

POLICY BRIEF

# Debt-for-Climate Swaps as a Tool to Support the Implementation of the Paris Agreement



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# Debt-for Climate swaps as a tool to support the implementation of the Paris Agreement

Under the Paris Agreement, developed and developing countries have committed to do their part to ensure that the warming of the planet is capped at well below 2 °C above pre- industrial levels and are pursuing efforts to limit the temperature increase to 1.5 °C above pre- industrial levels. These commitments are reflected in their Nationally Determined Contributions (NDCs), which countries are required to submit every five years.<sup>1</sup> However, with COVID-19 recovery efforts demanding a massive increase in government expenditure amid slowing economic activity, sovereign debt levels have risen sharply in 2020 and are likely to remain high in the near future. Currently, 11 Asia-Pacific countries are at high risk of debt distress, seven of which are Pacific Small Island Developing States: Afghanistan, Kiribati, Lao PDR, Maldives, Marshall Islands, Micronesia (Federated States of), Papua New Guinea, Samoa, Tajikistan, Tonga and Tuvalu.<sup>2</sup> Furthermore, as countries prioritize addressing health concerns and a speedy economic recovery, relatively less attention is being paid to tackling climate change.

Given this situation, there has been increasing support for debt-for-climate swaps as a solution to simultaneously reduce sovereign debt burdens and increase financing to scale up investments in climate mitigation and adaptation projects. Earlier this year, the Managing Director of the IMF announced that the IMF and the World Bank are working together to develop an “organizing

framework” for connecting debt relief to countries’ plans for investing in green, resilient and inclusive development.<sup>3</sup> Their joint proposal for green debt swaps will be announced during COP 26.

A debt-for-climate swap can be defined as an agreement between a debtor country and its creditors, where the former’s debt stock is reduced in exchange for a verifiable commitment to invest in climate mitigation or adaptation projects. The idea of providing debt relief in exchange for actions to protect the environment has its origin in the debt-for-nature swaps first proposed by Thomas Lovejoy, the vice president of the World Wildlife Fund, in 1984.<sup>4</sup>

There are two kinds of debt-for-nature swaps. The first one is a bilateral swap, in which a creditor country agrees to cancel a debtor country’s deficit in exchange for the debtor’s commitments to spend the newly available funds on approved projects. If more than one creditor country participates in the deal, it is called a multilateral swap. The second type, which has been the most common, is third-party swaps. In this case a third party, typically a non-governmental organization (NGO), intermediates between the debtor and its creditors to facilitate the deal. Specifically, the third party purchases a developing country’s debt in the secondary market at a discounted value and then transfers it back to the debtor in exchange for the government’s commitment to mobilize funds for specific projects.<sup>5</sup> An example is the Seychelles’ debt-for-nature swap concluded in 2018 with support from The Nature Conservancy, a US-based environmental group.<sup>6</sup> In the late 1980s and 1990s, when debts of

<sup>1</sup> [NDC Registry](#).

<sup>2</sup> World Bank (2021). [COVID 19: Debt Service Suspension Initiative](#).

<sup>3</sup> Andrea Shalal (2021). [IMF, World Bank to unveil 'green debt swaps' option by November, Georgieva says](#). Reuters.

<sup>4</sup> Brijesh Thapa (1998). Debt-for-nature swaps: an

overview. *International Journal of Sustainable Development & World Ecology*.

<sup>5</sup> UNESCAP (2021). Chapter 4: Fiscal and Financing Policies for Building Forward Better. *Economic and Social Survey of Asia and the Pacific*.

<sup>6</sup> Commonwealth Small States Centre of Excellence (2019). [Case Study: Debt-for-Nature Finance Swap](#).

developing countries with private banks traded in secondary markets at steep discounts, third parties facilitated debt-for-nature swaps by buying the arrears from commercial banks in secondary markets. The case of Bolivia in 1987 is an example of an early debt-for-nature swap.<sup>7</sup> In all cases, the swaps allowed debtors to fund committed projects in domestic currency, thus alleviating foreign exchange constraints.

