CROSSBOUNDARY

Sovereign Advisory Viewpoints

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In Focus: Debt for Climate Swaps

Everyone is talking about Debt for Climate Swaps. And for good reason. Climate change, industrialisation, and rapid human population growth have all had negative effects on the planet – effects that reach beyond borders and pose an existential threat to our species. This report is a brief explainer on the topic of Debt for Climate Swaps and should (ideally) be useful to both experienced market participants and the casually curious.

At the 2015 UN Climate Change Conference (COP21) in Paris, and in an acknowledgement of the severity of the climate crisis, 196 nations agreed to a binding treaty aimed at combating climate change, limiting global warming to 1.5°C and adapting to its effects. This "Paris Agreement" required countries to submit climate action plans – known as **Nationally Determined Contributions (NDC)** – that specified actions to reduce greenhouse emissions and build resilience to the effects of climate change.

Figure 1: **Annual anomalies in temperature, from 1880 to 2021 (in °C)**

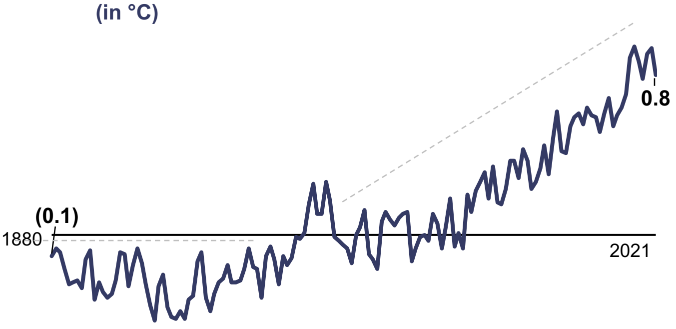
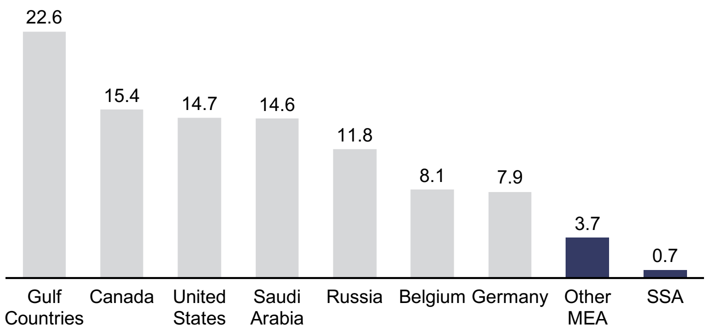


Figure 2: **CO_2 emissions per capita per region, 2019 (in MT/capita)**



Sources: Statista, World Bank Data

So what bearing does this have on the topic of Debt for Climate Swaps? Well, given the economic, geopolitical, and demographic divide between developed and developing countries, the Paris Agreement also provided a framework for the provision of financial, technical, and capacity-building support to countries that needed it. This represented an acknowledgment that developed countries, most of whom were significant (if unwitting!) contributors to the climate crisis in earlier periods of unhindered industrialization, could not simply ask - or expect - developing countries to shoulder the burden alone. Debt for Climate Swaps are a potential source of financial support to developing countries, enabling them to meet their NDCs while also relieving their debt burden at a fiscal cost no higher than the debt reduction.

Debt for Climate Swaps provide **partial relief** to a **fiscally constrained** debtor in exchange for a **commitment** towards **climate** and **nature-based initiatives**. They can cover both commercial and bilateral debt, and can be structured directly between borrower and creditor as bilateral swaps or with the participation of two or more interested stakeholders as multi-party swaps. Regardless of the exact structure, the conditionality in which the swap is provided remains the same.

