

CLIMATE INVESTMENT FUNDS

FIP/SC.3/4
March 2, 2010

Meeting of the FIP Sub-Committee
Manila, Philippines
March 17, 2010

FOREST INVESTMENT PROGRAM: INVESTMENT CRITERIA AND FINANCING MODALITIES

Recommended FIP Sub-Committee Decision

Based on the above, the FIP Sub-Committee is invited to review and approve document FIP/SC.3/4, *FIP Investment Criteria and Financing Modalities*, specifically:

- (a) The objectives, scope, eligibility criteria and approval procedures for FIP investments, including preparation grants (as described in Annex B).
- (b) An MDB fee of 5% of the FIP preparation grant amount and where grants are used in public sector projects.
- (c) Three blending products for public sector activities: grants, contingent loans and concessional loans (on terms described in Box 1, including MDB fees).
- (d) Two guarantee products for public sector activities: loan guarantees and contingent finance (on terms described in Box 2, including MDB fees, and paragraph 26).
- (e) Financing procedures and conditions.
- (f) Private sector financing products and terms will be developed to address specific program barriers and will be presented to the FIP sub-committee for approval at the time of program submission.
- (g) Project management costs for MDB private sector operations would be proposed at the time of program submission and would reflect the tenor and complexity of the program.

Purpose of Document

1. This note details the investment criteria to guide the programming of FIP investments in selected pilots based on priority assessments and the financing modalities for those investments. The basis for these guidelines is the FIP Design Document, specifically chapter VI. *Criteria for FIP Investment Strategies, Programs and Projects* and Annex II *Initial Guidance on How Transformational Change will be Defined and Assessed under the Forest Investment Program*. It should be considered alongside the *FIP Operational Guidelines* which detail the more operational aspects of FIP programming at the country level.

2. The paper also defines the financing products that the multilateral development banks (MDBs) may deploy using FIP resources, the terms for such financing, including fees for MDB project development and supervision costs, and standard FIP co-financing conditions and review procedures. It is proposed that these products, terms and procedures be revised by the FIP Sub-Committee on the basis of actual experience in their application and that the MDBs prepare a report for consideration by the Sub-Committee within 24 months of start-up to identify any changes that would serve to enhance the effectiveness of the FIP.

3. In this context, the note will also identify the role of the public and private sector in FIP investments. Forest and forest landscape management, including the interaction with other sectors, is capital intensive and requires long-term investments. It also involves a concerted effort by the various sources of finance – public and private, be it national or international. Both are not only a potential source of co-finance for leveraging FIP resources but also resources for transformational change in the way they approach the management of forest resources or of natural resources affecting forests.

4. The FIP may also support innovative international financing for forest climate. This would include: a) moving away from traditional project-based aid approach to support national REDD+ strategies and programs (or equivalents); b) financing results-based incentives through performance-based payments based on multi-year contracts for reduced forest-based emissions; c) concessional financing to the private sector for forest rehabilitation and sustainable forest management; and d) grant financing to protect existing stocks of forest carbon.

Role of Public and Private Sector in FIP Investments

5. The public sector plays an important role in the forest sector and those sectors affecting forests as it fulfils three main functions: (a) establishing a policy, regulatory and institutional environment that can support private-sector and public investments; (b) stimulating private-sector investment in sustainable forest and forest landscape management (SFM), re-/afforestation and conservation through grants, tax-relief and subsidized loans; and (c) providing the main source of finance for forestry activities that produce social and environmental benefits.

6. Private sector investments in forest and natural resource operations as well as forest-based industries dwarf the combined flows from multilateral development banks, bilateral agencies, civil society organizations, and charities. Currently, it is estimated that the private sector accounts for about 80-90 percent of financing for forestry, with small and medium scale businesses forming the overwhelming majority of forest-related enterprises in developing countries.

7. The FIP's role in initiating transformational changes in the forest and other sectors affecting forest ecosystems is primarily catalytic in terms of shifting countries from the business-as-usual of how forests are managed to a sustainable low-carbon growth path with multiple co-benefits. It is crucial that FIP investments directly respond to country priorities identified in REDD+ strategies and action plans (or equivalents). Forest management is capital intensive and a long-term investment. Mechanisms channeling finance for forestry and related sectors have diversified considerably and become more innovative over the past few years by introducing concepts such as payment for environmental services, performance-based payments or carbon credits linked to the emerging carbon market.

8. Most barriers to sustainable forest management are linked to a non-conducive enabling environment manifested in policy, legal and institutional arrangements. The short-term economic gains from unsustainable forest management practices and conversions of forest land to other land uses currently outweigh the investment returns from sustainable practices. Incentives supporting a long-term sustainable forest management regime need to be put in place. These enabling activities are in the domain of the public sector.

9. Well-targeted support from the FIP can also help to reduce investment risks and market barriers for responsible private operators in regions or countries where national enforcement capacity is weak by addressing forest governance, transparency, land tenure and complex social and environmental challenges which are beyond the capacity or appropriate role of such private operators. There are also significant opportunities for the FIP to help leverage environmentally and socially sustainable private sector investment in climate relevant operations, such as afforestation, reforestation, and restoration of degraded landscapes, conservation and sustainable natural forest management. FIP funding can be instrumental in supporting sound agro-business and bio-energy investments which are climate friendly and socially acceptable by providing incentives for stabilizing forest margins, supporting best practice examples of sustainable management through involvement of local populations, and by supporting mutually beneficial company supplier partnerships with forest smallholders. In addition, FIP investment to the private sector can promote sustainable market chains for wood and non-wood products; support the country-wide establishment and implementation of a certification scheme for wood and non-wood products; support country and region-specific environmental management and land use planning promote payment schemes for ecosystem services for create viable partnerships between the private sector and local

communities such as eco-tourism in forest protected areas; and support forest-relevant processing industries with low-carbon technologies.

