is institutional weakness along many dimensions. Adequate country capacity should be built up to make full use of the increasingly diversified and complex external and internal funding instruments for forests.

Thematic Needs in Financing SFM

The main thematic bottleneck is financing of mainstream upfront investment on all aspects of SFM, while conservation and capacity building are already covered from a variety of sources, albeit not to a required extent. Access to funding of such mainstreamed upfront investment will be critical in developing countries so that they can make progress towards a higher degree of self-financing of SFM. This self-financing as an objective would be based on revenue generated for forest owners and managers from forest goods and services, including payments for global public goods generated by forests, as appropriate in local conditions. In view of the existing and emerging financing flows, major geographic gaps appear to be in low forest- cover countries and least developed countries. These gaps are strategically important because significant opportunities for maintenance and enhancement of global and local public goods from forests remain untapped while the ecosystems of these countries are being degraded. Development of new financing instruments should consider addressing these gaps.

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