T20 Policy Brief

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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

An Inclusive G20 Strategy to Scale 'Debt-for-Nature/Climate Swaps' for Effective Climate and Biodiversity Action in Developing

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Abstract

The number of highly indebted countries has increased from 22 in 2011 to 59 in 2022. Trapped in a vicious cycle of unsustainable debt, high interest rates, frequent natural disasters, poverty and inadequate capacity to meet climate and nature commitments, these economies struggle to secure affordable borrowing. Without a well-conceived global debt management plan, these vulnerable countries are likely to continue lagging in sustainable development and climate and nature action. Shrinking fiscal space limits their ability to invest in just, resilient and sustainable low-carbon development, undermining the stability and health of the global economy. Innovative financing instruments like debt-for-nature/climate swaps that align debt sustainability, mobilizing private capital and freeing fiscal space, can expedite national priority-linked climate and nature action as well as sustainable development. These instruments can be a key part of the solution to address debt instability and support effective implementation of Nationally Determined Contributions (NDCs) and National Biodiversity Strategies and Action Plans (NBSAPs).

Taking forward G20 India's *High-Level Principles on Lifestyles for Sustainable Development,* G20 Brazil's *Taskforce for the Global Mobilization against Climate Change,* and the *Bioeconomy Initiative*, G20 should mainstream debt-for-nature/climate swaps. Inclusion of debt-for-nature/climate swaps into a comprehensive, transparent, and inclusive G20-rescue strategy can increase the amount of credit enhancement available, reduce transaction costs, bring down perceived risk and ensure the scaling of the novel financing mechanism.

Diagnosis of the Issue

Effectively resolving the rising indebtedness of developing countries has become a G20 priority. Unsustainable sovereign debt in many countries has led to fiscal constraints, adversely impacting investment flows and consequently hampering developmental efforts especially climate and nature action. Greater climate and nature vulnerability has resulted in heavy indebtedness and fiscal stress exacerbating the debt distress situation (United Nations, 2023). This alarming situation requires a global collective strategy incorporating innovative financing and debt alleviating mechanisms to meet the Paris Climate Agreement objectives and the Global Biodiversity Targets by 2030.

The recent global shocks have further stretched the budgets of developing economies, reduced bilateral concessional financing, and tightened private investment flows. These short-term shocks coincide with the long-term ever-increasing costs resulting from climate crises. There is a need for a four to eight-fold increase in annual climate finance to developing nations by 2030 (Habbale and Urpelainen, 2023). Net zero investment gap is estimated at around $18 trillion (Fitz, Berns, Seshadri, Sastry et al, 2023), and developing countries alone face an annual SDG investment gap of $4 trillion (IISD, 2023; UN News, 2023).

Debt restructuring initiatives by G20 like the Common Framework and the Debt Service Suspension Initiative have proved to be insufficient (Bretton Woods Project, 2022). Therefore, it is imperative to expedite novel approaches. Bilateral versions of the debt-for-nature/climate swaps, around since the 1980s, are considered a viable tool in the fiscal support and conservation funding toolbox. Though their usage declined in the 2000s, there is renewed interest since the COVID-19 outbreak and the consequent debt crisis, especially in the new *commercial* debt-for-nature/climate swaps (Nedopil., Yue and

Hughes, 2022). The two swaps' structures ensure full or partial bilateral debt waiver or more favourable commercial debt refinancing terms to the debtor in return for the debtor ensuring that the savings are channelised towards environmental protection and/or climate action.

The fiscal space created by the debt-for-nature/climate swaps (Nedopil, Yue and Hughes, 2024) (see Figure 1 and 2) helps ensure adequate funding for sustainable development initiatives in the climate and environment space. Moreover, the inclusion of climate and nature commitments into the financial transaction, that are monitored by credit enhancement providers, investors and NGOs, raises the effectiveness of the commitments and the probability of success by the governments while increasing debt sustainability.

