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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Mainstreaming Debt Swaps for Sustainable Development: Enhancing the G20 Common Framework for Debt Treatments

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Abstract

Many emerging markets and developing economies are burdened with high debt stocks and lack the fiscal space to meet their **climate, biodiversity, and sustainable development goals (SDGs)**. Most of these countries are rich in natural resources and biodiversity hotspots that function as global public goods. One potential solution is to mainstream SDGs debt swaps. A creditor allows debt relief and the debtor commits part of the savings toward investments in achieving climate, nature and other SDGs goals, while also improving their fiscal position.

Based on experience from the Heavily Indebted Poor Countries Initiative, SDGs debt swaps could mobilize over US$105 billion from debt negotiation and US$329 billion from new debt issuances. To date, implementation has been limited and hindered by high transaction costs, institutional challenges, and lack of transparency. The few swaps that have taken place have been small in comparison with the total need across highly-indebted countries and were all in upper-middle or high-income countries where the debt involved was privately held and was bought back via auctions. For low and lower-middle-income countries whose main creditors are bilateral and multilateral, that approach is less feasible and complex, costly and asymmetric negotiation processes will be needed, which may limit the scalability of these swaps.

The G20 has an opportunity to call for enhancing current efforts to address debt through a complementary Common Framework that integrates the broader concept of SDGs debt swaps, establishes guidelines, and supports their implementation to facilitate and promote fair negotiations.

Keywords: Debt Swaps, Climate, Nature, Sdgs, EMDEs

Diagnosis of the Issue

Although emerging market and developing economies (EMDEs) have contributed the least to climate change, they suffer the most from its effects, given their greater exposure to extreme weather events and the lack of infrastructure and fiscal space to fund adaptation (Georgieva et al., 2022a). In addition, biodiversity, and its ability to provide key environmental services is decreasing at an unprecedented scale and pace (IPBES, 2019). Many EMDEs are rich in natural resources and biodiversity hotspots that—given their capacity to capture greenhouse gasses and regulate water cycles—function as global public goods. There is a global commitment to address climate change and support the conservation and restoration of such regions as captured in several conventions, including the United Nations Framework Convention on Climate Change (UNFCCC), the United Nations Convention on Biological Diversity (UNCBD), and the United Nations Convention to Combat Desertification (UNCCD). However, compliance with these commitments is not on track. The target to channel $100 billion per year in climate finance from developed to EMDEs has still not been met and huge financing gaps exist in supporting countries to achieve climate and biodiversity targets.

In addition, many EMDEs have high debt stocks and are at a high risk of fiscal distress (Georgieva et al., 2022b), which is preventing them from investing in their climate, biodiversity, and sustainable development goals (SDGs). A large share of revenues in many EMDEs is going toward debt servicing, which has risen substantially in the last couple of years with surging global interest rates. Sixty percent of low-income countries are currently at risk of debt distress (World Bank, 2023). This context calls for coordinated international action toward innovative and sustainable debt management arrangements.

One potential solution to help address fiscal problems and climate, biodiversity, and other SDGs simultaneously is to mainstream SDGs debt swaps. In these transactions, a creditor(s) provides debt relief[1] and the debtor sovereign commits part of the savings toward investments in achieving climate and nature goals, which can be expanded to include all SDGs (Steele and Patel, 2020; Jain et al., 2023; Pérez-Beltrán and Landry, 2023). When properly designed in alignment with national policies and commitments and in a proper macroeconomic context, they can provide greater fiscal space to reduce poverty and enhance economic growth (Steele et al., 2021).