FIP Investment Criteria

10. Financing from the FIP will be provided on the basis of an Investment Strategy, developed under the leadership of the recipient country in coordination with the MDBs, for the use of FIP resources in the country through a joint MDB program. The Investment Strategy should highlight how it is embedded in national development plans and REDD+ strategies and action plans or any equivalent framework that include low carbon objectives from natural resources management. The Investment Strategy will include a potential project pipeline and associated notional resources envelop.

11. Country requests for FIP investments will have to make the case for initiating transformational change by highlighting activities that are additional to the business-as-usual scenario and result in sector- and cross-sector wide impact related to GHG savings. Investment Strategies¹ as well as projects and programs supported under it would need to describe what and how activities will result in significantly reduced GHG emissions or enhanced carbon sequestration that would not have occurred or are significantly enhanced had it not been for the FIP investment.

12. The following criteria are based on the initial guidance provided in the *FIP Design Document* as to what constitutes transformational change in the context of FIP and the need for proof of going beyond business-as-usual. The criteria are complemented by more detailed information on ways to review a proposed investment strategy, program or project. These criteria are consistent with the FIP Design Document (see annex 1):

- (a) Climate change mitigation potential.
- (b) Demonstration potential at scale.
- (c) Cost-effectiveness.
- (d) Implementation potential.
- (e) Integrating sustainable development (co-benefits).
- (f) Safeguards.

13. The FIP will focus on high abatement opportunities at the country level and address the country-specific key barriers to address REDD+.

Climate change mitigation potential.

14. The FIP was established to “catalyze policies and measures ... to facilitate the reduction of deforestation and of forest degradation ..., leading to emission reductions and the protection of forest carbon stocks” (paragraph 7, *FIP Design Document*). Each proposal for FIP funding will provide an assessment of the direct GHG savings over the lifetime of the proposed project/program. Emission reductions and avoidance will be calculated by subtracting projected lifetime emissions of the FIP-financed project from

¹ See FIP/SC.3/3, *FIP Operational Guidelines*

the projected lifetime emissions of the business-as-usual using a clearly-articulated reference level (baseline).

Demonstration Potential at Scale

15. Investment Strategies, programs and projects should support replicable pilot programs in order to demonstrate how to scale up public, private and other resources and activities so as to achieve transformational change.
16. FIP investments should address REDD+ priorities as presented in national REDD+ strategies or action plans (or equivalents). This indicator will help ensure that FIP investments address the main drivers of deforestation and forest degradation.
17. The demonstration of scale of project and program proposals will be based on information on the area targeted by FIP investments compared to the total area affected by forest degradation and deforestation. Each proposal will provide information on the direct or indirect contribution of the FIP investment to the forest and forest landscape area conserved, restored, sustainably managed, protected, or afforested/reforested.
18. Each project and program should include information on relevant existing good practices which have potential to be scaled up through the FIP investment.
19. A core set of indicators will be applied to FIP investments which are consistent with the FIP results framework.

Cost-effectiveness

20. FIP investment strategies, programs and projects should catalyze self-sustaining financially profitable models for REDD+ at scale without the need for continuing subsidies. Each project and program should include information on how achieved results will be sustained after completion of the FIP investment, including measures that generate positive incentives and reverse problematic incentives across sectors and lead to lasting change.
21. Each project and program, where appropriate, will include a calculation of the costs per ton of CO₂eq reduced or avoided.
22. FIP investments should leverage additional financial resources, including from the private sector. It is expected that both public and private sector institutions will be involved in the development and implementation of an Investment Strategy and related projects and programs. Projects and programs should provide information on the public and private sector institutions potentially involved in the implementation of the Investment Strategy, projects and programs, including the anticipated ratio of FIP co-financing to leveraged additional financial resources. The ratio of private to FIP funds

actually invested should reflect substantial leverage (target at least 4:1), in circumstances where private sector investment is relevant.

23. In addition to the above listed cost-effectiveness considerations of FIP co-financed investments, proposals should confirm that the investment falls within the REDD+ national strategies or action plans (or equivalents), including, where appropriate, REDD+ readiness plans.

Implementation Potential

24. FIP investment proposals will be reviewed for dimensions closely related to successful implementation, consistent with MDB standards:

25. Public policies and institutions should support REDD+ principles and efforts, demonstrated through:

(a) *Country and sector strategies*: Key policy, institutional and other issues relevant to achievement of REDD+ objectives should be addressed. FIP investment strategies, programs and projects should capitalize on the lessons learned concerning inclusive and effective improvements in governance and enhancement of law enforcement in other environmental sectors. FIP investments should support such improvements as an integral part of necessary measures and policies to ensure forest related climate change outcomes. Forest governance criteria and indicators should be integrated into project and program design as well as into performance assessments to ensure measurable outcomes.

(b) *Institutional and implementation arrangements*: Institutions responsible for implementation should be identified, together with a description of their capacity to support REDD+ objectives. Required capacity building should be identified and funded.

(c) *Sustainability*: Evidence of commitment to, and ownership of, project and relevant policies, as well as arrangements for long term continuation of initiated activities, including conflict resolution measures.