While debt swaps can be a win-win arrangement by simultaneously providing debt relief and financing for valuable projects, the experience of debt-for-nature swaps highlights some challenges. First, their transaction costs tend to be rather high because of the involvement of multiple stakeholders, which make their planning, negotiation, and implementation complex and time consuming. For instance, the Seychelles swap mentioned above took four years to reach consensus. Second, debtors are required to make a long-term fiscal commitment to fund the agreed-upon projects, which can be challenging in cases of fiscal crises or changes in the political regime. Third, as the government will fund the agreed projects in local currency, there is a risk that inflation or currency devaluation can erode the real value of the committed funding. Fourth, the size of debt swaps has been in many cases too small to have a real impact in providing debt relief.<sup>8</sup>

An additional challenge pertaining to debt-for-nature swaps is that conservation projects may create conflicts in local communities as well as land ownership issues. One example is Bolivia's 1987 debt-for-nature swap mentioned above, where the indigenous peoples of the area that the government agreed to protect were never consulted about the implications of the swap agreement. The swap unilaterally titled the land to be protected by the government of Bolivia, de facto terminating a process initiated before the swap to allow the indigenous peoples to obtain land tenure in the

reserve areas. In addition, the agreement imposed restrictions on traditional activities of the indigenous peoples considered to be detrimental to forest preservation, and it granted logging concessions to operate in the area surrounding the reserve, further fuelling conflicts between the indigenous people and logging and ranching interests that would continue into the 1990s.<sup>9</sup>

Understanding these challenges and avoiding the errors of past debt-for-nature swaps is essential to design an effective debt-for-climate swap mechanism. To this end, the following recommendations could be considered:

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## 1) CONDUCT CONSULTATIONS WITH ALL RELEVANT STAKEHOLDERS TO UNDERSTAND THEIR VIEWS AND SEEK TO ENSURE A STRONG POLITICAL SUPPORT FOR A DEBT SWAP DEAL

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Relevant stakeholders include at a minimum the debtor country government, its creditors, and other domestic stakeholders who need to agree to the projects to be implemented under the swap arrangement. Development partners, such as donors, multilateral development banks, and non-governmental organizations are most likely to be part of the group of stakeholders if they agree to provide support, such as grants or technical assistance, for the implementation of projects. Developed countries included in Annex II of the Paris Agreement could also be stakeholders in the debt swap because supporting the agreement through grants would count towards meeting their commitment to contribute \$100 billion per year in climate finance. As discussed below, the Paris Agreement provides an appropriate framework for debt-for-climate.

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<sup>7</sup> In this case, the environmental NGO Conservation International bought \$650,000 of Bolivian sovereign debt for \$100,000 in exchange for the government providing legal protection to the Beni Biosphere Reserve plus \$250,000 for management support within the reserve. See Philip Shabecoff (1987). [Bolivia to Protect Lands in Swap](#)

[for Lower Debt](#), New York Times.

<sup>8</sup> UNESCAP (2021). [Economic and Social Survey of Asia and the Pacific. Towards post-COVID-19 resilient economies](#).

<sup>9</sup> Knicley, Jared E. (2012). [Debt, nature, and indigenous rights: Twenty-five years of debt-for-nature evolution](#). Harvard Environmental Law Review.

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## 2) DESIGN A DEBT-FOR-CLIMATE SWAP TERM SHEET TO REDUCE TRANSACTION COSTS AND NEGOTIATION TIMES

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Debt-for-climate swaps agreements are complex because of the different stakeholders involved and the array of issues that need to be considered, ranging from the amount and profile of public debt to be swapped, the beneficiary of climate mitigation and adaptation projects, co-financing sources, the debt discount or conversion rate, the schedule of government payments to an entity to be responsible for project implementation, and recourse measures in case of nonfulfillment of an obligation under the agreement.