To date, implementation of these swaps has been limited and hindered by high transaction costs, institutional challenges, and a lack of transparency (Jain et al., 2023). Recent swaps were externally driven, without adequate involvement of affected communities, and their scale falls short of addressing the needs of highly-indebted countries (Kelly et al., 2023). Moreover, those swaps involved upper-middle-income or high-income countries (Seychelles, Belize, Barbados, Ecuador, and Gabon). In the latter three cases, the debt was privately held and was repurchased through auctions, allowing the sovereign to realize savings when bonds were trading at a discount and avoiding complex negotiation processes (Pérez-Beltrán and Landry, 2023; Jain et al., 2023, see Table A1 in the appendix for a summary of recent swaps). However, for EMDEs that lack access to capital markets and whose main creditors are bilateral (official and Paris Club) and multilateral, a new generation of swaps may be needed that involve complex, costly, and asymmetric negotiation processes, limiting their scalability.

[1] This could be either by conversion to local currency and/or paid at a lower interest rate, some form of debt write-off, or by supporting conversion to a different financial vehicle.

An international platform to facilitate these swaps is needed. A relevant precedent is the Heavily Indebted Poor Countries Initiative (HIPC), established in 1996 to address EMDEs' debt and poverty challenges. HIPC demonstrated that debt reduction on a large scale is feasible with sufficient political will, and based on that experience, SDGs debt swaps could mobilize more than US$105 billion from debt negotiation and US$329 billion from new debt issuances (Patel, 2022).

Such a facilitating platform could leverage the Common Framework for Debt Treatments (CFDT), designed to cooperate on debt treatments for low-income countries eligible for the Debt Service Suspension Initiative (DSSI) during the pandemic. It made a notable contribution by bringing China, the largest official creditor for many EMDEs (The Economist, 2020), into these debt negotiation processes (Ahmed and Brown, 2022). However, only four countries have requested debt relief under the CFDT and have experienced significant delays and difficulties (Georgieva and Pazarbasioglu, 2021).

Recommendations

Recent proposals to the T20 called for initiatives to free up resources in EMDEs to invest in resilience and a just transition (Akhtar et al., 2022; Narula et al., 2023; Canuto et al., 2023; Nair et al., 2024; Chakrabarty et al., 2024). In addition, UNESCWA (2020) proposes a new generation of (bilateral) debt swaps. Building on these, we recommend that the G20 finance ministers formulate an action plan for developing **a complementary Common Framework for SDGs debt swaps (CFSDDS),** which sets out key principles that guide a G20 response to drive action globally. The CFSDDS would integrate the broader concept of SDGs debt swaps, establish guidelines, and support their implementation.

Historically, debt-for-climate swaps were aimed at climate action while debt-for-nature swaps targeted preserving and restoring biodiversity. Given that climate action and biodiversity preservation are among the 17 SDGs, it is reasonable to formally integrate them under the broad umbrella of SDGs debt swaps to allow for these instruments to be used to meet other sustainability goals.

To ensure this alignment and effective transactions, a programmatic approach that takes a broader perspective on the swap, shifts support from projects to programs, and prioritizes transparency is key (see Figure 1). Following this overarching principle, the CFSDDS could enable a conducive environment for fair transactions and guide its implementation through the following: define eligibility criteria, standardize to reduce transaction costs and promote fair negotiations, and provide technical assistance to align Key Performance Indicators (KPIs) with national and global goals.

Within this integral concept of swaps, it is necessary to differentiate those dealing with debt with private creditors from those with official creditors. In the former, the use of auctions to buy back debt and the standardization of much of the swap, including the design of the new bonds and KPIs and the de-risking mechanisms, can considerably ease and accelerate the process. This is the likely scenario for some middle-income countries seeking to attract private investors. In the second case, which is the typical scenario for low and some lower-middle-income countries, the debt involved is in the form of loans, which may require complex negotiations and greater flexibility in determining KPIs, and the possibility of standardization is reduced to certain initial parameters.

