Global Sovereign Advisory

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Asian Development Bank

East Asia Forum – Considerations on Debt-for-Nature Swaps

ADB

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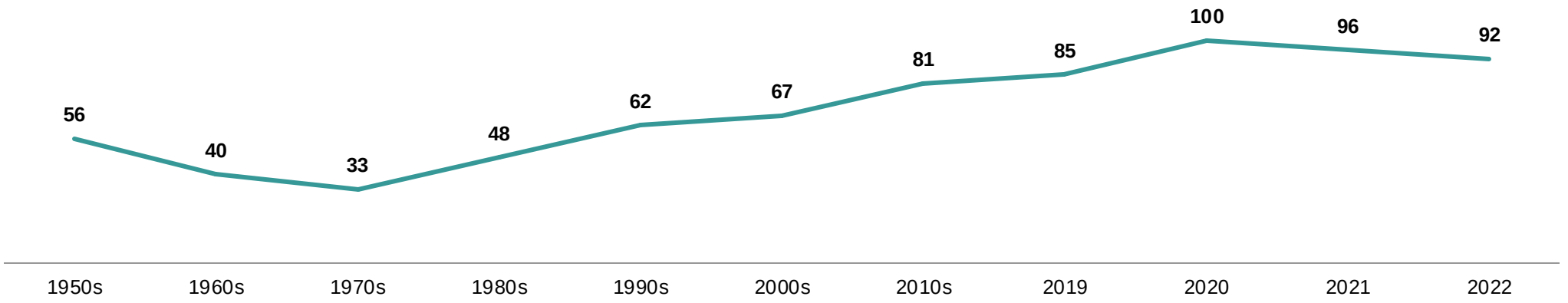
Public debt and environmental challenges are accelerating simultaneously

Rapid rise of public debt pressures is leaving low- and middle-income countries with limited fiscal space for much-needed climate and nature related investments

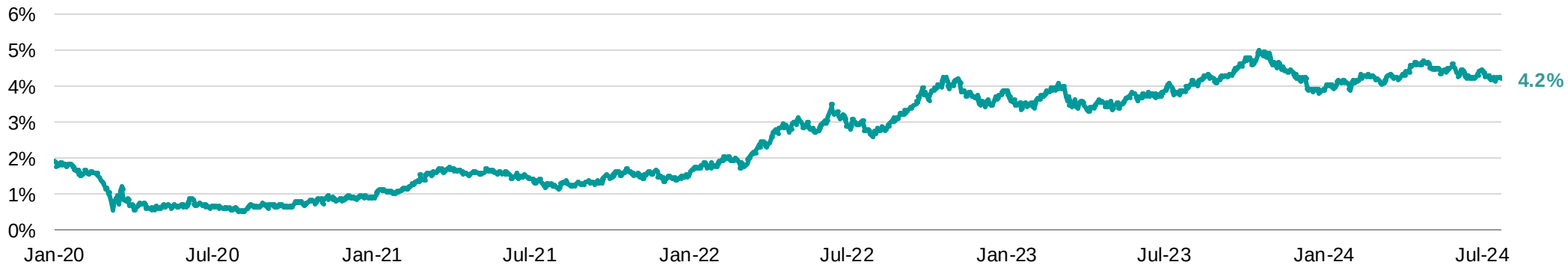
Global public debt increased rapidly over the past decade

Global public debt stock evolution from 1950 to 2022 (% of GDP)[1]



Refinancing costs are expected to remain high going forward

Interest rates 10-year UST government bond yields (in %)[2]



Source 1: IMF Global Debt Database (September 2023)
Source 2: Bloomberg, as of July 24, 2024

Public debt and environmental challenges are accelerating simultaneously

The intensifying environmental crisis exacerbates public debt challenges through macroeconomic shocks and the need for additional green funding

Increased debt and environmental vulnerabilities reinforced each other

Environmental Crisis-Sovereign Debt Doom Loop

1. **Environmental shocks cause economic disruptions** on the supply side (damage to capital stock, productivity, price volatility) and on the demand side (reduction in wealth, assets, consumption, etc.)
2. **Fiscal pressures are exacerbated** due to physical and social costs generated, as well as reduced economic activity weighing on revenues
3. **This leads to increased borrowing needs for the Sovereign**, while being faced with higher debt servicing costs as investors price in environmental shocks due to **increased credit and country risk**
4. **The deterioration of public finances leads to under-investment in adaptation and mitigation policies**, which increases environmental vulnerability

Green finance needs cannot be met without all stakeholders, including the private sector