26. While an Investment Strategy should provide information on the status of the enabling environment for REDD+ (public policy, regulatory framework and institutions), projects and programs should describe how they will address identified barriers and related needs, including the creation of a cross-sectoral coordination mechanisms to deliver on REDD+ and to integrate the role of forests into national sustainable development strategies.

27. A key objective of the FIP is to mobilize resources at scale for the implementation of REDD+ activities. Investment proposals should be prioritized on the basis of the co-financing leveraged from domestic public and private sector sources, including carbon finance, as well as bilateral and multilateral development partners.

28. Consistent with MDB policies and procedures, projects and programs will present risks associated with the proposed FIP investment and proposed mitigation measures.

Integrating sustainable development (co-benefits)

29. A key objective of the FIP is to contribute to the livelihoods and human development of forest dependent communities, including indigenous peoples and local communities, and to generate co-benefits to sustain biodiversity and ecosystem services and enhance the adaptive capacity of forest ecosystems and forest dependent communities.

30. The potential development impacts of projects and programs will be assessed consistent with standard MDB appraisal criteria. To monitor and evaluate the contribution of projects and programs to sustainable development, a core set of indicators will be applied to FIP investments which are consistent with the FIP results framework.

31. Investment strategies, projects and programs will need to demonstrate economic, social and environmental impacts from FIP investments and demonstrate consistency with relevant national strategies and plans. Proposals should set out how FIP investment will catalyze, support and measure and monitor the delivery of, *inter alia*, the following (as appropriate):

- a) Demonstrable improvement in social and economic well-being of forest dependent communities, including poverty reduction, job generation, wealth creation, equitable benefit sharing, and acknowledgement of the rights and role of indigenous peoples and local communities.
- b) Protection and enhancement of biodiversity.
- c) Strengthened resilience of ecosystems, with associated ecosystem services.

32. The Investment Strategy should detail the inclusion of activities to be financed through the *Dedicated Grant Mechanism for Indigenous Peoples and Local Communities* and how coordination between projects and programs and the Mechanism will be ensured.

Safeguards

33. Consistent with its objectives, the FIP should safeguard natural forests and should not support the conversion, deforestation or degradation of such forests, *inter alia*, through industrial logging, conversion of natural forests to tree plantations or other large-scale agricultural conversion. In particular, the FIP should safeguard high conservation value forests (paragraph 16(g), *FIP Design Document*).

34. Consistent with relevant international instruments, obligations and domestic laws, FIP investment strategies, programs and projects should be designed and implemented under a process of public consultation, with full and effective participation of all relevant stakeholders on matters that affect their distinctive rights, including in particular groups that historically have tended to be marginalized such as indigenous peoples, local communities and women.

35. FIP financed activities should, moreover, be consistent with, and/or complement, national sustainable development plans and be based upon broad community support and effective collaboration between indigenous peoples and local communities, government ministries, private sector and financial institutions in planning and implementing investment strategies.

36. MDBs should provide detailed information on applied safeguards to each project and program.

Additional Project-specific Criteria

37. In addition to the above criteria that are focused more on assessing proposed FIP investments against their potential for initiating transformational impact, additional criteria may clarify and help guide the design of FIP public and private sector programs and projects. Public and private sector projects may be assessed against how they will mitigate market distortions.

38. In addition, private sector projects may be assessed how effective they will utilize concessional finance.

Financing Modalities

39. A number of financing products will be available under the FIP, all of which will include a grant element tailored to the identifiable additional cost of the investment, or the risk premium required, in order to make the investment viable. These products could include concessional finance in the form of grants, and contingent and concessional loans with a significant grant element, guarantees² as well as equity, or a combination of these. The grant element will be tailored to provide the appropriate incentive to facilitate the scaled up deployment of forestry investments or investments positively impacting forest ecosystems.

40. It will be important to ensure that concessional terms do not displace investments that might have taken place anyway using commercial or standard MDB borrowing or guarantees, or carbon finance. Contingent and concessional forms of finance need to be designed to minimize market distortions and potential disincentives to long-run private investment.

41. A key feature of the FIP will be its ability to provide the MDBs with the instruments to blend FIP resources with other sources of financing to tailor terms to a target level of concessionality, which will vary depending on project-specific factors. As noted in the Development Sub-Committee paper *Strengthening the World Bank's Engagement with IBRD Countries* (2006), while multilateral development banks would be ready to provide additional lending for projects and programs related to the MDGs and global public goods (such as climate change mitigation activities), governments are reluctant to borrow

² The actual term of the debt would be determined by the lenders who are expected to take into account the guarantee while determining the debt terms.

on non-concessional terms for projects and programs that generate little additional revenue. Concessional forms of finance could help unlock demand for the financing of such projects and programs. Blending FIP resources and multilateral development bank loans could augment the volume of financing available, and better tailor concessionality to needs, with the degree of concessionality calibrated to achieve transformative investments which would otherwise not proceed.

42. It is proposed that the FIP provide the multilateral development banks (MDBs) with a menu of blending options to accommodate different needs of client countries and program interventions. The FIP could co-finance MDB non-concessional loans or provide additional financing of new components within ongoing investment lending operations, on concessional terms. Resources from the FIP would thereby increase the concessionality of the overall financing for the project. The development of such co-financing arrangements can be done in a relatively low-cost manner when fully embedded in the project preparation and supervision process.

43. Co-financing from the FIP may be provided through a variety of financing instruments utilized by the MDBs for investment lending. For example, in the World Bank, these would include Specific Investment Loans, Adaptable Program Loans, and Financial Intermediary Loans, as well as risk mitigation instruments, such as partial risk and credit guarantees. For the purpose of clarification and taking into account the particularities of the engagement with the private sector, the presentation FIP finance products will distinguish between public and private sector finance products.