Our policy recommendations are detailed below:

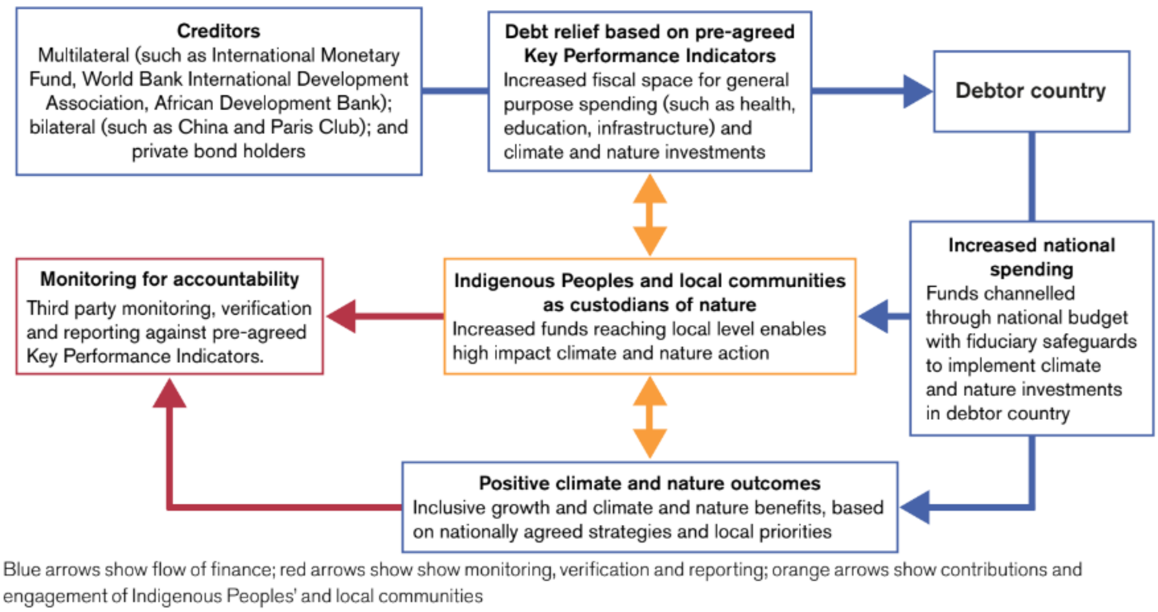

FIGURE 1. Overview of SDGs debt swaps

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Define eligibility criteria

Debt swaps are not a universally viable solution and their effectiveness varies depending on, among many factors, country context. Swaps are a tool for countries that are heading towards debt distress or liquidity problems or have high debt burdens that hold the potential for investing in SDGs. For countries with unsustainable debt dynamics, grants, and comprehensive debt restructuring through mechanisms such as the CFDT should come first (Chamon et al., 2022). The eligibility should be larger than that of the CFDT, extending to all countries at risk of debt distress. Support could be prioritized based on climate and biodiversity vulnerability, poverty, indebtedness, and readiness of financing systems (Steele and Patel, 2020).

Standardize to reduce transaction costs and promote fair negotiations

Despite variations in country contexts, a set of features can be standardized. This will promote fair negotiations, enhance its scalability by streamlining the process of reaching a deal, and add to the liquidity of the bond when issued as part of the transaction.

The CFSDDS should elaborate a standardization of the general parameters of debt swaps to facilitate their negotiations. A relevant precedent is the Paris Club's DSSI framework, which ensures that all creditors are on the same page and supports the legitimacy of the process (Paris Club, n.d.). A memorandum of understanding was produced outlining how the broad parameters of the DSSI could be translated into revised lending agreements. This reduces the amount of bilateral back-and-forth needed to agree on the general aspects of debt suspension before addressing the country-specific conditions, and can also be used by non-Paris Club creditors to come in to support debt suspension based on the same terms. Several initiatives that could serve this purpose are emerging, such as the Sustainable Debt Coalition and the V20 Accra to Marrakech Agenda.

A common problem with both official and private debt swaps is that some rating agencies may view the swap as a default event. Proactive debt management aimed at improving debt and economic stability should not be perceived in the same way as debt restructurings and defaults in times of crisis. The CFSDDS should promote an update on how rating agencies address these issues considering the net benefit to the sovereign's fiscal outlook along with providing for the common good of meeting SDGs.