Funding needed in per year until 2030 to meet the Paris Agreement and related development goals[1]

Climate and nature related spending requirements
USD 2,400bn

Domestic resource mobilization	External financing		
USD 1,400bn	**USD 1,000bn**		
	Bilateral and other concessional finance	Private finance	MDBs and other development finance
	USD 150 – 200bn	**USD 500 – 600bn**	**USD 250 – 300bn**

Source 1: Second report of the Independent High-Level Expert Group (IHLEG) on Climate Finance (2023)

Debt-for-Nature Swaps can provide a solution to the twin challenges of debt and climate

Debt-ridden countries are often more exposed to environmental risks

Debt-for-Nature-Swaps (DFNS) explained

- **A DFNS constitutes a debt relief granted by creditors in exchange for the commitment by the beneficiary Sovereign to allocate the savings to environmental expenditures,** thereby supporting long-term resilience
- **Environmental spending commitments can cover the full amount or a share of the savings** on debt service generated through the DFNS
- **A debtor government has strong incentives to implement a DFNS when it faces liquidity pressures in combination with environmental vulnerabilities,** and has limited fiscal space to address those challenges

USD 100bn

More than USD 100bn of debt in developing countries could be freed up to spend on environmental project[1]

Key advantages and limits for the debtor Government

- **Improvement of the country's fiscal balance** by reducing debt service when savings are only partly allocated to project spending
- **Mobilization of funding for environmental projects** without requiring additional indebteness
- **Reduction of debtors' FX risk** by reducing part of the debt service in denominated in foreign currency
- **Environmental and social co-benefits,** supporting sustainable development

- **Structures can be complex** which, in combination with the involvement of different stakeholders, can make them costly and challenging to assess in terms of impact
- **Potential fiscal rigidity created by the DFNS mechanism,** reducing the budget flexibility of the debtor country
- **Potential rigidities added to the country's debt stock,** especially should there be a need for new funding enhanced by MDBs

Source 1: International Institute for Environment and Development (April 2024)

Debt-for-Nature Swaps can provide a solution to the twin challenges of debt and climate

Since COP 20, a renewed interest via large-scale multipartite transactions

		Face value of debt treated	*Face value savings*	*Environmental financing to be generated*
Seychelles	*2015*	USD 22mn	USD 1.4mn	USD 12.2mn
Belize	*2021*	USD 553mn	USD 189mn	USD 180mn
Barbados	*2022*	USD 151mn	USD 4mn	USD 50mn
Ecuador	*2023*	USD 1,600mn	c. USD 1,000mn	USD 323mn
Gabon	*2023*	USD 500mn	USD 64mn	USD 163mn

Source: Public information available

Debt-for-Nature Swaps can be structured through bilateral or multipartite structures

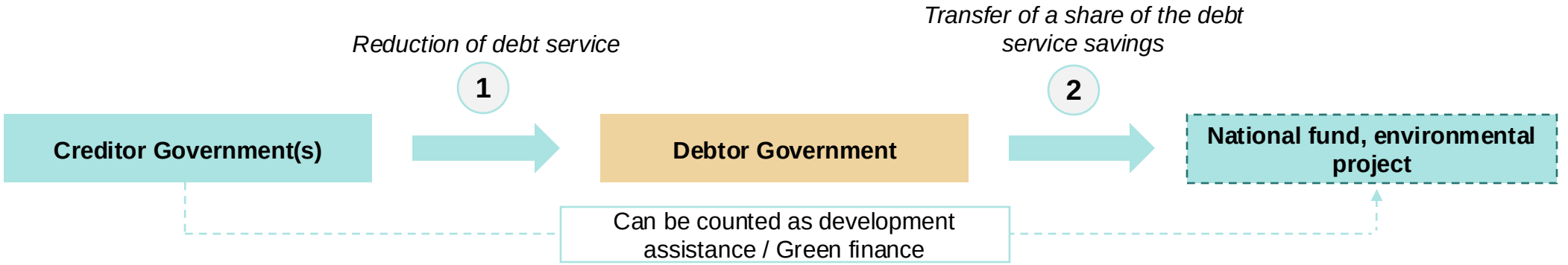
Three main DFNS structures can be identified

