Debt for Climate (DFC) Swaps
Supporting a sustainable recovery

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The COVID-19 pandemic has worsened the debt vulnerabilities of many low- and medium-income sovereigns. Debt levels were already high prior to COVID outbreak.

This is exacerbated because government revenues have declined due to COVID – while the timing/quantum of debt servicing payments remain the same. Exchange rate fluctuations will further increase the burden of foreign debt servicing payments.

The IMF estimates that the ratio of public debt service costs to government tax revenue will exceed 20% in a majority of low-income and emerging countries in 2021.

As a greater proportion of governments revenues are now dedicated to servicing debt, spending towards reviving growth or achieving climate goals has taken a backseat.

Depending on the fiscal situation of a nation, there’s a need to provide fiscal headroom through either of the following routes:

- Debt suspension
- Debt forgiveness
- Reorientation of debt so that service payments are utilized for a green recovery
Existing interventions to address sovereign debt

- While there are interventions focused on providing debt relief to Low Income Countries (LICs), no such interventions exist to support Middle Income Countries (MICs).

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<th>Sovereign external debt holder</th>
<th>Income level of the debtor nation</th>
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<td>National governments</td>
<td>Low Income Countries (LICs)</td>
<td>Distressed debt/liquidity</td>
<td>DSSI (Debt Suspension Servicing Initiative)(^4)</td>
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<tr>
<td>National governments</td>
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<td>High external sovereign debt – potentially leading to underspending on economic stimulus and climate finance</td>
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Debt for Climate (DFC) Swaps

An introduction
What are Debt for Climate (DFC) Swaps?

- Debt for Climate (DFC) swaps are a type of debt swap in which the debtor nation, instead of continuing to make external debt payments in a foreign currency, makes payments in local currency to finance climate projects domestically.

*Credit is likely to be another sovereign, but private sector creditors are also encouraged to participate in a DFC swap.

- Debt for Climate (DFC) swaps are a type of debt swap in which the debtor nation, instead of continuing to make external debt payments in a foreign currency, makes payments in local currency to finance climate projects domestically.
What issues can DFCs address for MICs?

DFC swaps would be used to generate the following outcomes:

- **Enhanced climate spending:** The avoided debt service payments should be used for climate friendly activities or to incentivize participation in climate friendly sectors.

- **Boosting economy recovery:** Given suppressed economic demand, the investments can stimulate private investment and assist in economic recovery, while incorporating climate resilience and protecting biodiversity.

- **Reduced external sovereign debt:** DFC swaps help highly-indebted nations (who are still servicing their debt) reduce debt service and free up cash flows for more productive investments.
Eligibility for DFCs

DFC swaps should be proposed for countries that meet the following criteria:

- **High level of public external debt held bilaterally by other sovereigns** (e.g., >USD 3 billion or >5% of GDP). While our focus is on debt issued by a federal government, debt owed by public sector entities are included as it can be part of DFC solutions.

- **No imminent liquidity crisis** because DFC swaps as proposed here are for nations that are servicing their debt but underspending on climate finance given limited fiscal capacity and/or competing demands post-COVID. Therefore, we assume that eligible nations would not be part of DSSI.

- **Nation should ideally be a MIC** (Middle Income Country), as per World Bank classification. However, LICs that are not part of DSSI can be considered.

- **The beneficiary country should not be a major creditor nation** (e.g., China) or a part of a major creditor group (e.g., The Paris Club).

- **The country shouldn’t be unstable** – politically (e.g., Syria) or economically (e.g., Venezuela), as measured by the Fragile States Index.
Criteria for using proceeds

Given that the overall objective of DFC swap is to convert sovereign debt into enhanced spending on climate activities, the use of proceeds should abide by the following principles:

1. **Type of sectors:** The avoided debt service payments should be used for climate friendly activities whose outcomes can be monitored and measured.

2. **Commercial viability:** Proceeds should be used for underspent activities that have (close to) commercial level risks/returns. There may be a portion allocated for technical assistance or capacity building.

3. **Mobilize private investment:** The proposed use cases should not crowd out private investment and, in fact, should leverage downstream private investment that otherwise may not have occurred.
(Optional) Conditionality for DFCs

Only those eligible nations that agree to the following conditions could be considered for DFC swaps:

• **Higher transparency** in debt reporting and monitoring, akin to that for the DSSI Initiative.

• Recipient nations **pledge increased climate commitments** in their NDCs under the Paris Agreement.
Use of Proceeds – Representative Example - Accelerated Coal Power Retirement Mechanism (ACPRM)

Avoided debt service payments + additional commitment from debtor nation

- Creditor Nation partly forgives public external debt
- Eligible Debtor Nation
- Accelerated Coal Power Retirement Mechanism (ACPRM) fund
- Buys out and retires coal plants early
- Cheaper renewable energy including energy storage hybrids
- Retiring coal plant
- Offtakers pay price agreed upon in the original contract*

* While the replacement renewable energy may be delivered at a lower cost than the coal power being replaced, it is likely that the economics of early retirement will need the original PPA to be honored for at least some time into the future.
Key Issues for Structuring Debt for Climate Swaps

Participating entities and their roles
Who may need to participate and guide

In addition to the willing debtor nation and at least one creditor nation, other parties will need to be either directly or indirectly engaged on structuring a swap transaction:

- **Engaging the IMF** will remain key in any large restructuring of sovereign debt and reprogramming debt service to increase climate-aligned capital formation. It is also developing a framework for ‘green debt swaps’ in conjunction with the World Bank.

- **Other creditor nations** if it is a plurilateral swap. Given the outstanding sovereign debt held bilaterally by China, engaging China will be key to many swaps.

- **Relevant DFIs** – will be key to providing technical assistance and helping build capacity across various ministries in the debtor nation

- **Private financial groups.** Experience shows that creditor nations are politically averse to allowing the private sector to get a “free pass”.

- **Credit rating agencies** should be engaged to ensure there are no negative repercussions to the credit rating for debtor country.
Summary

- The COVID-19 pandemic has exacerbated the debt vulnerabilities of developing countries.

- In the case of LICs, this may manifest in the form of liquidity crunch, which could lead to a potential default.

- However, MICs face other issues. A number of MICs do not face liquidity crisis – they have capacity to payback upcoming debt servicing payments, but due to limited government revenue collections (as a result of pandemic), a greater proportion of fiscal resources is now dedicated towards servicing debt payments.

- This leaves very little headroom to spend on climate projects and stimulus measures aimed at economic recovery.

- DFC Swaps may emerge as a viable option that can generate the much-needed fiscal space for MICs to focus on climate ambitions and economic recovery, while reducing their overall debt burdens.
Thank You

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