To facilitate the negotiation process among the various stakeholders, a debt-for-climate swap term sheet could be designed to encapsulate the main terms and conditions of the swap deal. Similar to a term sheet for an investment deal, a debt-for-climate swap term sheet would reduce the likelihood of misunderstandings or unnecessary disputes among the stakeholders that could delay agreement on the deal. The term sheet would also serve as a template and basis for a more detailed, legally binding document. Once the parties involved reach an agreement on the details laid out in the term sheet, a binding agreement or contract that conforms to the term sheet details would be drawn up.<sup>10</sup>

The debt-for-climate swap term sheet could take advantage of existing taxonomies and standards, as well as environmental and social safeguards within the broader UNFCCC and climate finance space. For example, the term sheet could require that the projects to be funded by the swap comply with international standards, such as the CBI Climate

Bonds Taxonomy or the EU taxonomy for sustainable activities. Likewise, the term sheet could require that any conservation project to be funded by the swap comply with the UNFCCC REDD+ Safeguards, to protect local communities and biodiversity.<sup>11</sup>

To be sure, a term sheet will only provide an initial basis for the negotiation of a debt-for-climate swap deal. Given the bespoke nature of debt-for-climate swaps, the term sheet will need to be tailored to each country's specific context and circumstances. Nonetheless, the existence of a standardized term sheet is likely to facilitate and speed up the negotiations of a final deal by making clear to all stakeholders the key parameters to be agreed upon.

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## 3) ADOPT AN EFFECTIVE MONITORING, REPORTING AND VERIFICATION (MRV) FRAMEWORK

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While debt relief is an important objective of a debt-for-climate swap deal for the borrower country, effectively implementing climate mitigation and adaptation projects using savings in debt services payments is of paramount importance for creditors and development partners contributing additional funding. For that purpose, an effective monitoring, reporting and verification (MRV) framework needs to be a key component of implementation in the swap deal. The MRV framework could be based on Sustainability Performance Targets (SPTs) and Key Performance Indicators (KPIs), similar to those in the ICMA Sustainability-Linked Bond Principles, and appropriately adapted to the projects to be funded by the swap.<sup>12</sup> In case of conservation projects to be funded by the swap, the performance targets and KPIs should include consideration of issues such as land rights and natural resources management. All in all, a robust MRV will help create confidence among key stakeholders about the effectiveness of the debt-for-

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<sup>10</sup> Akhilesh, G. (2020). Term Sheet. Investopedia.

<sup>11</sup> For details on the UNFCCC REDD+ Safeguards, see ClientEarth (2013). [A Guide to Understanding and Implementing the UNFCCC REDD+ Safeguards: A Review of Relevant International Law.](#)

<sup>12</sup> The use of KPIs to evaluate sustainable strategies has been discussed mostly in the business context. See Ivo Hristov and Antonio Chirico (2019). [The Role of Sustainability Key Performance Indicators \(KPIs\) in Implementing Sustainable Strategies.](#) Sustainability, MDPI.

climate swap to reach the desired climate objectives. As such, it can also contribute to speeding up the negotiation process.

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#### 4) ENSURE NATIONAL OWNERSHIP

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The projects to be funded by debt-for-climate swaps should be selected by the debtor countries based on their NDCs and other national planning documents.<sup>13</sup> While it is true that the swaps will allow debtor governments to obtain relief from their public external debt obligations, the deal will commit them to provide agreed-upon funding to the projects decided in the swap. To ensure compliance by debtors on this funding, the projects should be in the national interest and should be agreed by all the domestic stakeholders, including indigenous and local communities, through a broad consultation process. An important consideration by national governments considering a debt-for-climate swap deal is that the scale of it is enough to justify their negotiation and implementation costs. The scale of the deals should also be enough to provide sufficient deficit to ensure the sustainability of their external debts.

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#### 5) ADDITIONALITY

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The funding provided by the debt swaps should be in addition to the creditor governments' ODA commitments. While it is beneficial to have a vision for concrete climate objectives and measures, and the institutional capacity to deliver them, payments originating from the swap should not be used to legitimize cutbacks in government spending in other areas.

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<sup>13</sup> Ulrich Volz, Shamshad Akhtar, Kevin P. Gallagher, Stephany Griffith-Jones, Jörg Haas, and Moritz Kraemer (2021). [Debt Relief for a Green and Inclusive Recovery: Securing Private-Sector Participation and Creating Policy Space for Sustainable Development](#).

<sup>14</sup> Within the context of developing countries' NDCs, a conditional contribution is part of an NDC that countries

will undertake if international means of support are provided, or other conditions are met. See European Capacity Building Initiative (ECBI) (2018). [Pocket Guide to NDCs under the UNFCCC](#).