A critical feature of debt swaps seeking to engage private finance is the credit enhancement provided by a third party as it helps determine investor demand for the bond and the fiscal savings that can be achieved. Currently, each guarantee is tailored to a particular swap and may vary considerably, which requires investors to peruse the prospectus of the new bond carefully to assess its specifics (Jain et al., 2023). Standardizing this could reduce uncertainty and increase demand for the bond (UNFCCC, 2023). The CFSDDS should also support credit enhancement by maintaining a capitalized fund supported by multilateral development banks (MDBs) and development finance institutions (DFIs) to back guarantees for these transactions in a uniform fashion.

Provide technical assistance to align KPIs with national and global goals

Debt swaps should shift from projects to programs through the use of budget support, where funds are paid directly into a debtor government's budget, allowing for a more cost-effective, strategic approach to delivering on SDGs (Steele and Patel, 2020). Such schemes would need to demonstrate minimum fiduciary standards, requiring countries to have certain constraints on corruption and requirements for accountability and policy credibility. Budget tagging and tracking can be useful. When a new bond is issued as part of the transaction, only part of the proceeds raised should be allocated toward SDGs investments. The rest should go towards increasing fiscal space.

In some cases, the lack of capacity for minimum fiduciary standards and the need for more complex financial structuring require arrangements to manage that complexity and ensure the faithful execution of the commitments. Creating a uniform governance structure—that provides credibility with the funds disbursed by boards with majority nongovernment representation—could expedite and simplify the process. This process may have started based on the recent deals (Jain et al., 2023).

Swaps dealing with official creditors should be based on KPIs decided by the debtor aligning with their national plans and commitments, such as their Nationally Determined Contributions (NDCs) and National Biodiversity Strategies and Action Plans (NBSAPs), ensuring consistency with global targets and reducing monitoring costs. KPIs should be developed through a broad and inclusive in-country consultation process and then followed through transparent national verification systems, which include mechanisms for independent verification (UNDP, BIOFIN).

When swapping privately held debt, attaching KPIs from a harmonized list along with attaching penalties for not meeting them—not just for non-payments—can help both accelerate the transaction and mitigate the risk associated with monitoring investments that can vary considerably from one deal to another and could create uncertainty among private creditors (Jain et al., 2023).

Scenario of Outcomes

Finding ways to scale up **SDGs debt swaps** could significantly contribute to the global effort to free up resources in heavily indebted EMDEs to invest in SDGs. Our recommendations are a step in that direction. However, their implementation may not be straightforward as there are trade-offs involved.

The CFSDDS should learn from the CFDT experience (Georgieva and Pazarbasioglu, 2021) and create the right mechanisms and incentives to ensure the participation of a broad range of investors, especially when debt with official creditors is involved. For example, although China has been willing to participate in the CFDT, it has historically preferred bilateral negotiations and geopolitical tensions could exacerbate that. Private creditors tend to deny debt reductions when official creditors are slow to act (Canuto et al., 2023). It is also important to update the way rating agencies see debt swaps and not assign default ratings when they occur because they do not involve involuntary transactions. Otherwise, this could deter some sovereigns from debt swaps.

Maintaining a capitalized fund to support the liquidity of these transactions may be constrained by balance sheet limitations of MDBs and DFIs, particularly if eligibility is extended and if the principal of the new bond has to be almost fully guaranteed (Jain et al 2023a). Such additional funding should therefore also be raised from developed economies, which is in line with their commitments to global climate and biodiversity targets.

Finally, the implementation of the programmatic approach and KPIs monitoring can be constrained by institutional weaknesses in EMDEs, such as corruption and lack of accountability. In contexts of economic instability, EMDEs tend to defund environmental institutions, as opposed to other priorities. It is, therefore, important not only to consolidate the structures in charge of executing the debt swap but also to guarantee its financing and stability.