A Debt for Climate Swap reduces debt in exchange for climate-focused spending or policy commitments

Figure 3:
Basic Debt for Climate Swap Model[1]

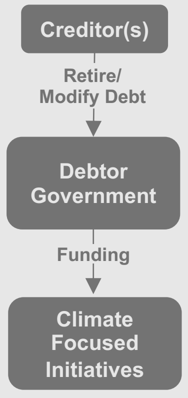
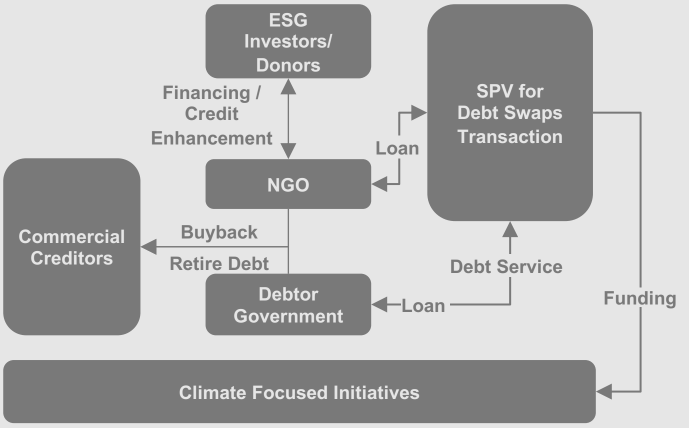


Figure 4:
Tripartite Debt for Climate Swap Model[1]



[1] *See appendix for a detailed process explainer*

Debt for Climate Swaps : The *When?*

So when does it make sense to participate in a Debt for Climate Swap? Wouldn't it be easier to just provide (or receive) grant financing or some other concessional facility to ensure the progress or success of a climate & nature initiative?

Well, **it depends**.

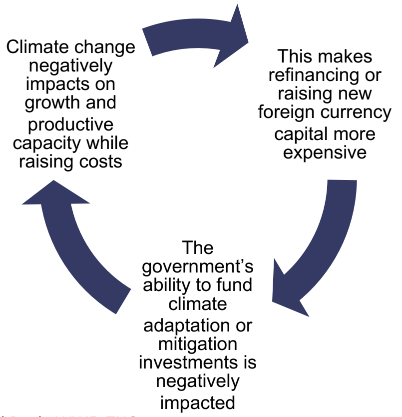
There are a few instances when a debt swap would be a suitable instrument (and some instances when it would not)

Debt for Climate Swaps work when…	Not when…
The debtor country is fiscally constrained and unable to fund climate and nature initiatives - potentially due to climate change	The creditor or donor organization is not able to take the risk that changing fiscal environments adversely affect the debtor's ability to maintain climate and nature commitments
The debtor country is unlikely to receive concessional or grant funding due to it being a middle-income country or on account of its political positioning	The debtor is on a severely unsustainable debt trajectory and the proposed climate and nature initiatives do not materially affect the Governments' overall risk profile (e.g., in countries prone to weather extremes)
The debtor country has significant climate and nature reserves at risk alongside its fiscal burden and no viable means of preservation at its disposal without resorting to measures that would compromise the integrity of said reserves	The debtor country is not able to provide the monitoring needed for any underlying climate and nature projects due to ongoing conflict. It could also be the case that the debtor country has a history of corruption or mismanagement, raising concerns about the effective use of the funds from the transaction
The debtor country has public debt that is trading at a significant discount and/or bilateral debt with Paris Club members	You have lots of debt, but you also happen to be an objectively *rich* country (obviously!)

As you can see, the question is a nuanced one. And this is one of the reasons why the Debt for Climate Swap structure is still considered in its infancy. **There just isn't a standardised process in place to issue them yet**, and so each case is structured with some new detail or feature that takes into account learnings from preceding swaps as well as market conditions specific to the debtor country (or market conditions at large when this happens after a global pandemic, or in the middle of a major geopolitical crisis). One thing is for certain, in cases where a country has high climate vulnerability, there is a strong correlation between this vulnerability and adverse fiscal metrics.