In sum, debt-for-climate swaps offer the opportunity to bring together two critical pillars of the Paris Agreement – the NDCs and the climate finance commitments by developed countries – while at the same time providing debt relief to developing countries. To make the most of this opportunity, political support from key stakeholders is needed so that the swaps can be applied to countries at high risk of external debt distress. By providing a dedicated source of funding to the NDCs, especially conditional contributions,<sup>14</sup> it will create incentives for developing countries to increase their level of ambition and to undertake critical investments in climate adaptation and decarbonization. The scheme also provides developed countries an outlet to fulfill their commitments under the UNFCCC.

Figure 6 presents a schematic view of debt-for-climate swaps that links the two pillars of the Paris Agreement. It considers the case where the creditor is a developed country that partially or fully cancels a debt of a developing country. According to Article 11.5 of the UNFCCC, “the developed country Parties may also provide and developing country Parties avail themselves of financial resources related to the implementation of the Convention through bilateral, regional and other multilateral channels.”<sup>15</sup> If a developed country is a bilateral creditor of a developing country, a partial or full cancellation of such debt would constitute a bilateral transfer of resources to the developing country debtor. As such, it would count towards the global commitment of developed countries to provide \$100 billion per year in climate finance.

The rest of the scheme is similar to conventional debt-for-nature swaps with the exception that the debtor allocates part of the savings in debt services exclusively to climate mitigation and adaptation activities specified in its NDC. As in conventional debt-for-nature swaps, the debtor's funds go to a trust fund or special purpose vehicle (SPV) that manages the funds and implements

would undertake if international means of support are provided, or other conditions are met. See European Capacity Building Initiative (ECBI) (2018). [Pocket Guide to NDCs under the UNFCCC](#).

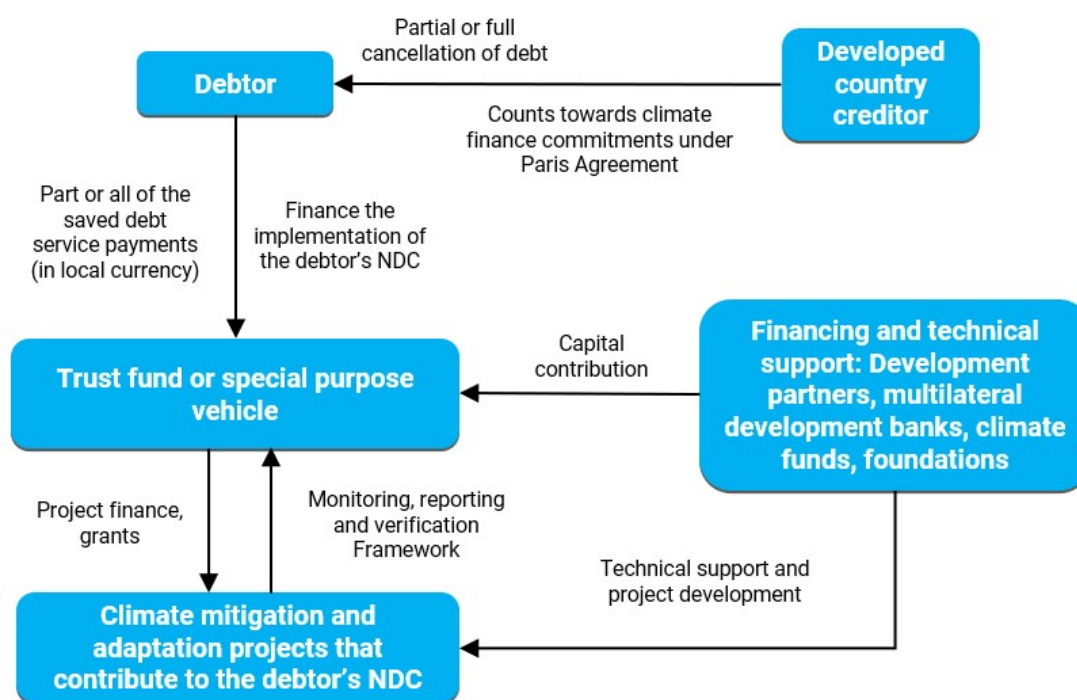
<sup>15</sup> United Nations (1992). [United Nations Framework Convention on Climate Change](#).

the projects selected by the debtor, while a reporting and verification framework ensures the effective and efficient use of the funds. In addition, the trust fund or SPV can invite entities such as development partners, multilateral development banks, climate funds, or foundations to provide additional capital.