Financing Modalities for Public Sector Involvement

Grants

44. Grants may be used for:

- (a) Preparation of FIP investment strategies, where needed.
- (b) Preparation of FIP co-financed projects.
- (c) Capacity development activities and activities related to policy and regulatory frameworks in the context of mitigating risks for future investments (especially in IDA countries).
- (d) Grants for FIP investment projects or programs.
- (e) Grant mechanisms for indigenous peoples and local communities.

Care should be taken not to overlap or duplicate support but rather complement what is available from related programs such as UN-REDD or the Forest Carbon Partnership Facility.

45. *Preparation of Investment Strategies:* Since investment strategies will build on existing country strategies and programs, including REDD+ strategies (where available), it is expected that such grants will be used primarily for project and program preparation

and less for the preparation of the FIS. In countries lacking an adequate basis for preparing investment strategies, the FIP may provide financing for such plans. Such grants can be used to finance:

- (a) strengthening consensus among key national stakeholders;
- (b) ensuring that FIP investments are based on sound analytical work linking forest sector investments to economic growth and poverty-alleviation strategies; and
- (c) assessing the poverty and social impacts of programs and projects.

46. The maximum total FIP preparation grant for an investment strategy will be US\$250,000. The request for a preparation grant for the Investment Strategy will be submitted together with the TOR for the Joint Mission. The MDB Committee will review and approve the TOR and request for the preparation grant. This preparation grant should be recipient country-executed.

47. *Project preparation grants:* The purpose of FIP project preparation grants is to develop a quality investment project or program by financing feasibility studies and associated analytical and design tasks. These grants could also support project or program preparation-related consultations, workshops and training.

48. No cap will be set for a FIP preparation grant for projects and programs. Funds for project preparation grants would be included within the envelope requested for the Investment Strategy. Proposals for project preparation grants should be included in the Investment Strategy, and the FIP Sub-Committee would be requested to approve the requested funding when it endorses the Investment Strategy. It is proposed that the MDB would receive a fee equal to 5% of the preparation grant for the MDB's costs of administering and supervising individual preparation grants. The same concept will be applied to covering the costs of the MDB for implementing a project; hence the MDB would receive a fee of equal to 5% of the total funding of the project. Guidelines for the approval and management of FIP preparation grants are attached as Annex B.

49. *Capacity building:* Grants can also be used to support capacity development and policy analysis/formulation for forest and climate issues, especially where public sector financing would not normally be available. The need for capacity building is likely to be the greatest in low income countries.

50. *Dedicated Grant Mechanism for Indigenous People and Local Communities:* Grants will also be provided through the Dedicated Grant Mechanism for Indigenous People and Local Communities that is described in the FIP Design Document and detailed in upcoming guidelines.

51. *Grants for FIP investment projects or programs:* Grant financing could also be considered for project components with very high additional costs that constitute a substantial portion of the total costs or with significant risks, and innovative financing instruments to soften commercial and/or MDB lending terms for forestry projects or

programs.³ This would be on a case-by-case basis and considered by the FIP Sub-Committee on the basis of an assessment of the justification for grant financing (including the amount requested) and the availability of grant funding from other sources, such as the GEF.

Blending for Concessional Loans

52. The FIP financing is to fill the investment gap in projects and programs that address the underlying causes of deforestation and forest degradation, with concessionality related to the additional costs and risks of such investment. Concessional lending from the FIP could be used, possibly in combination with revenues from emissions reductions, to make forestry investments financially attractive by improving the internal rates of return on such investments. It is important to note that lending on concessional terms will contain a grant element, which is defined as the difference between the loan's face value and the sum of the present value of debt service to be made by the borrower, expressed as a percentage of the face value of the loan. Care should be taken not to overlap or duplicate concessional financing that is available from other sources such as bilateral donors, other development partners or GEF grants in sustainable forest management.

53. MDBs may provide FIP financing support through: (a) lending to national governments; (b) lending to national governments for on-lending to sub-national entities; or, (c) lending to sub-national entities⁴. The FIP grant or loan will have the same legal ranking as the MDB loan for the project (i.e., if the MDB loan is unsecured, the FIP grant or loan will be unsecured and if the MDB loan is collateralized, the FIP grant or loan would also be collateralized). MDBs' standard appraisal criteria will address credit risk through their assessments of borrower creditworthiness, financial viability, corporate governance, and safeguards against irresponsible borrowing.

54. Consistent with MDBs' standard lending practice, they will not seek any guarantee or security for FIP grants or loans to sovereign governments. If a FIP grant or loan is made to a sub-national entity, the member country will be required to guarantee the grant or loan, where MDB sub-sovereign lending requires such guarantees. Annex A provides further information on measures the MDBs will take to administer loans, particularly with respect to guarantee or security of loans, as well as default provisions.

55. Given the objectives of the FIP to address the costs and risks of scaled-up forestry and forest-relevant investments by pilot countries, it is proposed that the FIP adopt lending terms similar to IDA or Regional Bank's equivalent for its loan operations. Furthermore, given the potential development impacts and environmental co-benefits of

³ For such grants, fees would be determined on a case-by-case basis, not to exceed 5% of the grant amount.