	Bilateral swap	Multipartite swap	Multipartite structured swap
Description	A creditor government (or other creditor) voluntarily reduces the debt service owed by a debtor country. In return, the debtor designates an agreed amount (usually in local currency) for a specified purpose	The debtor government buys back its outstanding debt, usually at a discounted price, with grants or concessional loans from donors directly	The debtor government buys back its outstanding debt, usually at a discounted price, with financing from commercial investors and a credit enhancement mechanism provided by a third party
Face value	Small to medium amounts: *USD 5 to USD 50 million*	Medium amounts: *c. USD 25 million*	Large amounts leveraging on markets: *USD 500 – USD 1,500 million*
Transaction costs	No or low transaction costs	Low to medium transaction costs	High transaction costs
Ease of transaction	Streamlined process with few actors involved	Complexity proportional to number of donors	Complex operation, involving numerous players and stages
Environmental commitment	Bilateral involved in governance	Third party involvement in governance	
Context	Ad hoc operation	Liability management operation with commercial debt trading at significant discount or official debt	
Examples	• Peru (2023) • Kenya (2023) • Indonesia (2024)	• Seychelles (2015)	• Ecuador (2023) • Gabon (2023)

Debt-for-Nature Swaps can be structured through bilateral or multipartite structures

Focus on bilateral swaps

In a bilateral DFNS, a creditor government (or other creditor) reduces the debt service owed by a debtor government in exchange for the debtor government's commitment to allocate an agreed amount to a specific purpose



Bilateral DFNS are well suited when there is urgency to implement the swap, limited project absorption capacity, and less financial incentives for private creditors

Streamlined process
- Lower number of players
- Shorter, more standardized process
- Specific priorities of governments directly addressed

Incentives for creditor governments
- Increased ODA without additional budgetary expenditures
- Lower direct budgetary outflows in comparison to providing a grant
- Influence in the use of proceeds
- Strengthened relations with debtor country
- Support in meeting international environmental commitments

Bilateral DFNS rely heavily on 'good will' of bilateral creditors, requiring strong diplomatic ties, and imply smaller amounts / savings

Need for strong diplomatic ties
- Bilateral discussions required
- Debtor governments may lack direct diplomatic access to creditor governments (especially with non-Paris Club governments)

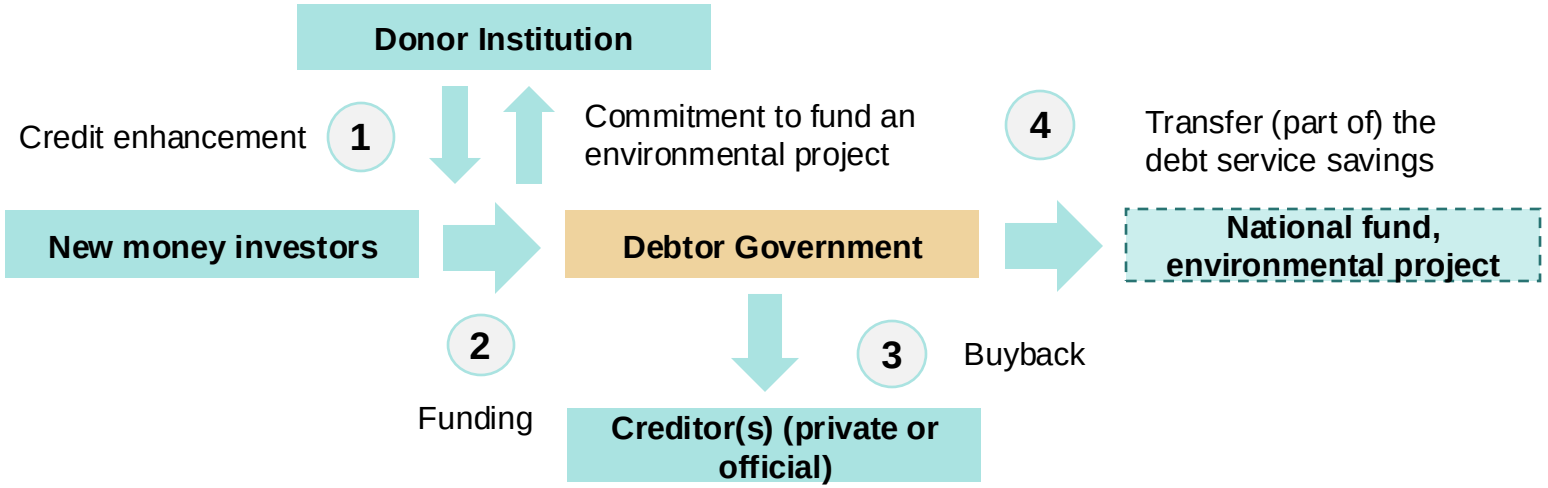
Administrative burden for debtor country
- Numerous commitments and processes can be associated with bilateral transactions, including binational committee meetings