As an example, suppose that the debtor has a debt of \$100 million and pays an annual interest of 10 per cent. If the creditor partially cancels 50 per cent of the debt, \$50 million would count as climate finance provided by the creditor under the Paris Agreement. Suppose also that the debtor is required by the agreement to contribute 50 per

cent of the saved interest to the trust fund or SPV. In this case, the debtor would reduce its payments to the creditor to \$5 million per year and contribute \$2.5 million per year to climate mitigation and adaptation projects that would allow it to implement its NDC. As is standard in debt-for-nature swaps, the contribution would be in domestic currency. The amounts of debt cancellation and contributions of the debtor to the trust fund or SPV, as well as the projects to be funded, capital and technical assistance contributions by other parties and the monitoring, reporting and verification framework are all subject to negotiation. As suggested above, a debt-for-climate swap term sheet could facilitate the negotiations by providing clear guidance of all the elements to be considered in a final deal.

**FIGURE 1: A DEBT-FOR-CLIMATE SWAP SCHEME TO SUPPORT THE IMPLEMENTATION OF THE PARIS AGREEMENT**



Source: ESCAP.

The scheme in Figure 6 could apply to a developing country creditor as well. The provision of climate finance by countries other than the developed countries is possible

according to Article 9.2 of the Paris Agreement.<sup>16</sup> The UNFCCC does not specify how developing countries can contribute to climate finance, as Article 11.5 applies only to developed countries.

<sup>16</sup> Article 9.2 states that “other Parties are encouraged to

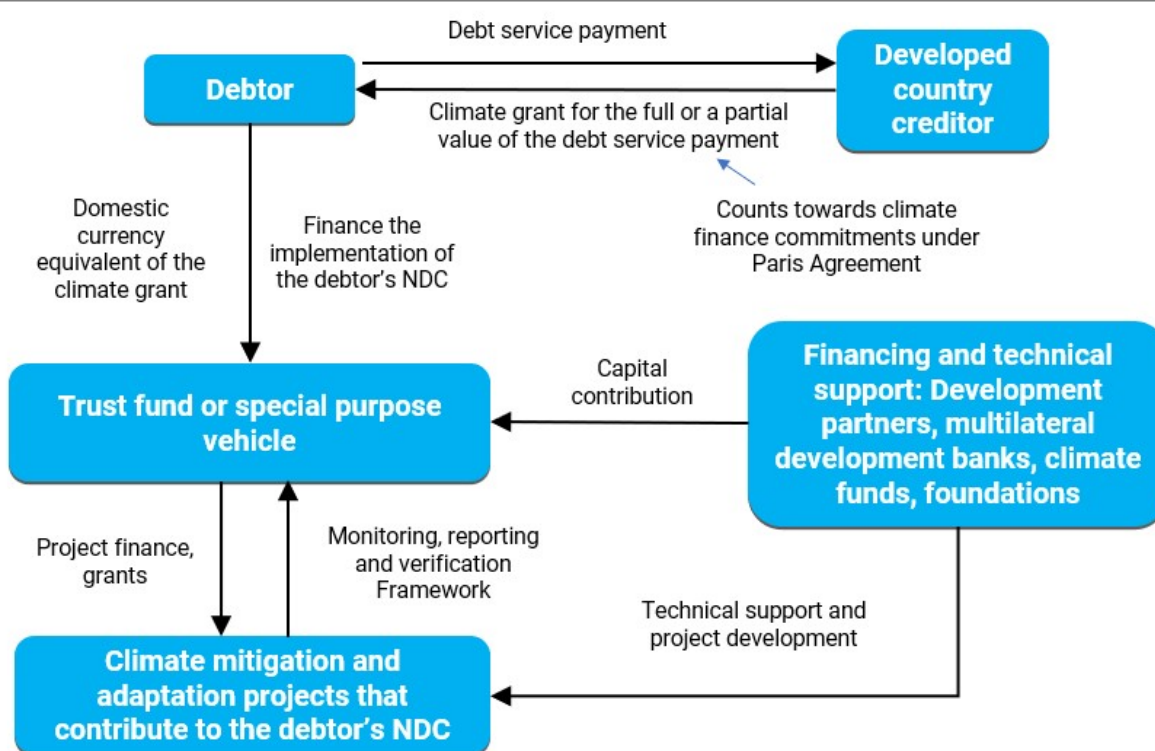
provide or continue to provide such support voluntarily.” United Nations (2015). [Paris Agreement](#).

