Creating a Multilateral Wealth Fund for a Global Public Good: Proposed Governance Arrangements for a Tropical Forest Financing Facility

Michele de Nevers, Patricia Bliss-Guest, Kenneth Lay, and Michael Wolosin

Abstract

The Tropical Forest Finance Facility is a proposal to establish a pay-for-performance mechanism to finance reduced deforestation of tropical forests. The overarching goal of the Tropical Forest Financing Facility (TFFF) would be to slow and reverse tropical deforestation. The TFFF would support the development, environmental and global benefits that reducing deforestation and protecting tropical forests can ensure. The facility would be akin to a multilateral sovereign wealth fund whose investment returns, above the rate of return to funders on the initial investments, would be used to reward tropical forest countries for their performance in reducing, and eventually halting, deforestation. The TFFF would mobilize significant low cost resources that can be invested in private markets to generate substantial financial returns, above the cost of funds. Performance would be measured using satellite monitoring data against a benchmark, specified in advance by investors who are funding the global offer. It would build on major technology breakthroughs for measuring results. The proposal would maximize the efficient use of public credit and not rely on overseas development assistance.

This paper outlines the proposed governance arrangements for the TFFF. The performance payments would be allocated as part of a global offer, available to all countries with extensive tropical forests that meet the performance standards.

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Creating a Multilateral Wealth Fund for a Global Public Good: Proposed Governance Arrangements for a Tropical Forest Financing Facility

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This initiative is the result of the generous and immensely valuable input of many people over the last three years. We are grateful for valuable feedback on the ideas presented here and on initial drafts of the paper by a long list of people, too numerous to include here. We were able to share and discuss the ideas outlined here with a wide range of people in CGD, other think tanks and NGOs and government representatives, particularly from forest countries and from potential sponsor investor countries. Their guidance and outreach were critical to the enhancement and refinement of the proposal. We appreciate how much the analysis and design were improved by so many people who gave their expertise and encouragement at consultation meetings at CGD and in Belgium, California, Canada, Denmark, France, Germany, Norway, Switzerland, the UK, and the US and with officials at the IMF, International Forum of Sovereign Wealth Funds, and the World Bank.

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Any remaining errors are our full responsibility.

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Note

This paper is one of four related papers. The overarching paper, "Creating a Multilateral Wealth Fund for a Global Public Good: A Proposal for a Tropical Forest Financing Facility," presents a summary of all the details about all the components of the proposal. Three complementary papers focus in depth on the core elements of the proposal related to: financing strategy, performance assessment and allocation of investment returns, and governance arrangements (the current paper), respectively. For the reader's ease, each subsidiary paper includes a brief summary of the overall proposal.

Contents

I. Introduction

Reaching the Sustainable Development Goals will require new investments estimated well into the trillions of dollars annually, an order of magnitude greater than total global annual foreign aid. This investment will be needed in traditional development sectors, such as education and health, as well as in global public goods like climate change mitigation.

Given the scale of the challenge, there is a keen recognition that public sector funding will not be sufficient to achieve the SDGs, and scarce public resources must be leveraged effectively to deliver development returns. Recognizing the strains on national budgets and new demands on foreign assistance and climate change finance, CGD's work in sustainable development finance explores how to maximize the efficient use of public credit and to structure effective partnerships between public and private investors.

Catalyzing "massive transformative investments" is at the heart of the discourse on sustainable development and global public goods.

This paper sets forth an innovative financing proposal aimed at addressing a critical environment and development challenge: reducing the loss of tropical forests, both for national development benefits and to promote the global public goods they provide, including biodiversity and climate mitigation. The proposed financing mechanism would generate substantial resources to provide an incentive for action to halt deforestation without encumbering national budgets nor drawing on foreign aid budgets.

The proposal is to establish a long-term investment fund, akin to a multilateral sovereign wealth fund. Investors (sovereigns and private investors) would provide low cost loans to the fund, which would then be invested in a diversified portfolio of higher return assets. Drawing on CGD's work on Cash-on-Delivery aid, the excess returns on the investment fund, above the cost of the loans and fund management, would be used to reward tropical forest countries for their successful performance in reducing deforestation. While the proposal outlined here utilizes an innovative financing mechanism to address environmental goals, the ideas could as well be applied to other sustainable development priorities and global challenges.

Why Forests?

Healthy forests are a cornerstone of sustainable economic growth across the tropics. Halting and reversing tropical forest loss yields large-scale development and ecosystem service benefits, including protecting biodiversity, local and global water cycling, carbon sequestration and climate protection, reduced flooding and landslides, health, food, and pollination. Furthermore, local communities and indigenous peoples often depend on forests for their livelihoods, health, food security, culture and safety. Ecosystem approaches, including the maintenance of forest cover, can also strengthen resilience and adaptation to climate change. Maintaining forests and other ecosystems to buffer the impacts of climate change is often less costly than having to replace lost ecosystem functions through infrastructure or technology.

Although tropical forests generate both local development benefits and global public goods, such as biodiversity and climate mitigation, tropical forest countries face significant political and economic pressures to convert forest lands to other uses. Cleared forest land often can be “repurposed” for agriculture or other uses that quickly produce steady streams of much-needed income for individuals, businesses, local communities, and provincial and national governments. Globally, the annual rate of deforestation remains unacceptably high, with an area the size of Austria being cleared every year. Unless deforestation is halted, it is likely that an area the size of India will be lost by 2050.

Why Pay for Results?

The Development Case

Results-based payment approaches focus on structuring incentives to change behavior. CGD has carried out research and developed policy advice on results-based approaches in a range of sectors. An extension of these ideas, Cash-on-Delivery (COD) aid, aims to change the behavior not just of recipients but also of funders. COD aid provides funding for the achievement of results aimed at addressing constraints to development at the national level. COD aid differs from other programs in that it eschews the imposition of pre-conditions and does not require agreements between funders and recipients on strategies to achieve results. The only “preconditions” relevant to COD aid are a good measure of progress and a credible way to verify it.