⁴ Sub-national entities would be eligible for support under either the public or the private sector window depending upon the source of complementary multilateral support. FIP financing could also be provided to special purpose vehicles owned either by the private sector or owned in part by the private sector and the government to carry out a project on a limited recourse basis where the resources for the project are derived from government entities. Such entities would be eligible for support under either the public or private sector windows depending upon the source of complementary multilateral support.

the FIP's investments, IDA-like terms should offer the appropriate balance in the concessionality of funding.

56. Therefore, it is proposed that the FIP offer three products for blending with MDB loans on the basis of an analysis in each project of its financial internal rate of return without FIP co-financing:

- (a) Contingent loans, for projects that link FIP up-front investments with performance-based payments with the following contingency criteria:
 - i. if all agreed performance targets are met and validated and contract with payment entity successfully completed, the country would repay the FIP investment over a period of 40 years at 0% interest from those proceeds;
 - ii. if all agreed performance targets are met and validated but contract with payment entity not successfully completed, hence the country does not receive payment for validated performance, the loan would turn into a grant; or
 - iii. If agreed performance targets are not met, the country would need to repay the full loan amount over a period of 20 years at 0% interest.

- (b) Concessional loans, for projects:
 - i. with rates of return near or above normal market threshold, but below risk premium for project type, technology or country; or
 - ii. With rates of return near or above normal market threshold, but where intensified forestry investment will have higher opportunity costs.

- (c) Grants, for projects with:
 - i. Negative rates of return.
 - ii. Rates of return below normal market threshold.

(Note: this might include investments in protected area systems to conserve existing reservoirs of forest carbon and biodiversity)

57. The following concessional loan terms for public sector projects are proposed. It is proposed that the FIP Sub-Committee reviews these terms after experience is gained in developing FIP programs and projects.

Box 1: Proposed Public Sector FIP Loan Terms⁵

FIP Loans	Maturity	Grace Period	Principal Repayments Year 11-20	Principal Repayments Years 20-40	FY09-10 MDB Fee a/	FY09-10 Service Charge b/	Grant Element c/
Contingent loan:							
(a) if all agreed performance targets are met and validated; and performance contract completed	40	10	2%	4%	0.10%	0 %	76%
(b) if all agreed performance targets are met and validated; but performance contract not completed	n/a	n/a	n/a	n/a	0.10%	0%	100%
(c) if agreed performance targets are not met	20	10	2%	4%	0.10%	0 %	60%
Concessional loan	40	10	2%	4%	0.10%	0.10%	75%

58. Consistent with the objective of simplified loan administration procedures and streamlined project processing, it is proposed that the FIP will have uniform financing terms, rather than terms varying by country and/or projects, or each MDB applying different terms. Increasing or decreasing the proportion of FIP concessional financing blended in the overall financing plan would calibrate the grant element to the country, sector and project contexts. For example, a project with relatively high marginal abatement cost could have FIP concessional financing accounting for a higher proportion

⁵ a) The borrower will have two options for payment of MDB fees: (a) a fee of 0.1% of the undisbursed balance of the loan, in which case the fee payments will accrue semi-annually after loan signing, or (b) a fee equivalent to 0.25% of the total loan amount, payable in a single lump sum amount, which may be paid by the borrower out of its own resources or capitalized from the loan proceeds following the effectiveness of the loan. The fees are to be retained by the MDB for its lending and supervision costs. See Annex C for a description of the MDBs' expenses related to project development and implementation.

b) The service charge is charged on the disbursed and outstanding loan balance. Principal and service charge payments accrue semi-annually to the FIP trust fund.

c) Grant element is calculated using the IDA methodology (assumptions: 6.33% discount rate for harder loans; 6.43% discount rate for softer loans; semi-annual repayments; 8-year disbursement period)

of the total financing, while an investment that is lower on the abatement cost curve might merit FIP concessional financing at a lower proportion of the financing package.

Guarantees

59. Guarantee instruments are used to improve conditions for investment in, or lending to, projects by mitigating risks that lenders and investors would not be willing or able to accept. FIP resources may be deployed as guarantees to promote forestry projects and programs which would otherwise fail to attract adequate capital. Proceeds from the FIP may be used to issue such guarantees by the MDBs, in accordance with their policies for determining eligible beneficiaries, eligible forms of investment, maximum tenor and maximum amounts. While guarantee support can be structured flexibly and may take various forms, these guidelines are intended to set generic parameters to guide MDBs in designing proposals which include the use of guarantees and similar risk mitigation mechanisms.

60. For each FIP operation, MDBs will appraise whether risk mitigation instruments could be an efficient and effective means to facilitate the mobilization of debt capital to finance the project, instead of, or in combination with, loan support from the FIP. Risk mitigation instruments should also be considered if the government or sub-national entity is not able to borrow debt on terms required for financial viability or attract financing without support, or if there is a perceived technology risk.

61. For purposes of FIP support, a distinction is required between conventional risks for which adequate mitigation measures are already available and “incremental” risks that are not assumed by sponsors and lenders, despite the appearance of financial viability of the investment. The additional risks of forestry projects can be quantified as the relative variance of a project’s returns, as perceived by the main investors, for a given level of expected return.

- (a) Technical and economic performance risks generally constitute conventional risks because they can be mitigated by the quality of project design and the structure of mutually reinforcing contracts. However, technical and economic performance can also represent risk barriers insofar as they are attributable to the application of commercially viable technologies in new markets. Lack of experience with forestry management and/or conservation options may create risk to project operations that may be reflected in higher rates of return required by sponsors and lenders. Risk mitigation instrument could address increases in operations and maintenance costs above estimates and where the operator has refused to guarantee additional cost coverage because of a new management or conservation technique, or performance below the expected reduction in deforestation or forest degradation resulting in loss in expected revenues from the carbon market.

