August 30, 2012

Response of IDB to United States on the Approval by Mail: Mexico: Financing Low Carbon Strategies in Forest Landscapes (IDB)

Dear Andrea,

On behalf of the Project's team, I am happy to send you the responses to the questions raised by the US on the FIP Project "Financing Low Carbon Strategies in Forest Landscape" for Mexico.

Kind regards,
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FIP Project "Financing Low Carbon Strategies in Forest Landscape" – Mexico

RESPONSES to US QUESTIONS

1. From the documentation, it appears this is a stand-alone project.

a) Is there any co-financing for this project from the IDB?

Yes, co-financing for this project is provided by IDB through a Loan aimed at "Rural Financing in Mexico"-ME-L1055. The loan, executed by *Financiera Rural* (FR), has the objective of increasing investments in projects with high environmental impact, including activities in the Agriculture, Forestry and Land Use (AFOLU) sector. This US$20 million loan is non-concessional and was given under normal IDB ordinary capital conditions. ME-L1055 was the first international external loan acquired by FR. In the preparation of ME-L1055, FIP criteria was taken into account in identifying potential investments. As such, FIP funding was referred in the ME-L1055 loan and its operative guide (annex 3 is dedicated to defining AFOLU projects).

b) If the FIP financing is stand-alone, please explain how FIP financing will leverage additional resources, in line with FIP investment criteria.

As explained above, the project is not a stand-alone, but it is additional to an ongoing IDB project. The Government of Mexico and the IDB have followed relevant FIP guidance, including the guidelines provided by the FIP Investment Criteria and Financing Modalities (June 29, 2010) and by the MDB Project Implementation Services Under SCF's Targeted Programs – Sources of funding and implementation arrangements (Adopted in June 2011). This includes adherence to the principles of

minimum concessionality, avoiding distortion and crowding out, leveraging and financial sustainability.

All FIP projects are interrelated and linked to other operations and programs with significant leveraging potential. This is the third of four interrelated projects included in Mexico´s Forest Investment Plan. These projects are linked to various operations that, combined, provide significant opportunities to scale up investments. In addition, since they are aimed at overcoming barriers to mobilize public and private investment in REDD activities, their aggregate impact is expected to result in additional public and private resources being effectively mobilized.

The financing provided through FR as loans will attempt to address the following issues particular to natural forest landscapes in Mexico and which have been detailed at greater depth in Mexico's Investment Plan:

- Returns for traditional agriculture and livestock are more profitable in the short term due in part to the significant support mechanisms and policies and to their quicker rate of returns.
- More than 70 % of natural forests are owned by collectivities in the form of *ejidos* or communities. These collectives are often deemed to be credit unworthy due to their lack of collateral and financial education and therefore are not attractive to commercial banks.

Specifically, FIP financing will leverage additional resources by:

- Enhancing technical and financial capacity in ejidos, communities and technical assistance providers, extension services and promoters. (This is where the majority of the grants will be used)
- Demonstrating the financial viability of REDD relevant projects using minimum but targeted concessionality.
- Linking this operation to broader FR finance portfolio, which will potentially mobilize additional financing available for the sector towards REDD relevant activities.

2. The amount of concessionality provided would appear to be very high. We would appreciate any information to help us understand the thinking around the calculation of the grant element required to make this investment viable, keeping in mind FIP requirements with respect to tailoring grant elements to the additional cost of the investment to make the investment viable, and catalyzing self-sustaining, economically viable models without the need for continuing subsidies. If a very high degree of concessionality is in fact required, does this undercut the argument that the project is demonstrating a replicable and sustainable approach that will eventually be viable without FIP financing?

Concessionality is not particularly high in this project, especially when considering risk factors associated with rural investments, the exchange rate coverage cost

associated with the loan and the resources directed towards capacity building to address key structural barriers to investment along the investment supply chain. Once these factors are taken into account the concessionality effectively granted to FR or its financial products is not high.

While FR as a national development bank does not look for profitability, it is mandated to preserve its capital in real terms and its legal mandate stresses very clearly the need to preserve financial sustainability. This also implies that i) it cannot offer resources to projects that are deemed financially unviable and ii) it must include an adequate risk premium. Thus, FR carefully analyzes project viability before committing to any investment. Combined with the FIP design principle of minimum concessionality, this provides for an ideal context to produce relevant lessons learned for private sector investments.

As the emphasis of this FIP project is to provide accessible loans to ejidos and comunidades so as to promote the economic viability of low carbon productive activities, the concessionality will be passed down directly to the ejidos through the interest rates offered by FR. FR, as most banks, establishes interest rates based on the cost of capital + risk + administrative costs. FIP concessionality would bring lower rates than FR would normally offer to these projects, and hence develop a credit market for these activities. However, the concessionality is not necessary for the sustainability of the program, as the resulting interest rates at market cost would not elevate substantially the cost as to render the projects unviable (see Cost-Benefit analysis). In any case, they would still be attractive to the alternatives of i) no funding at all and ii) informal credit markets.

It should also be highlighted that CIF resources are transferred in USD or Euros, passing on to the borrowers (in this case Financiera Rural) the cost and the risk related to long term currency exchange rate. This effectively reduces the rate of concessionality awarded.

The loans provided by FR will serve as in incentive to change production patterns in forest landscapes in both forest and non forest activities. The loan concessionality will be minimum, but targeted to those elements that are most critical to create effective incentives for ejidos and comunidades to acquire and use loans to scale up investments in low carbon projects and activities in their communities (such as new methods in agriculture, silvopastoral systems, and traditional forest activities, among others). The concessionality provided will also address the perceived lack of income they will receive while these projects gain the maturity needed to take off. Hence it will serve as a bridge between subsidies and market mechanism. Targeted design features for financial instruments may include terms, rates, collaterals, technical assistance packages, linkage with other support programs.