One of the key features of COD aid is that the funder embraces a hands-off approach, emphasizing country ownership and the power of incentives to drive outcomes, rather than financing projects that provide guidance or technical assistance. Many tropical forest countries may lack capacity to deliver results; TFFF may provide an additional incentive for these countries to fully utilize, invest in and seek success on capacity building work that may be financed by the various traditional mechanisms of support. Building on the goals articulated in the 2005 Paris Declaration on Aid Effectiveness, COD aid aims to foster accountability among funders, recipients and their constituents, build local ownership and rely on local institutions, permit learning by doing, experimentation and assessment. Without information about whether goals are being met, it is difficult to determine whether programs are successful. COD aid also seeks to attract new funders, including private sources, enable better funder coordination, reduce administrative and reporting burdens and generally promote the expansion of aid.

Under the COD aid model, at no point does the funder specify or monitor inputs. Similarly, the funder does not impose conditions or restrictions on the use of funds (rewards payments). It provides recipient countries with full authority and flexibility to undertake interventions or address policy issues that will lead to the desired results, even if such interventions and policies are outside the domain of the relevant sector ministry or sub-national government entity. It does this by recognizing and further encouraging the recipient country’s inherent ownership and responsibility over strategies and implementation, and then paying for measured and verified results.

Results-Based Payments for Forests

A major incentive is needed to encourage the governments of the countries in which tropical forests are located to protect and conserve them. With the exception of a few large bilateral programs between Norway and countries with large forest resources, until now, almost all the money spent by governments and aid organizations to reduce deforestation is channeled through traditional aid approaches that focus on inputs such as technical assistance for "readiness," analytical studies, project-based financing and staff salaries, rather than paying for actual results—reduced forest loss. Toward this end, CGD has been working with tropical forest countries and potential investors to create a multilateral wealth fund, similar to a sovereign wealth fund (SWF), whose proceeds, after costs, would reward tropical forest countries for their results in reducing deforestation and protecting forests.

Forests lend themselves to pay-for-performance funding approaches because recent advances in satellite monitoring technology make results measurement relatively straightforward, transparent and consistent, compared to other sectors where there may be less agreement on outcomes and performance measures, and where assessing outcomes would require expensive on-the-ground surveys.

In the case of forests and climate, a results-based payments mechanism called REDD+ has been developed through more than a decade of efforts by dedicated professionals around the world under the aegis of the UNFCCC. This framework for international partnerships to support forest country efforts to protect and enhance forests has been codified and embodied in a series of international climate agreements, including most recently the sections relating to REDD+ in the Paris Climate Agreement. The idea is that by offering serious and reliable funding to reward successful efforts to reduce deforestation, a major incentive can be provided to developing countries to move forward with the necessary actions.

Like COD aid, REDD+ recognizes that macro decisions that are in the purview of national governments, such as prices, taxes, and land use policies, shape actions on the ground and that the problem of deforestation cannot be addressed simply by building capacity and enforcement at the local level. A large and visible payment for reducing deforestation can help to strengthen public institutions and motivate politicians, not just technocrats, triggering helpful changes in political and bureaucratic arrangements. The incentive payment complements conventional forest assistance programs and motivates countries to draw on the range of other forest finance programs already in place (FCPF, Profor, UN REDD+, etc.).

While there is widespread agreement that a financial incentive to tropical forest countries to reduce deforestation is essential, until now, the large-scale, results-based finance initially envisioned for REDD+ has yet not materialized. Finance for forests in tropical forest countries accounts for less than 2 percent of global mitigation-related development funding, with total REDD+ assistance of about USD 1.7 billion and results-based commitments of USD 4.1 billion cumulative since 2010. Total finance for forests is insufficient, and is dwarfed by private investments and public-sector subsidies in agriculture and other deforestation drivers.

Furthermore, even if the REDD+ mechanism were dramatically scaled up, carbon-based payments would still be insufficient to generate economically optimum forest protection. According to one recent estimate, carbon and climate regulation services make up only about 39 percent of the total ecosystem services value provided by a hectare of tropical forest. There is no major performance-based financing supporting the non-carbon public goods from forests. The TFFF is being proposed in the context of an international forest financing landscape that is fragmented and insufficent:

- Foreign assistance to promote the development benefits of forests is limited;
- Support for forests' global public goods is limited in scope to just carbon;
- Even for carbon services, forests are globally underfunded through REDD+ compared to the value of those services;
- Progress in "greening" the trade and investment in forest-risk commodities is slow.

This paper outlines proposed governance arrangements for The Tropical Forest Finance Facility. The paper draws on lessons from international climate finance mechanisms and, perhaps more importantly, on the experience of international sovereign wealth funds in promoting good governance, accountability, transparency and prudent investment practices.

II. Overview: A Proposal for a Tropical Forest Finance Facility

This section outlines the proposal to establish TFFF. It describes its goals, sources of funding and performance measurement and allocation formulas. The third section of the paper focuses on the details of the proposed governance arrangements.

2.1 Goals of the TFFF

The overarching goal of the TFFF would be to slow and reverse tropical deforestation. The theory of change is that the promise of results-based payments to governments will raise the domestic political priority of forest protection by giving it financial value. This could catalyze a shift in economic development pathways away from deforestation-intensive practices.

In creating the multilateral wealth fund, the immediate operational objectives are: (1) to maximize the returns on the invested capital to generate significant funds that can be used as performance payments, and (2) to ensure that payments to tropical forest countries are made in accordance with a performance measure that is credible, sustainable, objective, and comparable across countries with reference to an agreed global benchmark.

By setting up a long-term investment portfolio, like a sovereign wealth fund, that is funded with non-ODA assets and managed consistently with global best practice, investors will both dramatically amplify the incentive to protect forests and maximize the efficient use of public credit.