- (b) Commercial and financial risks such as high transaction costs, small project scale, weaknesses in domestic capital markets, and perceived credit risks are often primary risk barriers at the project level in the specific context of developing countries, contributing to the increased required rates of return or otherwise general unavailability of financing. Such risks are relevant to the application of risk mitigation instruments with FIP resources.
- (c) While country or political risks are more easily differentiated from commercial risks in private sector projects, differentiation of these risks is more difficult for public sector projects and programs, where the project or program will be implemented by the government and its agencies. The FIP would not, therefore, provide “political risk guarantees” in public sector projects to protect lenders against specific political risks. Regulatory and institutional barriers are generally more effectively addressed through support for policy reform, capacity building and technical assistance, or other risk mitigation instruments available in the market as well as from bilateral and multilateral institutions.

62. It is proposed that FIP resources may be deployed for two categories of guarantee products:

- (a) Loan guarantees covering the loss on account of debt service default for lenders up to an agreed portion of the actual loss⁶, with a view to extending maturities of commercial loans for forestry projects so that they are competitive with alternative land uses, or to address specific incremental operating or management risks that could cause default.
- (b) Contingent finance disbursed to the project upon underperformance of a forestry technology and where such risk is not commercially insurable at reasonable costs or has occurred beyond the period for which commercial insurance is available.

63. In both types of guarantees, the borrower may be a sovereign government, sub-national government, state-owned utility, or any other public sector entity which implements the proposed forestry project or program. Guarantees from FIP resources offered to public sector projects will have the following general terms:

⁶ Depending upon the project and market needs, the amount guaranteed could be up to 100%. Some sharing could be useful for providing the right incentives to guarantee holders.

Box 2: Proposed Public Sector FIP Guarantee Terms

	Loan Guarantees	Contingent Finance
Guarantor	MDB will issue the guarantee acting as the Implementing Entity for the FIP (i.e. the guarantee beneficiary's recourse is solely to funds in the FIP).	MDB will be the provider of contingent finance acting as the Implementing Entity for the FIP (i.e. the Contingent Finance provider will provide funding solely from funds in the FIP).
Guarantee Beneficiary	Commercially-run institutions providing debt	Project entity
Guaranteed Debt	Any form of debt instrument (e.g. loans, bonds)	Not applicable
MDB Fee ⁷	0.1% per annum on the undisbursed balance of the guaranteed financing, or 0.25% front-end fee on the guaranteed amount, to cover the MDB's appraisal, negotiation, supervision, disbursement, and reporting costs and any costs associated with restructuring and dispute resolution.	One-time charge of \$200,000, to cover the MDB's appraisal, negotiation, supervision, disbursement, and reporting costs.
Guarantee Charge	0.1 % per annum on the disbursed and outstanding amounts of the guaranteed financing (accrues to the FIP trust fund).	0.1% per annum of the committed and undisbursed balance of the contingent finance (accrues to the FIP trust fund).

64. The following general terms are applicable for both types of guarantees:

Fund management: In order to maintain the creditworthiness of the guarantor in the eyes of commercial financiers, the MDB will retain FIP funds in an amount to match guarantees committed on a one-to-one basis.

Currency of Denomination: US Dollars.⁸

⁷ See Annex B for explanation of the MDBs' project development and supervision costs.

⁸ In the event that an MDB issues a guarantee in another currency, it bears the foreign exchange risk.

Maximum Maturity:	Loan Guarantee term will be consistent with the maturity of the guaranteed debt. The term of the contingent finance will be decided on a case by case basis but not exceeding 20 years.
Minimum Maturity:	No restriction. MDB will ensure that the proposed tenor for either Loan Guarantee or Contingent Finance will make the proposed project or program financially viable and affordable in the given regulatory environment of the country.
Counter-Guarantee:	No requirement for sovereign government indemnity for any Loan Guarantee or Contingent Finance. Credit risk exposure under the FIP financing will be borne by the SCF trust fund.
Cross Default Clause:	There will be an optional cross default clause with MDB loans for the project/program.
Conditions:	Application of standard MDB policies and procedures. This should also ensure that the borrower has in place acceptable warranties and insurance consistent with industry practice.

Financing Modalities for Private Sector Involvement

Grants

65. Grants may be used for:

- a. Market development activities, including but not limited to developing technical expertise, knowledge dissemination and capacity building of project sponsors and strategic market players (e.g. certifiers).
- b. Capital cost buy-downs or performance grants for projects with a strategic / catalytic nature which cannot be better addressed through concessional financing or guarantees (capital cost buy downs would need to demonstrate how the use of FIP funds in this structure could lead to future projects of a similar nature without the need for subsidies).
- c. Implementation and administrative costs.

66. Care would be given not to overlap or duplicate but instead complement activities undertaken in related programs such as public sector FIP activities or activities supported by UN-REDD or the Forest Carbon Partnership Facility.