Bilateral

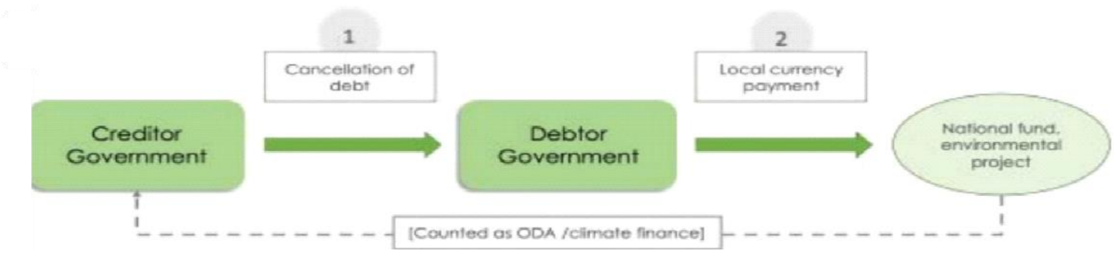

FIGURE 1. Structure of Debt-for-Nature Swaps

Source: Energy, Sustainability and Society (Lukšić., Bošković and Novikova, 2022)

Commercial

FIGURE 2. Structure of Debt-for-Nature Swaps

Source: IMF (Chamon, Klok, Thakoor and Zettelmeyer, 2022)

Bilateral debt-for-nature swaps have treated almost $4 billion of sovereign debt in 140 deals (African Development Bank Group, 2022) over the last four decades. In less than three years, commercial debt-for-nature/climate swaps have refinanced almost $3 billion of debt and are anticipated to create almost $850 million for conservation over the next 15 years for 4 countries (see Table 1). The current size and number of deals are small compared to the debt available and investor appetite.

TABLE 1. Commercial Debt-for-Nature/Climate Swaps Financing

Country	**Debt Refinanced**	**Nature / Environment Funding Outcome**	**Debt Outcome**
Belize	Bonds $550million	$180 million over 20 years	Reduced debt/GDP 10%
Barbados	Bonds $150 million	$50 million over 15 years	Extension of tenor USD debt/interest reduction
Ecuador	Bonds $1.6 billion	$450 million over 15 years	Reduced debt ~USD 972 million (debt/GDP <1%)
Gabon	Bonds $500 million	$163 million of 15 years	Extension of tenor

Source: Compiled from various sources.

Recommendations

In continuation of G20 India's *High-Level Principles on Lifestyles for Sustainable Development*, G20 Brazil's *Taskforce for the Global Mobilization against Climate Change* and the *Bioeconomy Initiative*, G20 may consider the following:

1. ***Elevate debt-for-nature/climate swaps within the global dialogue as solutions for developing countries with insufficient fiscal space and unsustainable debt to meet their climate and nature obligations.***

It is essential to mainstream debt-for-nature/climate swaps by including them in the G20 rescue strategy and developing a G20-level multilateral mechanism/platform to reduce the costs and time needed for coordination. The market and structure of financing nature and climate with swaps is established and should be targeted on achieving a country's Paris Agreement and the Global Biodiversity Framework rather than diluting efforts into other public funding across a wide range of SDGs. Nature and climate action have deep interlinkages with most SDGs and can potentially lead to 'positive social transformation' (Caetano, Winkler, and Depledge, 2020) and help "leverage additional finance" to meet the SDGs (Lukšić, Bošković, Novikova and Vrbensky, 2022). Estimates of the size of potentially swapable debt in the market range from $600-800 billion; however, much of that debt will not be applicable and the universe of available credit enhancement is limited. Therefore, the size of the commercial debt-for-nature/climate swaps will not likely make a significant contribution to financing all SDG needs. Expansion into all SDGs will also increase the complexity of a product that is already considered very complex. Focusing swaps on nature and climate will attract stakeholders dedicated to nature and climate issues, such as international environmental NGOs and philanthropists who may be more willing to support and fund these swaps than generic debt swaps.