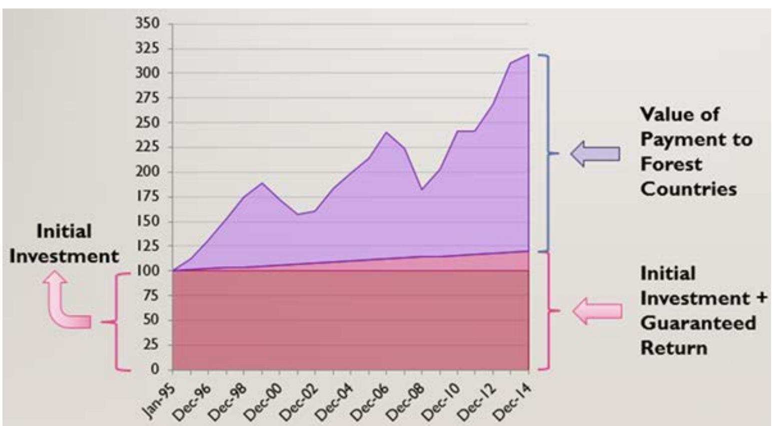
The Global Offer

The global offer itself would be put forth by a group of investor sponsors. These may be governments of donor countries, philanthropies, or private investors for whom reducing deforestation is a high priority. The global offer will clearly specify how performance is to be measured and how the annual returns on the invested funds are to be allocated to forest countries.

2.2 TFFF's Financing Strategy

The TFFF proposal is for a group of sovereign sponsors—with the potential participation of private sponsors, as well—to establish a large investment fund that would generate financial rewards for tropical forest nations that succeed in maintaining or enhancing their forests. These rewards would be comprised of the investment returns on TFFF, net of payments to sponsors to cover the cost to them to finance their sponsorship or a return equivalent to that of sovereign debt in the currency in which they make their investment. This "excess return" is the foundation of TFFF's value proposition. Figure 1, below, illustrates this "value proposition," based on excess returns that could have been generated over a 20-year horizon had it been established in 1995. Over extended periods, developed-country borrowing costs have been greatly exceeded by the returns on diversified portfolios of equity, debt and other investments.

Figure 1: TFFF Funding Model



Investors would capitalize the fund with low-cost investments that, mostly, are uniquely available to sovereign governments. Their capital investments would be funded in a manner appropriate to their particular situation, whether from existing reserves, a sovereign wealth fund, government borrowing, or government-guaranteed bank deposits. Investors could expect the TFFF to repay their initial capital upon the maturity of the fund, and in the meantime, investors would receive interest payments commensurate with their cost of funds, e.g., high-grade government borrowing.

Capital contributions would not come from "official development assistance" or other government budgets. Rather, countries could draw on reserve funds, issue governments bonds or draw on commercial savings deposits with government deposit insurance programs. If the TFFF were set up as a separate legal entity it could conceivably borrow in global capital markets in its own name, with the benefit of sponsors' sovereign guarantees.

The TFFF will seek to generate returns greater than the cost of the capital by investing in a fully diversified portfolio of relatively riskier assets with higher expected returns, similar to the portfolios of major university endowments, foundations, sovereign wealth funds and pension funds. To maximize capitalization and returns of the TFFF, it would be professionally managed consistent with best practice in the investment of comparable long-term funds or endowments.

The TFFF would operate for a fixed period (e.g., twenty years), after which time the endowment would be liquidated and the original capital payment would be returned to the investors. The accumulated earnings would be distributed to tropical forest countries based on their accumulated shares, which are based on performance.

As a starting proposal it is suggested that the TFFF have as its target size USD 100 billion in capitalization. For the last decade (based on the average return to U.S. university endowments and the average cost of short-term U.S. government borrowing) a dollar-based fund would have returned on average about 5.5 percent, net of estimated expenses including the cost of borrowing. With such a return on its investments, the TFFF would grow over 20 years to about USD 300 billion net of interest cost and other expenses, resulting in USD 200 billion to be divided among tropical forest countries based on their performance in protecting their forest resources. For simplicity we outline a financial model that retains all returns until the end of the fund in 20 years. But it is possible to consider a model in which a portion of the returns is disbursed to performing forest countries in regular intervals (for instance every 5 years) or each year and any remainder at the end of the life of the fund. Investment returns should be awarded in a way that maximizes their incentive function, while minimizing the financial risk to investors.

For more information on the financial aspects of the proposal, see the CGD policy paper "Creating a Multilateral Wealth Fund for a Global Public Good: Proposed Financing Strategy for a Tropical Forest Finance Facility."

2.3 Performance Assessment and Allocation of Returns

2.3.1 Performance Assessment.

The TFFF business model contemplates that the performance measure determining a country's allocation of TFFF's excess returns would score a country's annual rate of deforestation against a benchmark that could incorporate recent historical deforestation rates, and an allocation formula would incorporate both the performance score and a measure of each country's forest extent.

Performance in maintaining and expanding natural forests should be measured annually using data that is: (a) publicly available, (b) comparable across all countries, (c) accurate in measuring natural forest loss, (d) consistent across time, (e) complete by including all areas of natural forest without exclusions, and (f) transparent so that results can be reproduced and share allocations can be verified.

The performance assessment function should become more stringent over time, in line with the target of reaching zero natural forest loss by 2030. The performance measurement and allocation formulas should provide an incentive for maintaining and improving forest protection regardless of recent forest cover loss rates—e.g., for both high- and low-deforestation countries. The formulas should also provide incentives for both short-term and long-term performance success.

The performance would be independently verified by a third party, rather than the investor or the tropical forest country.

2.3.2 Allocation of Returns.

Shares of the fund's eventual returns would accrue to a forest country on an annual basis according the country's performance. The performance measure and the formula to allocate the fund's returns will be publicized at the time the offer is made. To heighten attention to the status of tropical forests, annual performance will be published in a global scorecard, showing each country's results in reducing deforestation, and the resulting accrual of the fund's returns—or foregone rewards if the country is not successful.

Shares of the earnings generated by the financing facility (net of funding and financial administration costs from the funds) would accrue annually to tropical forest countries based on each country's relative performance in maintaining and expanding its natural forests, and on each country's natural forest extent, such that a country with more forest would receive more shares for any given level of performance than a country with less forest. An agreed formula would be used for determining each country's shares of annual excess returns. A formula agreed prior to the start of the TFFF would be applied in a non-discretionary manner.