Concessional Loans and Equity

67. FIP will offer concessional finance and equity products to support private sector projects and programs that have the potential of being replicated in the future without further subsidies. The terms and structures of each financial investment would be

determined on a case by case basis to address the specific barriers identified in each case. These barriers may include:

- a) Perceived risk, either by a project sponsor, a financier or both.
- b) High costs of early entrants (the additional costs associated with being the first player to implement new regulations or work through unprecedented systems; they could also include higher input costs because economies of scale have not been achieved in the market.
- c) Combined risk and cost barriers

68. Examples of projects that could be financed with FIP resources include (not comprehensive):

- a) Lending for new non-traditional practices adoption which may reduce incentives pressures which lead to deforestation - concessionality may be needed to offset the costs of adopting such practices until a track record of costs and benefits can be achieved.
- b) Lending to alternative livelihood projects which can be replicated in scale to reduce deforestation - such projects are likely to be perceived as too high risk for commercial banks to finance; FIP funding could help to develop a track record for such projects until commercial banks enter the market.
- c) “Seed” equity could be provided to catalyze senior investments into a fund which makes FIP eligible investments (e.g. in reforestation or new sustainable harvesting practices) – once the projects have established a performance track record investors should be willing to continue investing without the need for additional seed capital.

Guarantees

69. Guarantees are typically used for the same reasons in the private sector as they are in the public sector, e.g. to address risks and improve the investment conditions for project sponsors. FIP would seek to use guarantees to mitigate risks in the project cycle with the objective of establishing a project performance track record which would then entice future private investment without the need for future subsidies/risk mitigants. For example, guarantees could be used to mitigate the risk and encourage external financiers to provide new financial products for FIP eligible projects (e.g. loans with extended grace periods to support harvesting cycles or first loss investments in a sustainable forestry bond structure; the benefit of guaranteeing commercial financiers is that their positive experiences would have the fastest replication impact, both in terms of scaling up their own financing programs and in eliciting competition among other financiers). The need for guarantees would be established on a case by case basis based on the project fundamentals.

Financing Procedures and Conditions

70. Individual operations under each country's FIP Investment Strategy will be processed through the MDBs selected by the country. Each operation will follow the investment lending policies and procedures of the MDB, including its fiduciary standards and environmental and social safeguards. Each MDB will apply its own appropriate procedures in appraising, approving, supervising, monitoring and evaluating operations to be financed from the FIP.

71. The following requirements will apply to all financing products financed by the FIP:

- (a) Each operation will be approved and administered in accordance with the applicable guidelines of the concerned MDB, which will discharge its responsibilities with the same degree of care as it exercises with respect to its own resources;
- (b) Allocations by the FIP Sub-Committee will be denominated in United States Dollars or Euros. However, MDBs may denominate individual financing provided by them to the beneficiaries according to their own policies and procedures, subject to the MDB assuming any exchange rate risk;
- (c) The MDB will, for purposes of each financing, conclude an agreement with the beneficiary, indicating in particular that the resources have been provided from the FIP;
- (d) Eligible expenditures under individual financing will be determined in accordance with the policies and procedures of the respective MDBs;
- (e) The design and implementation of activities financed with FIP resources will ensure that appropriate environmental and social safeguards arrangements are carried out in accordance with MDB's policies and procedures;
- (f) In each eligible country, the principle of sovereign programmatic prior no-objection will be a foundation of the Investment Strategy. The MDB will agree with the government on the overall program framework and will consult with the central government and request its endorsement on the engagement in each country. The MDBs will not seek their Boards' approval for any financial transaction which is not acceptable to the national government. The MDBs will follow their own operational procedures regarding notification of the national government of a proposed financing before Board consideration.

Annex A: Criteria to be considered in review FIP Investment Strategies, Projects and

Consolidated Criteria for FIP Investments		Guidance from FIP Design Document on achieving FIP Objectives
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Programs

Climate Change Mitigation Potential	GHG emission reduction or avoidance potential	Climate change mitigation potential
Demonstration Potential at scale	<p>FIP investment addresses REDD+ priorities</p> <p>Area targeted by FIP investment compared to total area affected by forest degradation and deforestation</p> <p>Core set of indicators for application in FIP investments (consistent with FIP results framework)</p> <p>Description of good practices with potential for scaling up through FIP investment</p>	<p>Addressing drivers of deforestation and degradation</p> <p>Demonstration, learning and impact capacity</p> <p>Measurable outcomes and results-based approach</p>
Cost-effectiveness	<p>Economic and financial viability (catalyze self-sustaining financially profitable models) (paragraph 16 (i))</p> <p>FIP investment per ton of CO₂eq reduced or avoided</p> <p>Co-financing ratio</p> <p>FIP investment confirms REDD+ activities in national strategies or action plan, including where appropriate REDD+ readiness plans</p>	<p>Leveraging additional financial resources, including from private sector</p> <p>Coordinating with other REDD efforts (and cooperation with other actors and processes)</p>
Implementation Potential	<p>Status of enabling environment for REDD+ (public policy, regulatory framework and institutions)</p> <p>Institutional framework and cross-sectoral coordination mechanism to deliver REDD+</p> <p>Identification of capacity building needs</p> <p>Public and private national</p>	<p>Forest-related governance provisions</p> <p>Country's ownership, preparedness and ability to undertake REDD+ initiatives (including strengthening cross-sectoral ownership to scale up implementation)</p> <p>Capacity building measures for local and national institutions identified, including indigenous peoples and local communities</p>

	<p>and international contribution to FIP investment</p> <p>Risk assessment</p>	
<p>Integrating sustainable development (co-benefits)</p>	<p>Identification of co-benefits from FIP-Investments (livelihoods, biodiversity, ecosystems, climate resilience)</p> <p>Core set of indicators for application in FIP investments (consistent with FIP results framework)</p>	<p>Integrating sustainable development (livelihoods, biodiversity, ecosystems, economic viability)</p>
<p>Safeguards</p>	<p>Stakeholder involvement and consultation plan</p> <p>Link between FIP investment and Grant Mechanism for LC and IP</p> <p>Application of MDB safeguards</p>	<p>Inclusiveness of processes and participation of all important stakeholders, including indigenous peoples and local communities</p> <p>Safeguarding the integrity of natural forests</p>

Annex B
**Guidelines for the approval and management of FIP preparation grants for
Investment strategies and Public Sector Projects**

1. Objectives. The purpose of Forest Investment Program (FIP) preparation grants is to develop a quality investment portfolio by: (i) strengthening consensus among key national stakeholders and development partners; (ii) enhancing capacity of national institutions for robust policy reform and priority setting; (iii) ensuring that FIP investments are based on sound analytical work linking forest sector investments to economic growth and poverty-alleviation strategies; and, (iv) assessing the poverty and social impacts of programs and projects.