However, a number of developing countries have contributed climate finance voluntarily through the Green Climate Fund and the Global Environmental Facility, and in 2015 China pledged \$3.1 billion to a “South-South Climate Fund” that will support climate action in other developing countries.<sup>17</sup> Given this precedent, it would be possible for a developing country to contribute climate finance voluntarily by supporting another developing country through a debt-for-climate swap.

The scheme described in Figure 6, whether the creditor is a developed country or a developing

country, could be problematic. This is because a debt write-off would be accounted in the creditor country as a government expense, and a large write-off could be undesirable because of its impact on the creditor country’s fiscal balance. An alternative arrangement would be a “debt service-for-climate grant swap,” by which the creditor provides a climate grant for the full or a partial value of the debt service payment. The debtor, in turn, commits to allocate the full or a partial value of the equivalent to the grant in local currency to the trust fund or SVP.<sup>18</sup> See Figure 7.

**FIGURE 2: A DEBT SERVICES-FOR-CLIMATE GRANTS SWAP SCHEME**



Source: ESCAP.

Assuming, as in the example provided above, that the debtor has a debt of \$100 million and pays an

annual interest of 10 per cent, in a debt services-for-climate grant swap, the creditor returns to the

<sup>17</sup> Ferreira, Patrícia Galvão (2018). [Climate Finance and Transparency in the Paris Agreement: Key Current and Emerging Legal Issues](#). Centre for International Governance Innovation (CIGI) Papers.

<sup>18</sup> See discussion by Thomas Melonio, Executive Director for Research and Innovation, French Development Agency in UNDESA (2021). [2021 HLPF Side Event: Financing a sustainable recovery: The role of debt-relief instruments](#). Summary of the side event.



debtor 50 per cent of the interest payment as a climate grant, and the debtor commits to allocate the full amount of the grant in local currency to the trust fund. The advantages of this arrangement for the debtor are three: (i) reduced pressure on the exchange rate, as the contribution to the trust fund is in domestic currency, (ii) a stable source of funding for climate action projects, and (iii) multiplier effects, as the funded projects will generate employment and other benefits to the local economy. From the creditor's point of view, the contribution to climate finance commitments under the Paris Agreement would be smaller than in the case of debt write-off but would be provided every year, easing impacts on the creditor's fiscal budget and becoming a more sustainable source of climate finance for the debtor. In practice both options — a partial debt write-off in exchange for contributions by the debtor to climate projects and a commitment by the creditor to allocate a percentage of the debt services received for the same purpose — could be considered and combined in a debt-for-climate swap deal, providing flexibility to accommodate the individual circumstances of debtors and creditors. Finally, this alternative arrangement would be available for non-Annex II countries of the UNFCCC as a way to provide a voluntary contribution to climate finance.

One specific example of an initiative that could benefit from a debt-for-climate swap is the Pacific Resilience Facility of the Pacific Islands Forum Secretariat. This facility aims to provide grants to governments to fund small-scale, community level, disaster risk reduction projects such as retrofitting critical infrastructure, community centers, and schools, or small-scale coastal protection projects. While the Facility is expected to be funded by capital contributions from development partners and Multilateral Development Banks, a debt-for-climate swap mechanism is also being considered as a complementary way to fund climate projects in the Pacific SIDS. ESCAP is currently providing technical assistance to the Pacific Islands Forum Secretariat to assess the feasibility of such a mechanism.

To conclude, there is no doubt that debt relief and scaling up financing for climate action are two major policy objectives in the era of COVID-19, and debt-for-climate swaps have the potential to simultaneously address both. This section has provided ideas for an effective way to negotiate and implement debt-for-climate swaps, which may prove useful for policymakers in debtor and creditor countries and other stakeholders.

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