See forthcoming CGD working paper on "Creating a Multilateral Wealth Fund for a Global Public Good: Proposed Approach to Assessing Performance and Awarding Returns for a Tropical Forest Finance Facility" for more details.

III. Governance Arrangements for the TFFF

While key characteristics of pay-for-performance (P4P) mechanisms in other sectors have been explored, particularly in the health and environment sectors, less attention has been paid to how a P4P mechanism could be established on a global scale and the governance of such a mechanism. While there is some literature on good governance principles for international partnerships, the governance arrangements in these partnerships are not necessarily fully relevant or appropriate for the global offer and the supporting investment vehicle proposed here. Governance often tends to be neglected in the early planning stages of new funding initiatives. Taking into account the goals and functions of a pay-for-performance financing mechanism, and drawing on principles for the governance of sovereign wealth funds, this section provides policymakers with an examination of the characteristics and structure of the TFFF governance arrangements.

What Kind of Governance Structure Suits TFFF?

In considering what the governance arrangements for the TFFF should be, we drew on two relevant sources for principles and lessons. The first is the COD aid model, which helps to define the characteristics of the pay-for-performance mechanism. The second is the Santiago Generally Accepted Principles and Practices (the "Santiago Principles")[1] which offer features relevant to managing a multilateral wealth fund.

Principles: COD aid and Santiago Principles and relevance for the TFFF.

COD Aid. Four key characteristics from the COD aid literature were considered particularly relevant:

a) **Payments for outcomes at national level**: The TFFF would make payments to the national level, based on changes in national natural forest biomass. Measuring performance success at a national level implies that countries can successfully implement effective policy, legal and institutional reforms nationwide. The TFFF would direct payments to the national treasury, based on changes in national forest cover. The performance financing can provide additional political and financial leverage to those in the country who are seeking to implement policies and actions to maintain the forests. It is imperative for success that action is being taken at the appropriate level, and each country will need to determine how internal incentives can be used to reward good performance. Governments may determine that success in achieving performance targets will require them to pass on some portion of the financial incentive to sub-national entities.

   The incentive payments would serve as a complementary reinforcement to existing programs, which may be at the national or local level. In fact, the existence of the TFFF should make it easier to mobilize project funds, recognizing that such an additional incentive for the country to perform well would add greater attention and focus and should lead to greater success in project activities at the sub-national level.

b) **Hands off approach and recipient discretion:** Tropical forest countries would have full ownership and responsibility for achieving the result of reduced deforestation, and they would have complete discretion and full flexibility to try interventions or address policy issues that will be needed to reduce deforestation. The investors would not specify, monitor or fund inputs as part of the TFFF. (They may fund complementary programs to help countries reduce deforestation.) There is

[1] See International Working Group of Sovereign Wealth Funds. "Sovereign Wealth Funds: Generally Accepted Principles and Practices—'Santiago Principles.'" 2008, p. 3.
http://www.ifswf.org/sites/default/files/santiagoprinciples_0_0.pdf

thus no need for operational procedures and policies to govern the use of the funds because the TFFF funds are a reward for success, not financing for specific actions.

c) **Independently verified country progress:** Progress toward the agreed outcome would be independently verified by a third party.

d) **Transparency.** is achieved by publicly disseminating the COD contract, the amount of progress, and the payments for each increment of progress.[2] In addition, the measured performance of the tropical forest countries and each country's accrual of the TFFF's returns would be published annually in a Global Score Card.

The Santiago Principles.[3] The proposed governance structure of the TFFF draws on the Santiago Principles which are principles and practices for the management of sovereign wealth funds. A sovereign wealth fund (SWF) is a special-purpose investment fund or arrangement that is owned by the government. Created by the government for macro-economic purposes, a SWF holds, manages, or administer assets to achieve financial objectives. SWFs tend to prefer returns over liquidity, thus they have a higher risk tolerance than traditional reserves. In the case of the TFFF, the proposal calls for the establishment of a multilateral sovereign wealth fund—one with multiple government owners established to generate significant funds through investment gains on the initial capital investments. The returns on investment would be used to incentivize tropical forest countries to mitigate or cease deforestation.

The proposed governance structure of the TFFF draws on the *Santiago Principles* which are principles and practices for the management of sovereign wealth funds. The Santiago Principles were formulated and approved by the International Working Group of Sovereign Wealth Funds[4] in 2008. They provide guidance on appropriate governance and accountability arrangements and the conduct of investment practices necessary for sound long-term investment results. The Principles arose out of the interest on the part of some investors and regulators to ensure transparency, independence, and good governance among the growing number of sovereign wealth funds. They provide guidance on proper controls around risk, regulation and a sound governance structure. As of 2016, thirty sovereign wealth funds, representing collectively 80 percent of assets managed by sovereign funds globally or USD 5.5 trillion, had formally signed up to the Principles and joined the IFSWF.

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[2] Birdsall and Savedoff, *Cash on Delivery: A New Approach to Foreign Aid*, pages 18-19

[3] International Working Group of Sovereign Wealth Funds. "Sovereign Wealth Funds: Generally Accepted Principles and Practices – 'Santiago Principles.'" 2008. http://www.ifswf.org/sites/default/files/santiagoprinciples_0_0.pdf

[4] In 2009, the International Working Group was replaced by the International Forum of Sovereign Wealth Funds (IFSWF) a voluntary organization of a group of countries with sovereign wealth funds. Member countries are committed to working together and strengthening the community through dialogue, research and self-assessment to promote a deeper understanding of sovereign wealth fund activity. The Santiago Principles are voluntarily endorsed by all IFSWF members.