2. Grant Execution Arrangements. Preparation grants will be generally Recipient-executed. All preparation grants will be supervised by the MDB in order to ensure compliance with its operational policies and procedures, including procurement and financial management guidelines. The closing date of FIP grants should not exceed 2 years from the date of signature of the grant agreement by the MDB.

3. Eligible Grant Activities. FIP preparation grants may be used for developing FIP investment strategies and preparing FIP co-financed projects by recipient countries. The following activities will be eligible:
 - (a) Analytic work to inform a country's policies and programs.
 - (b) Design of policy reforms and preparation of legislation and regulations.
 - (c) Consultation workshops.
 - (d) Training.
 - (e) Institutional development.
 - (f) Feasibility Studies.
 - (g) Environmental and social impact assessments.
 - (h) Technical⁹, managerial, and financial project design.

4. Maximum total FIP preparation grant allocation for an investment strategy will be US\$250,000.

5. Eligible Expenditures. There will be no maximum allocation for a project preparation grant. The grant amount will be included in the FIP funding available for the Investment Strategy endorsed by the FIP Sub-Committee but will be made available prior to approval of FIP funding for the project to finance country-driven preparation activities. The preparation grant will finance expenditures for: (i) consultants' services, local training, workshops and seminars and, (ii) operating costs and office equipment for the implementation management of grant activities not to exceed 10% of the grant amount.

⁹ Including environmental and social consultants.

6. Ineligible Expenditures. The following expenditures will be ineligible: (i) salaries for civil servants in recipient countries hired as consultants or otherwise; (ii) purchase of vehicles; (iii) foreign training and study tours; and (iv) salaries and travel of MDB staff and consultants.

7. Reallocation of Grant Activities and Funds. If the reallocation requires a formal amendment to the grant agreement according to the MDB's policies, then the MDB will seek approval from the FIP Sub-Committee prior to amendment. If no amendment is required according to the MDB's policies, the MDB may reallocate according to its procedures and will inform the FIP Sub-Committee upon such revision.

8. Grant Cancellation Policy. The balance of preparation grants may be subject to cancellation under the following circumstances: (i) the grant agreement has not been signed six months after approval of the grant; or (ii) there has been no implementation progress, including zero disbursements for 12 months after signature of the grant agreement. The MDB may approve exceptions on the basis of a satisfactory explanation, which will be reported to the FIP Sub-Committee.

9. Schedule. Requests for project preparation grants should be submitted as part of the Investment Strategy when it is submitted to the FIP Sub-Committee for endorsement. Upon approval by the FIP Sub-Committee, the appropriate authority in the MDB will be authorized to sign a grant agreement.

Annex C

MDB Public Sector Project Development and Supervision Costs

1. Cost recovery for the MDBs' expenditures related to managing the project cycle will be based on MDB fees approved by the FIP Sub-Committee and paid by FIP recipients in the case of loans and guarantees, and by the SCF trust fund in the case of grants. The MDB fee will reimburse the MDB for its incremental staff, consultants, travel and related costs of project development, appraisal, implementation support, supervision and reporting. In particular, the MDBs will carry out the following tasks:

Project Preparation

- (a) Project concept review.
- (b) Quality enhancement and assurance to meet quality at entry standards;
- (c) Risk management.
- (d) Financial management and procurement assessments of project implementing entities.
- (e) Country dialogue on and appraisal of the sector policy, technical, economic, financial, institutional, fiduciary, environmental and social aspects of projects.
- (f) Preparation and negotiation of legal agreements.
- (g) Board approvals.

Project Supervision

- (a) Implementation status reporting.
- (b) Adaptive management of project strategy and design.
- (c) Loan/grant disbursement management.
- (d) Implementing project at-risk systems.
- (e) Supervision of project monitoring, evaluation, environmental and social safeguard measures, procurement and financial management by borrower/recipient.
- (f) Implementation completion reporting.
- (g) Independent evaluation of completion reports.

2. FIP financing will generally be seamlessly blended with MDB financing, resulting in significant transaction cost savings. However, there will be some incremental costs to the MDBs for mobilizing FIP co-financing for clients, due diligence, and reporting, which will be recovered through the MDB fee. Such costs include:

- (a) Analysis of consistency with FIP investment criteria.
- (b) Additional financial analysis to justify FIP concessional financing.
- (c) Calculation of GHG emissions reductions benefits.
- (d) Inclusion of forestry specialists in operations teams.
- (e) Monitoring and evaluation for FIP results measurements system.
- (f) Additional cost of legal, loan and accounting departments to administer FIP trust fund resources.

3. The MDBs will provide an annual report to the FIP Sub-Committee on their project processing and supervision costs, which may provide the basis for any adjustments to the MDB fee by the FIP Sub-Committee.