2. ***Scale the use of debt-for-nature/climate swaps by strengthening the new Task Force to increase credit enhancement available for commercial debt-for-nature/climate swaps.***

By bringing together the major providers of credit enhancement, the *Task Force for Credit Enhancement of Sustainability-Linked Sovereign Financing for Nature and Climate (*UNFCCC, 2023) can facilitate the required scaling of credit enhancement solutions. The *Task Force* would identify the most efficient product offerings by analysing different risk mitigation strategies and risk tolerance of member entities and combine these into new products. This *Task Force* should be supported by G20 members as shareholders of the MDBs and global funds. G20 countries that can provide bilateral credit enhancement should be members of this *Task Force*.

3. ***Formulate and/or support the creation of high-level global principles and standards for debt-for-nature/climate swaps.***

Due to the time-consuming nature of the negotiations and to avoid a potential race-to-the-bottom, it is essential to develop and commit to a framework for all aspects of these swaps that is endorsed internationally at the G20 level. This -requires high-level political support and would include principles and guidelines on: alignment of swaps with the NDCs and National Biodiversity Strategies and Action Plans of the debtor nation; transparent monitoring systems for public expenditures related to climate and nature (Steele, Kelly, Ducros, and Patel,2022) (with clear Monitoring, Reporting and Verification processes) ensuring the funding for nature and climate is additional and not negated by a reduction in budget expenditure; and local buy-in and government approval processes. Several entities are working on global principles; however, none have been published.

4. ***Establish a Working Group to assess the potential role of incorporating debt-for-nature/climate swaps in the Common Framework process and sovereign debt restructuring.***

In view of high proability of debt distress and default in many countries, G20, as the creator of the Common Framework and member of the Global Sovereign Debt Roundtable, should establish a Working Group to analyse the potential role of debt-for-nature/climate swaps to help countries at high debt distress avoid default as well as helping countries already in a default workout. This analysis will also be helpful for non-Common Framework countries in a debt restructuring. While debt swaps can be complex and often take significant time to close, they offer cash to purchase debt at low market prices, new roles for MDBs that could help with Comparability of Treatment solutions and allow~~s~~ defaulted governments to continue to focus on and finance climate and nature priorities.

Swaps have proven to help countries in debt distress, with deeply discounted debt, reduce significant amounts of debt in dollars terms (Ecuador) and in debt/GDP (Belize). Countries with debt trading at higher price may not be candidates for swaps. It is agreed that debt swaps cannot replace a debt restructuring. However, they have high potential in providing requisite debt service relief to help avoid debt distress becoming debt default. The role of debt swaps for nature and climate in a debt workout/restructuring needs to be explored. Any consideration must be reviewed on a case-by-case basis.

5. ***Endorse technical assistance to bridge the knowledge and capacity gaps for countries considering debt-for-nature/climate swaps.***

It is important to ensure adequate capacity of debt countries to not only develop a science-based national environmental conservation framework but also enter complex negotiations with creditors/promoters of debt-for-nature/climate swaps. Access to existing and increased amounts of technical assistance is needed for multiple components of the debt swap process (The Nature Conservancy, 2023).

G20 can support or act as a platform for stakeholder coordination, harmonize efforts, share best practices, and streamline processes. Also, G20 can participate in the development and promotion of standardized principles for implementing debt-for-nature/climate swaps. These principles will ensure transparency, accountability, and effectiveness, making it easier for countries to engage in these transactions, reduce the costs and the time to market, facilitate greater investment and philanthropic commitment and help credit enhancement providers evaluate their impact.