The relevant Santiago Principles are:

a) ***Legal soundness***: The Santiago Principles address the need for a sound legal basis that will (i) support the effective operation of the SWF and the achievement of its objective, (ii) ensure the legal soundness of the SWF and its transactions, and (iii) publicly disclose the policy purposes as well as the legal relationship between the SWF and other government bodies.[5] A governance agreement to support the objectives and effective operation of the TFFF would be agreed by initial investors, in consultation with tropical forest countries, prior to the establishment of the TFFF. Given the potential financial and contracting responsibilities of the TFFF, investors may want to establish the TFFF as an independent legal entity in a conducive national system.[6] Alternatively, it may be sufficient for the facility to derive its legal personality from an entity that would "host" it.

b) ***Expertise and independence***: With respect to decision-making within a SWF, the Santiago Principles call for accountability and operational independence. The Board of the SWF is to act in the best interests of the SWF, and have adequate authority and competency to carry out its functions. The operational management of the SWF is responsible for implementing the SWF's strategies in an independent manner.[7] Thus it is proposed that the TFFF Board be small[8] and its members be selected for their personal qualifications and skill and not their affiliation with an investor or a

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[5] See GAPP 1 and 2 of the Santiago Principles: "The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s);" and "The policy purpose of the SWF should be clearly defined and publicly disclosed."

[6] One example of a global program where it was considered necessary to establish a new legal organization is the International Finance Facility for Immunisation (IFFIm). IFFIm is a multilateral development institution established in 2006 as a UK company and charity registered with the Charity Commission for England and Wales. IFFIm uses pledges of future payments from donor governments to sell bonds in the capital markets, making funds available now for programs under GAVI, the vaccine alliance. IFFIm has a Board, and it has outsourced its administrative support function to GAVI and its treasury functions and related accounting services to the World Bank. In considering the need for an independent organization, thought should be given to the benefits that would arise from an independent entity and a clear understanding of what would be the responsibilities and liabilities of such organization. Another consideration in determining the legal status of the TFFF is whether an independent legal entity would facilitate the investor sponsors' ability to provide off-budget financing to the TFFF: a consideration in the design of the IFFIm governance arrangements.

[7] See GAPP 6, 8, and 9 of the Santiago Principles: "The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives;" "The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions;" and "The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities."

[8] Newell and Wilson indicate that the optimal size of a board should be 5 to 9. See Roberto Newell and Gregory Wilson. "A Premium for Good Governance." Washington DC: The McKinsey Quarterly Number 3, 2002. http://www.globalclearinghouse.org/wefhongkong/Docs/Premium%20for%20good%20governance.pdf

potential beneficiary.[9] Recognizing the objectives of the TFFF, it is proposed that a majority of board members should have finance/investment expertise while remaining members should have expertise in forest monitoring. If providing a seat or seats on the Board for investors would facilitate the mobilization of funds, particularly from large potential investors, then it would be in the interest of the TFFF to include representatives from investors on the Board, particularly if these investors also have relevant skills. As for the independent Board members, such representatives should be selected based on their experience and skills relevant to the objectives of the TFFF. The primary responsibility of a Board member would be to act in the best interest of the TFFF. The process for appointing board members should be "double arm's length" to underscore the independence of board members.[10]

The Board will be responsible for overseeing the application of the objectives and criteria of the global offer. The ability of the Board to amend or modify the performance and allocation criteria will be limited in accordance with agreed parameters to circumstances where technological or scientific changes are required to maintain their effectiveness in measuring deforestation. The performance benchmark and the criteria for assessment of performance will be clear, agreed as part of the initial offer, and publicly disclosed.[11] Measurement will be based on satellite monitoring and a single measurement formula agreed in advance. All countries will be assessed against the same criteria utilizing independent data.

More flexibility will be required with respect to the Board's oversight of the investment strategy as it will need to be able to respond quickly to market changes. The goal is to underscore independence from investors and tropical forest countries, and insulate the Facility from subjective political considerations.

c) ***Clear Accountability:*** Several of the Santiago Principles stress the need for a clear and effective division of roles and responsibilities, with the governing body having a clear mandate and adequate authority to carry out its functions. The accountability framework for the SWF's operations should be clearly defined in its constitutive

[9] With these qualifications in mind, civil society organizations would generally have no direct role in the governance of the TFFF itself, but it is expected that they would have a critical role at country level in helping the country to achieve robust results in reducing deforestation.

[10] "Double arms length" means that investor governments/other investors would appoint members of an independent nominating committee; the independent nominating committee would identify candidates for the TFFF Board; the investors would then select Board candidates from the pool chosen by the independent nominating committee. The Board would decide investment policy and make investment decisions. Thus the investors do not decide on the pool of candidates (first arm's length) and the board members have independence in making investment decisions (second arm's length). Based on the New Zealand Super Fund. "Double Arm's Length Autonomy Explained." Auckland: Government of New Zealand, accessed November 2017. https://www.nzsuperfund.co.nz/documents/double-arms-length-autonomy-explained

[11] See GAPP 4 of the Santiago Principles: "There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations."

documents.[12] The accountability of the TFFF Board and its committees, outsourced providers and the secretariat would be clearly articulated in the governance agreement of the TFFF. It is proposed that Board members be accountable to: (i) investors with respect to exercising good faith and due care in approving investment policies and overseeing the facility with a view to preserving initial capital and paying debt service, (ii) to tropical forest countries with respect to seeking to maximize and protect reward payments, taking into account the intent of the investors, and (iii) to both investors and tropical forest countries to oversee fair, transparent and consistent application of performance measurement and allocations as incorporated in the global offer.

d) ***Understanding risks***: Under the Santiago Principles, the SWF is to have a framework that identifies, assesses and manages the risks of its operations.[13] The TFFF's investment risk tolerance will need to be similar to that of major university endowments, foundations, sovereign wealth funds and pension funds if the TFFF is to generate a robust return to be used for performance payments. With respect to financial risks, investors will assume the risk that their capital investments may not be preserved or debt service not paid, although modeling shows that this risk is small when the life of the fund is twenty years or longer.[14] The tropical forest countries will assume the risk that TFFF investments generate lower returns than expected or are lost due to market volatility, and thus the reward for their performance in reducing deforestation is not as large as anticipated. Again, the modeling shows that even under conservative estimates of returns, this risk is small. Both investors and tropical forest countries assume risks associated with performance measurement, such as inadequacy of satellite monitoring or inaccurate data. The TFFF's Board will be responsible for approving a risk management framework that identifies, assesses, and manages the Facility's risks.