Figure 4:

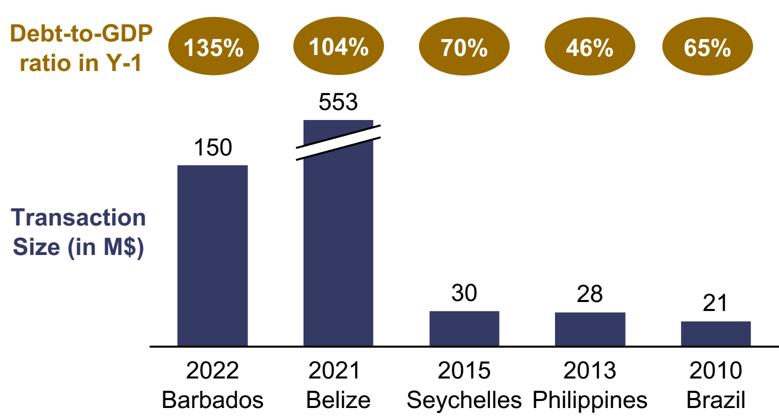
The cycle of climate vulnerability and govt. expenses



Sources: World Bank, WWF, TNC

Figure 5:

Examples of previous Debt for Climate Swaps



As to the matter of timing, the best practice is to initiate conversations as early as possible with as broad a stakeholder set as possible. **This needs to be initiated by the debtor country (or its advisors)** and the first step would be determining if there is enough bilateral debt (and sufficient bilateral creditor interest) to engage in bilateral swap negotiations, otherwise, the debtor country would need to explore the multipartite route alongside an experienced entity like The Nature Conservancy[1].

[1]TNC has sponsored all three of the modern era debt swap transactions.

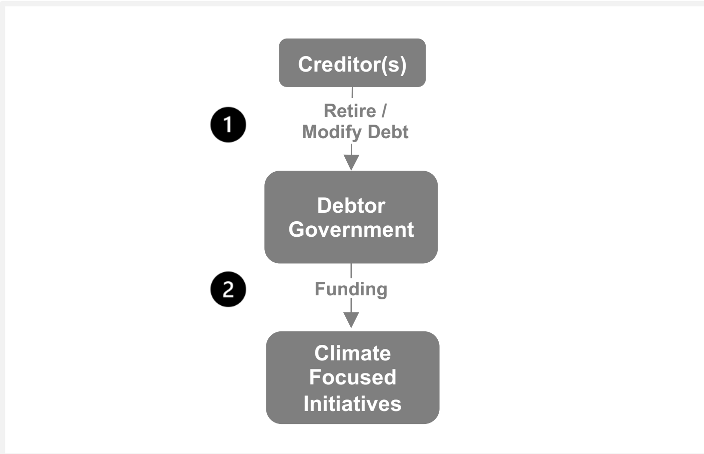
Debt for Climate Swaps : The *Why?*

Despite the recent popularity of debt swaps, they have to date mostly only provided modest debt relief. This is in part due to the relatively small sizes of historic transactions, reticence on the part of donors and potential transaction sponsors and lack of structural standardisation. And though they serve different purposes, restructurings often come up in conversations about debt swaps and vice versa. The table below lays out some of the key benefits of both approaches as well as areas where they are different.

		Debt Swaps	Restructuring
Public Finance	Fiscal Space	Debt swaps can create fiscal space by utilising the savings in debt servicing costs to address climate and nature-oriented projects in the government budget that would have been prioritised in any case.	These can result in a material increase in fiscal space following negotiations with creditors
	Debt Metrics	Debt swaps can also serve to reduce the nominal quantity of outstanding government debt which would in turn have a positive effect on Debt/GDP and lead to an improvement in the debtor's credit rating as was seen in Belize's 2021 debt swap	This would result in a larger reduction in outstanding debt at the cost of a more adverse short-term impact on credit rating. It has the potential to place the government on a path to a more sustainable debt trajectory
	Balance of Payments	Debt swaps improve a country's balance of payments in instances where part of the debt burden is converted to a local currency obligation. Doing so would have a positive impact on the country's external balance due to a reduction in foreign currency outflows	This would result in an improvement in external balance metrics but potentially have a negative impact on growth and the domestic banking sector
International Relations		Positive effect	Potentially negative
Flexibility		Low flexibility	High
Timing		Moderately Lengthy	Potentially faster than a swap
Use of Proceeds		High control	N/A
Transaction Costs		High	Higher
Climate Impact		High	None
Climate Finance Expertise		Required	Not Required