Lower value of treated debts
- Since the transaction relies solely on bilateral creditors, the amounts of debt treated, and thus financing for conservation, is usually lower

Debt-for-Nature Swaps can be structured through bilateral or multipartite structures

Focus on multipartite structured swaps

Multipartite transactions can generate larger savings by supporting DFNS at scale



- In multipartite structured swaps (represented here), the **Donor institution acts solely as a credit enhancer**, while financing is provided by commercial investors.
- In **multipartite swaps, the Donor Institution acts as the funder,** implying lower scale of the transactions due to limited availability of concessional financing

Multipartite structured swaps provide advantages in terms of scale, which explains their increasing use over the past decade

- **Scale**. Multipartite swaps can generate larger savings, with commercial debt trading at a discount as the main target.
- **Project governance** is critical. Third parties can support the debtor country in terms of use of proceeds monitoring.
- **Credibility.** The donor institution can leverage its networks and status to encourage creditors to participate in the transaction.
- **Technical assistance** provided by third parties, including transaction support, project identification and stakeholder coordination.

However, greater scale is matched with greater complexity and challenges linked to the number of parties involved

- **Complex transaction** due to involvement of many different stakeholders, all with their own incentives and priorities
- **High transaction costs.** In Gabon (2023), the all-in yield may be above the coupon of the repaid bonds
- **Transparency challenges.** due to the involvement of various intermediaries and stakeholders, including Special Purpose Vehicles (SPVs)
- **Debt stock rigidities** created when transaction involves guarantees and the recourse of multilateral institutions, which provide challenges when the need to restructure arises

Succesful implementation of Debt-for-Nature Swap relies on several key factors

Key success factors related to the financial transaction

Optimal DFNS financing calls for in-depth assessment of debtor needs and targeted debt line identification

- **Established needs for DFNS.** DFNS is suitable for countries whose Debt Sustainability Analysis (DSA) is threatened by climate change, particularly where financial constraints hinder environmental investments and when there is no ongoing debt restructuring
- **Relevant debt lines identified.** Establishing a DFNS framework necessitates an initial review of the nation's debt portfolio and creditors, steered by its DSA. This review aims to identify the debt instruments that, when included in a DFNS, would most improve debt sustainability
- **Right DFNS structure selected.** Based on its unique needs, economic conditions, and fiscal context, the country must determine the most suitable DFNS structure to adopt, ensuring it resonates with its strategic objectives and constraints

For bilateral swap transactions

- **Strong diplomatic relations with official creditors** showing interest in suppporting environmental projects
- **Existing policy and/or legislative framework** to support DFNS

For multipartite structured swap transactions

- **Sizeable discounted tradeable debt to generate funding at scale**
  - Tradable debt instruments are more easily purchased, sold, or exchanged
  - Debt that is traded at significant discount on secondary markets presents an opportunity to maximize the cost-effectiveness of the DFNS
  - Private debt, with more stable features but more rigid refinancing conditions, can be considered, especially when the Sovereign does not have access to the int. bond markets
- **Creditors willing, or incentivized, to engage in the buyback**
  - Commercial creditors that bought the targeted instrument at a lower price than current trading levels and are willing to exit
  - Largest commercial creditors, with several exposures to the country
  - Commercial creditors with greater sensitivity to ESG principles
- **Strong credit enhancement provider**
  - Improvement of the credit quality of a debt instrument or issuer to attract the private sector into transactions they would not otherwise consider by offering investors commercial protection
  - Reduction of borrowing costs, allowing debt buy backs at more favourable terms and generating larger fiscal savings

Succesful implementation of Debt-for-Nature Swap relies on several key factors

The success of a DFNS is contingent on the underlying projects

	Success factors
Project identification	▶ Proactive pipeline development and objective project appraisal ▶ Evidence of strong impact potential ▶ Viable project design and financing strategy ▶ Projects aligned with national strategies and policies
Project Implementation	▶ Diverse stakeholder participation and knowledge transfer ▶ Effective management and oversight ▶ Sustainable funding approach
Project Monitoring	▶ Well-defined MRV (Monitoring, Reporting, Verification) framework ▶ Feedback / Grievance Mechanisms