e) ***Transparency***: the Santiago Principles call for clear and publicly disclosed policies, rules, procedures or arrangements in relation to the SWF's general approach to funding withdrawal and spending operations. They also call for an annual report and financial statements on the SWF's operations and performance to be prepared in a timely fashion and in accordance with recognized international or national accounting standards.[15] Under the TFFF, governance decisions, performance

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[12] See GAPP 6, 8, and 10 of the Santiago Principles: "The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives;" "The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions;" and "The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement."
[13] See GAPP 22 of the Santiago Principles: "The SWF should have a framework that identifies, assesses, and manages the risks of its operations."
[14] See companion CGD paper on investment strategy and financial modeling for the TFFF.
[15] See GAPP 4 and 11 of the Santiago Principles: "There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending

measurement, financial and forest-related performance, and evaluations would be made public. Annual reports would be made available on financial performance and an annual Global Scorecard will show tropical forest countries' performance in halting deforestation.

Constructing the Global Offer. The TFFF would be a "global offer," that is, an offer presented to the global community by investors to pay a substantial sum to tropical forest countries that are successful in maintaining or enhancing their forests. Resources to make such payments are to be generated by returns from a multilateral wealth fund—similar to sovereign wealth funds—net of agreed fixed payments to investors. The fund would be capitalized with low cost investments from investors committed to financing this critical global public good.

The global offer itself would be put forth by a group of investors. These can be governments of donor countries, philanthropies, or private investors for whom reducing deforestation is a high priority. The TFFF's rules and formulas for measuring performance and allocating funds to forest countries would be agreed in advance of the facility's establishment and clearly stated as part of the global offer. The intention is to make sure that the offer is transparent, credible, and insulated from political revisions.

The global offer would constitute a "contract," with independent verification, between investors and tropical forest countries. Acceptance of the offer by a tropical forest country would be completely voluntary—it is neither a demand nor a requirement. By gathering the capital for the investment vehicle up-front , the TFFF will provide a high level of assurance to tropical forest countries that the resources for the reward payments will be available as and when the countries meet the performance targets, thus overcoming one persistent critique of foreign assistance that political and economic cycles in funder countries increase volatility in funding and hinder planning and implementation by recipients. In keeping with COD aid principles, once a country receives a performance payment, the funds can be used in any way determined by the country, without conditions or restrictions imposed by the investors.

To define the performance assessment, it is proposed that potential investors commission a group of recognized experts with expertise in forest monitoring and remote sensing, forest health and ecosystem services, forest management, forest conservation, REDD+ or national forest monitoring systems and international reporting. The experts would prepare an assessment of alternative options for measuring country performance. As an alternative, formulas for performance assessment and fund allocation could be developed through a deliberative process that engages a range of stakeholders, including the investors, tropical forest countries and others. But the final decision on the performance measurement and allocation approach would be made by the investors who are making the global offer. They

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operations;" and "An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner."

would determine what kind of performance they are willing to reward, and eligible tropical forest countries would then choose whether or not to take advantage of the offer.

Proposed Governance Structure

Once investors have agreed on the parameters of the global offer, a governance agreement will be developed. The governance agreement will address, among other things, the governance structure, roles, responsibilities, and accountability of each entity in the structure. It will provide guidelines and criteria regarding investment, performance measurement, and allocation of investment returns.

The specific structure and responsibilities proposed here have some key differences from many existing global international partnerships. These include: the qualifications of board members and the process for their selection; the responsibility of the board to oversee investment performance and the credible application of the performance metrics; the authoritative roles of expert subcommittees that will comprise boards members and outside experts; restricted authority of the board to change the terms of the offer, especially with regard to performance measurement and allocation, and the outsourcing of investment management and performance measurement.

It is proposed that the TFFF's structure would include the following:

a) Governing Board
b) Two standing committees (an Expert Investment Committee and a Performance Monitoring Committee)
c) Office/Secretariat
d) Monitoring Authority (outsourced)
e) Investment Management (outsourced)
f) Treasury Manager (outsourced)

Governing Board: The Governing Board would be responsible for strategic oversight of the TFFF and for the elaboration of policies and adoption of decisions and procedures that ensure the effective achievement of the goals and objectives set forth in the governance agreement. A key responsibility of the Governing Board would be to safeguard the independence of the TFFF with respect to financial decision-making, performance measurement, and allocation of returns.

Clear procedures for appointing the Board will be established. Consistent with the "double arms length" approach, for the first Board, investors (and possibly representatives from tropical forest countries) would agree upon a nominating committee. The nominating committee would be requested to propose a slate of candidates for the Board that meets the qualifications agreed in the governance agreement. It is proposed that a qualified majority of the Board members (e.g., at least two thirds) should have expertise in investing financial assets, managing investments and/or corporate governance. Some members of the Board should have expertise in forest monitoring. Once the nominating committee proposes candidates, the investors would then be invited to approve the slate of Board members recommended by the nominating committee. This would be an "up-or-down" vote, and if the recommended slate is not approved by the investors, the nominating committee would be requested to recommend a new slate.[16]

The Governing Board will be responsible, among other things, for:

a) Maintaining strategic oversight of the TFFF,
b) Appointing the Fund Asset Manager(s) and approving guidelines for selection of additional investment fund managers to invest parts of the TFFF,
c) Appointing the Monitoring Authority,
d) Appointing the Treasury Manager,
e) Approving and keeping under review the investment strategy, and related policies, standards and procedures of the TFFF,[17]
f) Reviewing an annual statement of investment performance expectations and an annual assessment of actual performance, monitoring the performance of the Fund Asset Manager(s) and taking action to change any Fund Asset Manager if appropriate,
g) Keeping the methodology for measuring performance under review, and approving revisions consistent with agreed parameters for such revisions,
h) Endorsing the Global Scorecard and allocation of net returns to tropical forest countries,
i) Approving and overseeing a risk management framework,[18]
j) Ensuring annual audits,[19]
k) Approving an annual report, including financial statements,[20] and
l) Clearly defining and approving professional and ethical standards.[21]