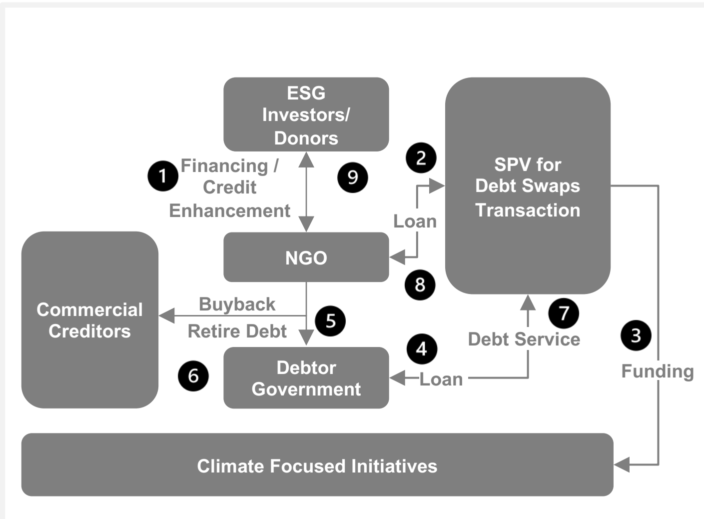
Most of the reasons why debt swaps are not as prevalent today as they could be given the focus on ensuring compliance with UN SDG's and NDCs can be worked around. This structure is scalable, but it first requires bold action on the part of donors, MDB's and the IMF. Much like with carbon credits, debt swaps have the potential to reward investment in our planet and should not only be seen as a solution in times of distress. We need to start with the most vulnerable countries with the greatest established need and work our way up.

In conclusion, Although Debt for Climate swaps are still considered to be in their infancy and there are times when grants, concessional financing or outright debt restructuring would present more efficient solutions. It is important, given the growing interlinkages between climate vulnerability and sovereign debt, and the growing scarcity of concessional financing for vulnerable countries, that there remains access to innovative financing options for LICs and LMICs to deal with both the financing gaps that stand between them, their NDCs and the fiscal burden that they often disproportionately face following global macroeconomic shocks. Debt for Climate Swaps are a useful resource in the toolbox of options that Donors, MDBs and Governments have at their disposal.



Basic Debt for Climate Swap Model

1. A Debtor government negotiates the financial terms of a debt swap exercise with bilateral creditors (individually or as a consortium). This Negotiation results in the modification of debt terms to reduce the overall fiscal burden to the borrower (e.g., coupon reduction or forgiveness, principal reduction or forgiveness, conversion to local currency or other mechanisms that would result in a lower debt obligation on the part of the debtor in real terms)
2. Some of the fiscal savings resulting from the debt swap are redirected to climate-focused initiatives in the debtor governments country



Tripartite Debt for Climate Swap Model

1. An NGO raises financing from ESG investors/Donors
2. Funds raised are passed on to a special-purpose vehicle (SPV)
3. The SPV disburses funds to specific climate and nature initiatives and uses some of the proceeds to buy back public government debt or…
4. …Lends some of the proceeds to the government directly for the purpose of a debt buyback
5. The government uses the funds provided by the SPV to buy back debt
6. This commercial debt is subsequently retired/ cancelled
7. The government services the concessional debt owed to the SPV which is on much more favorable terms than the cancelled commercial debt
8. This debt service is used to repay the NGO…
9. …Who in turn repays the ESG investors/Donors

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