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Appendix

TABLE A1. Key features of recent debt swaps

Country	Year	Instrument	Tenor	Coupon	Rating	Currency	Type	Size	Debt restructured		Savings/ haircut	Nature conservation		Guarantee/ insurance	Guarantor/ insurer
			(years)					(mm)	Amt. (mm)	Negotiation	(mm/%)	Amt. (mm)	Governance structure	Amt. (mm)	
Seychelles	2015	Blue bond (issued in 2018)	10	6.5% (effec-tively, 2.8% due to loan)	None	USD	Private placement	$15.0	$21.6	Bilateral	$6.6 / 31%	$15.0	Creation of a trust, SeyCCAT, to manage part of the proceeds, and the remaining by DBS	$5 + $5 loan to subsidize coupons	World Bank + GEF
Belize	2021	Blue loan/ blue bond	20	Step-up: 3.0%–6.1% (loan); 1.6%–4.5% (bond)	Aa2	USD	Syndicated to insti-tutional investors	$364.0	$553.0	Multilateral (Buyback of 100% of one bond; 25% of total debt)	$189.0 / 34%	$180.0	Creation by TNC of conser-vation fund and endowment to be transferred in 2041	$364 po-litical risk insurance + catastrophe insurance	DFC
Barbados	2022	Blue loan/ blue bond	15	3.8% (loan); 4.4% (dollar bond)	Aaa (Class A) and Aa2 (Class B)	50% USD + 50% BBD	Syndicated to insti-tutional investors	$146.5	$150.7	Buyback of a portion of one USD (via auction) and one BBD bond (via option)	$4.2 / 3%	$40.0	Creation by TNC of environ-mental sustain-ability fund and endowment to be transferred in 2037	$150 + natural disaster and pandemic clause	IDB + TNC
Ecuador	2023	Blue bond ("Galapa-gos Bond")	18.5	5.6%	Aa2	USD	New debt issued in market	$656.0	$1,630.0	Buyback of a portion of several USD bonds (via market tender)	$974.0 / 60%	$323.0	Creation of Galapagos Life Fund (GLF), a nonprofit, and an endowment	$85 + $656 political risk insurance	IDB + DFC

Note: SeyCCAT = Seychelles' Conservation and Climate Adaptation Trust, DBS = Development Bank of Seychelles, GEF = Global Environment Facility, DFC = US International Development Finance Corporation, IDB = Inter-American Development Bank, TNC = The Nature Conservancy, mm = millions.

Source: The Commonwealth, "Case Study: Innovative Financing – Debt for Conservation Swap, Seychelles' Conservation and Climate Adaptation Trust and the Blue Bonds Plan, Seychelles (on-going)," November 28, 2020, https://thecommonwealth.org/case-study/case-study-innovative-financing-debt-conservation-swap-seychelles-conservation-and; Olly Jackson, "Deal: Seychelles' Sovereign Blue Bond," Latham and Watkins, November 2018, https://www.lw.com/admin/upload/SiteAttachments/Seychelles%20blue%20bond.pdf; The Nature Conservancy, "Case Study: Belize Debt Conversion for Marine Conservation," May 17, 2022, https://www.nature.org/content/dam/tnc/nature/en/documents/TNC-Belize-Debt-Conversion-Case-Study.pdf; The Nature Conservancy, "Case Study: Barbados Blue Bonds for Ocean Conservation," May 10, 2023, https://www.nature.org/content/dam/tnc/nature/en/documents/TNC-Barbados-Debt-Conversion-Case-Study.pdf; Inter-American Development Bank, "Ecuador Completes World's Largest Debt-for-Nature Conversion with IDB and DFC Support," news release, May 9, 2023, https://www.iadb.org/en/news/ecuador-completes-worlds-largest-debt-nature-conversion-idb-and-dfc-support; Ministry of Economy and Finance, Ecuador, "Government of Ecuador Announces Debt for Nature Swap Operation to Preserve Galapagos Islands' Biodiversity," news release, May 11, 2023, https://ire.finanzas.gob.ec/content/2023/05/16.05.2023_Debt_for_Nature.pdf.

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