The activities financed are expected to produce a greater amount of profit than traditional agriculture and livestock production in the longer term. Thus, the concession

will no longer be necessary once the projects become viable and the ejidos and comunidades realize that their profits are sufficient to re-invest at normal commercial rates. Nonetheless, the loan concessionality will provide the tools that are needed for the pilot to take off and address one of the main underlying economic causes of deforestation and forest degradation in Mexico. By proving to be successful it is expected that more financial institutions will enter the market thus providing more competitive financing conditions.

In addition, a significant positive effect in credit worthiness of ejidos and communities is expected from the improvements in technical and financial assistance to design low carbon projects and related investments, which is the purpose of most of the US$5 million grant.

3. The TAF structure appears to be central to the development of viable and financeable proposals. Will TAF expertise and support be required after the project ends in order to ensure the sustainability of the approach demonstrated by this project? If so, is there a plan for who will provide these services after the project ends?

The main purpose of the TAF is not to substitute the role of existing technical and financial agents, but rather, to help them improve their capacity and acquire new skills, accelerating their involvement with low-carbon activities in the rural/forest sector. As such, the TAF is essential for the project, but their role will be less critical in the long term, as new skills are adopted by institutional and private agents and are gradually embedded into formal qualification requirements and service contracts. Forest extension services, including CONAFOR´s promoters, will also be supported by the TAF.

The capacity provided through the TAF is a key aspect in assuring the program's sustainability as it would form a group of FR agents, promoters and service providers with the skills needed to guide future projects. The capacity building directed at promoters, services providers and agents are attractive in their own right as they would provide them with a tool box that assures project viability and further growth while taking into account FIP criteria. Extension services, technical assistance providers, regional promoters of financial services and other relevant agents in the financial product supply chain do exists in various forms across Mexico. The main problem is their limited capacity and lack of expertise in low-carbon investment project design.

4. We would appreciate a better understanding of the use of grant funds to create a pool to collateralize FR lending. Is the use of grant funds as collateral for these loans a viable, replicable strategy in the long-term?

Lack of collateral available is one of the principle factors that exclude ejidos and comunidades from becoming credit worthy. Financial institutions require a ratio of 1:1.5 loan/collateral amount to provide credit. The most common form collateral of used

in Mexico are mortgages on real estate. Nonetheless, according to national legislation the land owned by ejidos and comunidades cannot be used as collateral. As a result, most loans in ejidos and comunidades are provided informally at extremely high monthly interest rates.

As ejidos cannot provide land as collateral, alternative collateral is necessary, including liquid guarantees. These are partial credit guarantees for the repayment to FR in case there is a default on the loan. By developing a liquid collateral fund, producers will be available to use it in order to access credit at competitive rates.

Several design features contribute to the long term sustainability of the liquid collateral fund. These include: (i) it will be used as a revolving fund earmarked by Financiera Rural for the FIP program, thereby ensuring that funds can be re-used by other eligible producers as guarantees are released, (ii) reducing default risk through improvements in the quality of technical and financial assistance, FR project screening, enhancing entrepreneurial and business skills in applicant communities and additional assistance and monitoring provided by FIP projects 1 & 2, (iii) alignment of incentives of *ejidos* and communities towards no-default by only providing partial collateral.

As the liquid collateral fund would cover only part of the amount needed; ejidos would also provide some other collateral (e.g. machinery, selling contracts or solidarity). Local agents and promoters will work with the ejidos and comunidades to identify further potential sources of collateral, in order to reach the 1:1.5 loan/collateral ratio required by FR to structure a loan. These will be specified in the loan regulations and an adequate scheme will be identified depending on each project. In some pertinent cases, agents would also work with the ejidos and comunidades to help them form community enterprises that could provide additional collateral aside from the actual ejido (their office space, warehouses, etc).

Finally, it is important to mention that once the ejidos and comunidades access credit, it would become easier for them to secure new loans as their credit risk would be reduced. In addition, many of them may decide to invest in machinery or other physical assets that could also be used as collateral.

5. If we understand correctly, it appears that FR may make new loans with reflows from loans previously disbursed under the project. Will IDB's supervision extend to the making of these new loans? If not, will new loans made by FR be consistent with FIP criteria, and what mechanisms are in place to ensure that? BID/FINANCIERA

The IDB will monitor during the period of disbursement. This is standard IDB policy. However, FR would be legally responsible to reinvest the proceeds in the same type of projects for the duration of the loan. Although after 5 years from last disbursement it may solicit modifications to the scheme, as long as the objectives are not altered. However, these are legal matters that have yet to be agreed on as the negotiation of the loan has not occurred yet.

It should also be mentioned that FR's mandated objective towards long term rural development is consistent with FIP criteria. As a result, FR has developed an environmental agenda that includes the design of environmental financial products. FR is currently working to diversify its portfolio towards sustainable investments in order to promote integral "sustainable rural investments". In doing so, FR hopes to resolve some of the perverse incentives against environmental protection while assuring profitability to the rural sector.

6. We would appreciate a cost/ton estimate, even though we acknowledge that such estimates may be imprecise.

It is conceptually difficult to make any sense of a cost/ton estimate of a project in isolation in the context of policy changes with multiple co-investments from multiple sources in the same regions and expected multiplier effects through leveraging of additional resources. In this sense, any estimate may be misleading and rely on a high level of assumptions. What we know is that the investments targeted under this project make financial sense from multiple revenue flows, including carbon.

The cost-benefit analysis supporting program design estimates a total direct reduction of 120,422 tons over 10 years for a US$10 million investment. This represents a cost of US$22.6 / tCO_2eq. It must be noted however, that this does not consider additional revenue streams arising from the investments, making the investment profitable at US$5/ tCO_2eq.