The Board would have authority to establish committees, with membership from Board members and/or independent members, and to delegate to committees such powers, duties and functions as the Board decides. To provide additional independent and expert-based decision making, at least two standing committees may be considered as described below. The two committees (expert investment committee and performance monitoring committee)

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[16] See GAPP 7 of the Santiago Principles: "The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operation."
[17] See GAPP 18 of the Santiago Principles: "The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by
the owner or the governing body(ies), and be based on sound portfolio management principles."
[18] See GAPP 22 of the Santiago Principles: "The SWF should have a framework that identifies, assesses, and manages the risks of its operations."
[19] See GAPP 12 of the Santiago Principles: "The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner."
[20] See GAPP 11 of the Santiago Principles: "An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner."
[21] See GAPP 13 of the Santiago Principles: "Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff."

would be accountable to the Board, and the Board would have the authority to make final decisions should it disagree with a decision or recommendation of a committee. Outsourced providers for financial management, investment and performance monitoring, would be accountable to Board through its committees.

Expert Investment Committee: The TFFF capital should be invested in a fully diversified portfolio constructed to maximize risk-adjusted returns commensurate with TFFF's long investment horizon. An Expert Investment Committee would be established as a standing committee of the Governing Board. The Committee would comprise members of the Board and independent experts with substantial expertise, training and experience in the investment and management of financial investments.

The Expert Investment Committee would be responsible for recommending to the Board for approval: (a) investment policies, standards and procedures consistent with the agreed investment strategy, and (b) the outsourcing to third party asset managers responsible for investing the TFFF assets.

The Expert Investment Committee would keep under review: (a) the financial performance of the TFFF, (b) its conformity with the approved investment strategy, policies, standards and procedures, (c) financial risks, and (d) performance of the outsourced investment services, and would report to the Board at least annually. The Expert Investment Committee would be responsible for alerting the Board of any strategic concerns.[22]

Performance Monitoring Committee: a Performance Monitoring Committee would be established as a standing committee of the Board. It would comprise members of the Board and independent members with expertise, training and experience in: (a) forest monitoring and remote sensing, (b) forest health and ecosystem services, (c) forest management, (d) forest conservation, (e) REDD+ as a complementary instrument under the UNFCCC, and (f) national forest monitoring systems and international reporting.

The Performance Monitoring Committee would be responsible for: (a) overseeing the monitoring and measurement of performance, (b) keeping under review the methodology for measuring performance with a view to suggesting updates as technology and science evolves, (c) keeping the work of the Monitoring Authority under review, (d) approving a Global Scorecard prepared by the Monitoring Authority, and (e) recommending to the

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[22] The Expert Investment Committee, in collaboration with the Fund Asset Manager(s), will submit annually to the Board a statement of financial performance expectations, including

a) a statement of the expectations about the financial performance of the TFFF over the next financial year, in sufficient detail to enable meaningful assessment against those expectations after the end of that financial year;
b) a statement of the key risks to the financial performance of the TFFF over the coming year and the actions being taken to manage those risks; and
c) forecast financial statements of the TFFF for the next financial year, including a statement of accounting policies;
d) annual assessment of financial performance measured against expectations.

Board the allocation of shares based on performance every year according to the principles, criteria and procedures in the governance agreement.

Office/Secretariat: A small office/Board secretariat would be established. The head of the secretariat would be accountable to the Board. The office would be responsible for: (a) servicing and preparing proposals for the Board and its committees, (b) ensuring regular communication with investors, tropical countries that may be beneficiaries of the facility, and other partners, (c) sharing knowledge and information, including through the preparation and publication of an annual report, (d) publishing and publicizing the Global Performance Scorecard, (e) representing the TFFF externally, and (f) building trust and facilitating resolution of differences.

Outsourced functions: Key functions for performance monitoring, investment of assets, and financial management of the facility would be outsourced to third party professionals. Such a structure would add to the independence of the Facility as well as its cost effectiveness.

Monitoring Authority: The Board would appoint a Monitoring Authority, based on a recommendation by the Performance Monitoring Committee, to be responsible for assessing the performance of participating tropical forest countries in maintaining and expanding natural tropical forests, according to the principles, criteria and/or formulae specified in the TFFF governance agreement and/or elaborated by the Performance Monitoring Committee and Board. The Monitoring Authority would have the capacity to process forest remote sensing data for the purposes of performance assessment. The Monitoring Authority would prepare an annual Global Scorecard reporting on the performance of tropical forest countries.

Investment Management and asset managers: The Board, based on the recommendation of the Expert Investment Committee, would approve guidelines for selection of third party asset managers and would subsequently approve a process for appointment by the Board of one or more third party asset managers that would be responsible for investing and managing the funds of the TFFF.

The Board would approve an investment policy, proposed by the Investment Committee, to guide the asset managers. The investment policy would build on the investment principles agreed in the governance agreement, and it would establish or reconfirm the risk tolerance of the fund, the asset classes in which it may invest, and required reporting and auditing standards.[23] The Expert Investment Committee and the TFFF office would provide

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[23] Based on the investment principles included in the governance agreement, the expert investment committee will recommend to the Board for approval an investment strategy and policies, standards and procedures that are consistent with best-practice portfolio management and that address among other things:

a) the classes of investments in which the TFFF is to be invested and the selection criteria for investments within those classes;
b) the determination of benchmarks or standards against which the performance of the TFFF as a whole, and classes of investments and individual investments, will be assessed;

necessary and relevant information on the TFFF's investment performance for publication in an annual report.