Challenges going forward

How can we better leverage DFNS fore the benefit of countries

1	**Willingness of creditor countries to engage in DFNS**	Enhance cooperation frameworks and build a strong rational for them
		Ensure highest standards of governance for projects
2	**Role of International Financial Institutions**	As technical assistance providers
		As funding providers
		As providers of guarantees / credit enhancement mechanisms
3	**Ensure that protected areas remain protected on a perpetual basis or for a long time**	Conditional debt forgiveness
		Land acquired by a Trust / Foundation
		Role of countries, NGOs, conservation agencies
		Incentives, such as the sale of carbon credits
4	**Credit Rating Agencies perception**	Ensure that swaps are voluntary and not viewed as distressed exchanges
		Allow rating upgrades thanks to improvement in debt metrics and ESG rating
5	**Ensure maximum impact**	On debt and/or debt service relief
		On nature protection

Case study – Ecuador's Debt-for-Nature Swap

A market-friendly liability management exercise

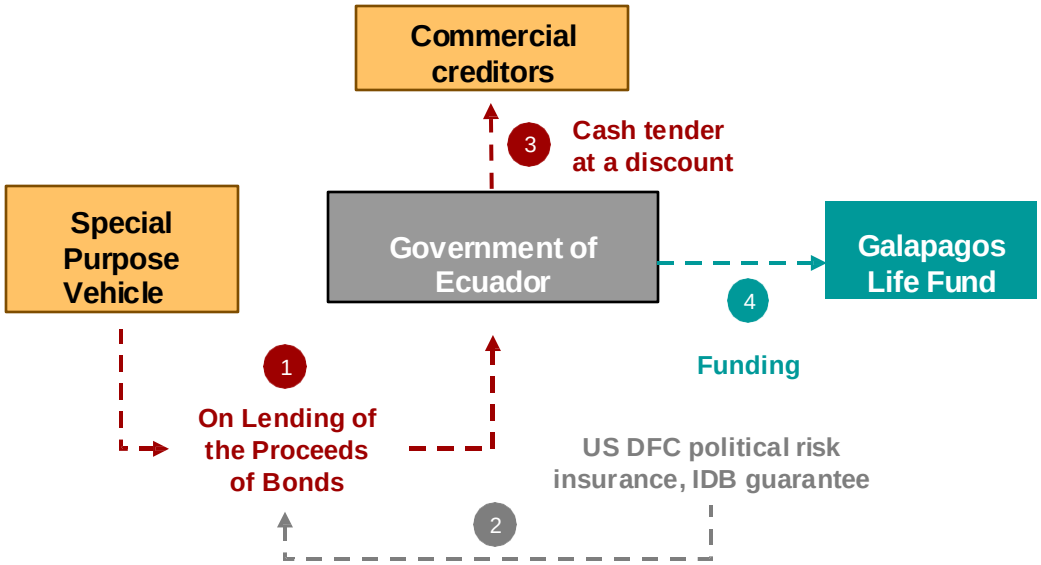
Execution of the tender offer

The tender offer was announced on April 26, 2023 and closed on May 4, 2023. In the end the country bought back $1.6bn in total face value from three bonds due in 2030, 2035 and 2040 respectively at a market value of c.USD 640mn

The results imply an average clean price of 39.6 cents on the dollar across the three tranches. This will entail a reduction of the debt stock by almost one billion dollars

Instrument	Oustanding amount (USD)	Tendered Amount (USD)	% tendered	Purchase price
2030 Step-Up	3,701,423,865	202,337,921	5.47%	53.25
2035 Step-Up	8,458,864,776	1,006,228,531	11.90%	38.50
2040 Step-Up	3,403,135,207	420,192,785	12.35%	35.50

Summary of the transaction



Issuance of a blue bond

The tender offer was financed by a $656m loan facility arranged by Credit Suisse with the following key features:

- An SPV, "GPS Blue Financing" issued $656m in bonds maturing in 2041 and with a 5.645% coupon
- The SPV then turned the bond into a $656m loan to Ecuador, which used the proceeds to execute the tender described above
- The loan has interest rate of 6.975% and shares the same maturity as the newly issued bond. Amortization for both instruments is expected to begin in 2030 according to media reports

Source: Bloomberg, Republic of Ecuador

Zoom on US DFC and IDB's supports to the blue bond

The transaction benefits from a $656m political risk insurance by the US Development Finance Corporation (US DFC) covering all of the outstanding

- In case of a missed payment investors would need to seek a judgement or arbitration award before receiving payment from the US DFC

The Interamerican Development Bank (IDB) also provides a $85m guarantee, designed as a liquidity support, whose amount will decline as the loan amortizes

- This is a more immediate and straightforward guarantee which does not require any judgement for the institution to step up when the country misses a payment

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Thank you !

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