6. ***Entrust IMF to advance the implementation of debt-for-nature/climate swaps in its Debt Sustainability Analysis (DSA) advisory and facilities.***

G20 could encourage IMF to consider factoring debt-for-nature/climate swaps into its DSA frameworks. In its role as the preeminent sovereign debt sustainability advisor, IMF can advise countries of the benefits of debt-for-nature/climate swaps. IMF should consider the benefits of debt-for-nature/climate swaps in its Article IV reviews (IMF, 2023) and provide forward-looking strategies identifying for countries where swaps are the best options. IMF support of these transactions could have a knock-on effect of encouraging credit rating agencies to incorporate debt swaps, and even the benefits of nature on credit strength, into their methodologies. IMF should be encouraged to understand and recognize the role of nature in mitigating fiscal stress in a climate crisis and demonstrate the cost/benefit analysis of protecting nature to vulnerable economies.

IMF should be encouraged to increase the sophistication of the Resilience and Sustainability Trust (RST) facility to offer sovereign guarantees (as opposed to just loans) to support debt-for-nature/climate swaps - allowing the use of *un-transferred* Special Drawing Rights pledged as callable capital to support these transactions.

Scenario of Outcomes

Elevating the dialogue on debt-for-nature/climate swaps will lead to clarification of when and how it is best for countries to use this tool, when and how bilateral and multilateral credit enhancers should support and maximize the efficiency of these structures, and how global investors can maximize investment. These recommendations should lead to achieving the requisite scale needed to have a significant effect on the global crises.

There are debates on whether simple grants or concessional financing are more efficient than a debt swap instrument. However, grants are not available to many counties and are scarce relative to the need for climate and nature financing. The long tenor of debt swap structures enforces sustained commitments and cash flow for projects. Unlike grants, debt-for-nature/climate swaps offer the discipline a step-up coupon that ensures achievement of outputs with a rigid monitoring of outcomes that are overseen by global investors, credit enhancement providers and global and local NGOs (Belize Blue Investment Company, 2023). Concessional lending, while better than commercial debt, still increases the debt and debt service burden of countries.

G20 collaboration with the *Task Force* could target increased use and efficiency of debt-for-nature/climate swaps by COP29 and COP30. Larger G20 members that can offer bilateral credit enhancement products can assist in using their products to create efficient structures increasing the amount of cover available and the efficiency, including cost, of the structures - resulting in more funding for climate/nature, and reduction in debt outstanding for Global South. As the major shareholders, G20 members can encourage MDBs and global funds in the *Task Force* to be more innovative, aggressive, and quicker to market. The reorganization of the World Bank Group credit enhancement facilities in

July 2024 offers high potential for the *Task Force* to create change at scale. Coupling these efforts with the Global Sovereign Debt Roundtable will increase speed, quality and efficacy of this product.

With the existing high interest in these swaps from developing countries, credit enhancement providers, NGOs and investment banks, coupled with the complexity in the structure, the demand for technical assistance is high. The swaps are best suited for indebted countries where prioritising climate action has broad buy-in (Georgieva, Chamon, and Thakoor, 2022). Capacity gaps have been identified and the systems to deliver technical assistance and disburse funds can be speedily put in place. Moreover, global principles agreed to and supported by G20 will ensure the increased volume of transactions will follow best practices and maximize delivery of climate/nature commitment and funding.

With G20 and Global Sovereign Debt Roundtable supporting the inclusion of debt-for-nature/climate swaps into the Common Framework, the process will offer a new tool to help debt workouts and countries at high risk of debt distress. Determining when to use this tool is key. Some do not consider this instrument suitable for unsustainable debt, which would mostly need a combination of deep restructuring and conditional grants (Chamon, Klok, Thakoor, and Zettelmeyer, 2022). This needs more analysis. Debt swaps are complex structures that can take time to arrange and are not right for every occasion. However, these challenges can be addressed and if applicable to the situation, this innovative product offers a source of commercial debt reduction, available cash to help the buy-back or workout negotiation, and potentially ways for MDBs to provide assistance via guarantees (as opposed to debt reduction).

Finally, G20 can influence IMF to expand further the scope of the RST to provide guarantees to scale this product expeditiously and offer a solution with both SDR-backed and callable capital - bringing in a new large source of credit enhancement financing. This will build on the successful RST structure, allowing a quick time to market.

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