National or subnational sovereign wealth funds might be strong candidates to manage the assets of the TFFF. (For example the New Zealand Super Fund). These funds, which are increasing in number, tend to have the ability, experience and skills to manage large investment portfolios as are envisaged for the TFFF. Working with sovereign wealth funds would be complementary to the goals of the TFFF and would enhance the credibility and reputation of the TFFF.

Treasury manager. It is proposed that an existing organization or organizations, with the required skills and experience, be requested to serve as the Treasury Manager. An existing financial institution with experience in mobilizing and managing resources from governments and other partners, such as the IMF, World Bank or another multilateral development bank, may be considered. Other public sector financial institutions could also be considered.

The Treasury Manager would engage with initial secure capital contributions to the TFFF. It would manage TFFF's finances and would work with the Expert Investment Committee to keep the TFFF investments under review, and would advise the Committee on capital markets, rating agency and investor outreach, hedging transactions and investment management. The Treasury Manager would also coordinate with the Board and the Secretariat in the preparation of financial reports, with investors on their investments and with tropical forest countries with respect to their performance payments.

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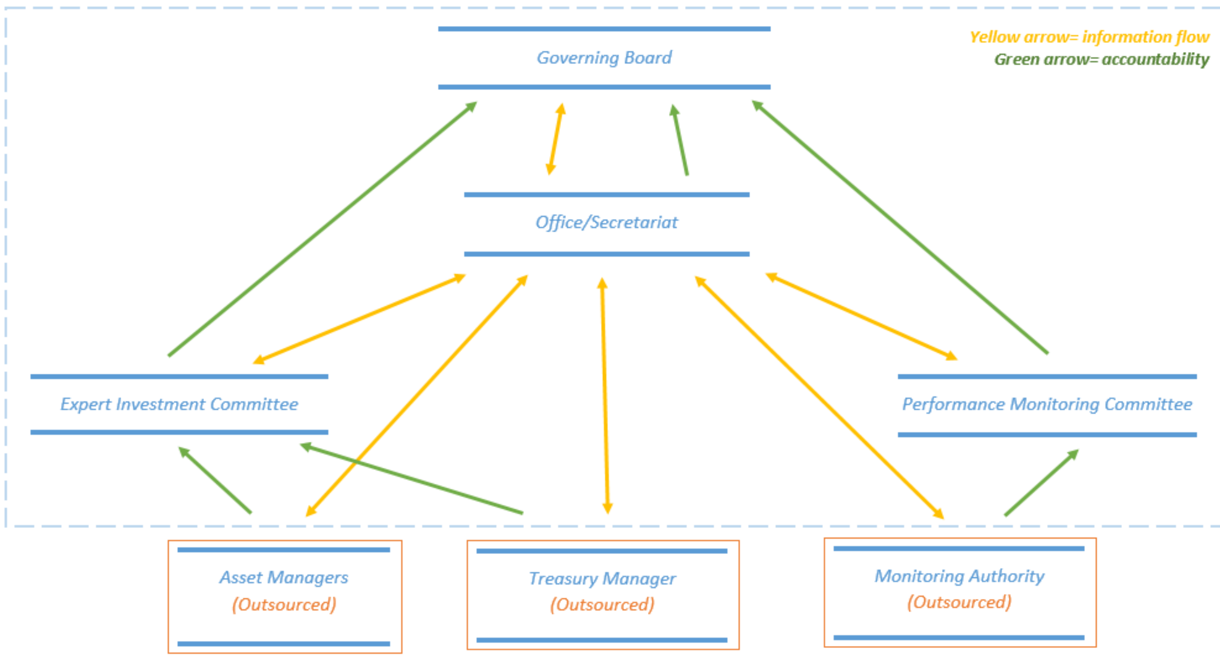
c) standards for reporting the investment performance of the TFFF;
d) ethical investment, including policies, standards, or procedures for avoiding prejudice to TFFF's reputation;
e) the balance between risk and return in the overall portfolio;
f) the management of credit, liquidity, operational, currency, market, and other financial risks;
g) the method of, and basis for, valuation of investments that are not regularly traded at a public exchange; and
h) prohibited or restricted investments or any investment constraints or limits.

Figure B. Proposed TFFF governance structure



Conclusion

With greater global integration, developing countries face increasing risks over which they have little or no control and which no one country has the incentive nor the ability to tackle on its own.[24] Hence there is a need to provide additional international financing to developing countries to address those challenges.

The TFFF is a proposal to mobilize significant low cost resources which can be invested in private markets to generate a financial return for rewarding successful actions that contribute to achieving a global goal, reduced deforestation. If it works, it could be an example of a new approach to delivering international financing for achieving the SDGs, and the sustainable delivery of international finance for securing global public goods.

The TFFF borrows from the experiences and cultures of both the public sector and the private sector. Utilizing primarily public funds to generate investment profits from the private sector that in turn provide international finance for public goods could serve to move beyond the finite borders of overseas development aid.

We propose that the first such financing facility be established to generate resources to protect tropical forests due to the crisis of reversing deforestation trends. Without urgent

[24] High Level Panel on the Future of Multilateral Development Banks. Washington DC: Center for Global Development, 2016. https://www.cgdev.org/working-group/high-level-panel-future-multilateral-development-banking-exploring-new-policy-agenda

action, there will be few remaining forests to protect. But if successful, this model would demonstrate a pathway to unlock a reliable and significantly enhanced flow of funds that could be used to address the SDGs and other critical global needs. The advantage of starting with forests is that modern satellite technology provides a relatively easy way to measure success unlike other outcomes at the domestic level which are more granular, subjective and expensive to measure. The high quality of satellite data allows shareholders in the TFFF to agree on what success means *ex ante* and to pool their resources to measure it. Each agency does not need to mobilize its own satellite system.

A key challenge will be to align the culture and governance principles associated with achieving greater societal goals with the culture and principles associated with generating profits through the private sector—a challenge that sovereign wealth funds are successfully addressing. TFFF's governance structure should be more closely aligned with those of sovereign wealth funds rather than existing international partnerships, with priority being given to clear, financial goals, independent decision making based on financial expertise and data, and accountability through transparent reporting.

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