STRATEGY, POLICY AND REVIEW

DEBT FOR CLIMATE SWAPS AS A CLIMATE FINANCE INSTRUMENT

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*The views expressed in this presentation are those of the authors and do not necessarily represent those of the IMF or IMF policy.

Overview

Renewed interest in debt swaps to help countries meet climate challenges given high debt and limited fiscal space.

This presentation draws on a **recently published WP** that analyzes whether:

- **Is there an economic case for debt-climate swaps along other instruments?**
- **Should debt-climate swaps be promoted and, if so, how?**

Our findings point to **yes for both questions**. But the efficiency case for swaps is relatively narrow and carries **important qualifications**.

We will discuss key questions, including:

- When is “bundling” the solution preferable to using other instruments to tackle the debt and climate problems separately?
- How do swaps compare with other forms of climate financing?
- What are the obstacles to wider use (including transaction costs and lack of standard KPIs)?

Why have swaps remained a niche instrument?

Debt for nature swaps have been around since the 1980s. But **not gained much scale** (linked to complexity of transactions and high transaction/monitoring costs).

Scale of swappable debt relatively small if limited to bilateral swaps (need coincidence of donor holding the debt of a country suitable for the swap). More scope once **"tripartite" swaps** are considered, where party subsidizing the transaction acquires a debt instrument in order to do the swap. Fiscal savings would depend on:

- Extent of the subsidy provided by the donor organizing the swap
- New green instrument trading at a premium (unlikely to be a significant channel)
- Some credit enhancement that makes the new instrument trade at a premium (e.g. guarantee)

Two recent cases financed by TNC provide a useful blueprint for "tripartite" swaps:

- Seychelles 2015 which involved bilateral debt
- Belize 2021 buying back its sovereign bond

A donor may be able to buy back commercial debt at more favorable prices than borrower.

- As debt is bought back, market prices will increase. But a "stealthy" buy-back can limit that effect.

Four ways to provide fiscal support for climate/conservation (c/c)

1. **Conditional lending instruments**
   - Sovereign ESG bonds; official concessional lending for c/c
   - Big (sovereign ESG: ~$90 bn in 2021; official lending ~$45 bn in 2019)
   - A bit cheaper than normal lending: ESG “greenium”; official subsidy
2. **(Official) climate-conditional grants**
   - Smaller, but not small (~$17 bn in 2019)
3. **Debt-nature swaps**
   - Partial debt forgiveness in return for a conservation commitment
   - Bilateral (official creditor/debtor) or trilateral (NGOs/private creditors/debtor)
   - ~200 mostly tiny transactions since 1987 (total treated: ~$3 bn)
4. **Comprehensive debt restructurings with climate conditionality**
   - So far, just a theoretical concept (but Belize 2021 $0.5 bn came close)

Which instrument to use?

It depends on the objective.

1. **Finance c/c in countries that have insufficient fiscal space or deserve a subsidy:**
   - *Climate-conditional grants generally better than debt-climate swaps*.
     - Conditional grants: Debt levels, debt risks remain same. But public investment commitment does not suffer this risk (pay out grant only upon seeing a bill/receipt).
     - Debt-nature swaps: Replace a debt service commitment with a public investment commitment.
       - As risky as debt service commitment (unless senior).
       - But if the investment is senior to debt service, a swap can be more cost effective to the donor.
2. **Finance c/c <u>and</u> solve a debt problem:**
   - *Either: Combine a standard debt restructuring with climate-conditional grants*
     - When debt problem is not linked to climate problem
   - *Or: Comprehensive debt restructurings with climate conditionality*
     - When climate action materially improves solvency

So, is there ever a case for debt-climate/nature swaps?

Yes.

1. **Pragmatic argument**: A debt swap may be on the table but the combination of a grant with standard debt relief may not be.

2. **Debt-nature or Debt-climate swaps as "debt restructuring lite"**.
   - Avoid the unpleasantness of a comprehensive debt restructuring. Usually voluntary. Fiscal support plus an extra bit of debt relief.
   - But also implies that standard debt-nature or debt-climate swaps are generally not the right tool to address unsustainable debt.

Policy implications

With respect to debt-nature swaps:

1. **Minimize subsidy to non-participating creditors!**
   - Try to make the c/c commitment de facto senior. Belize (2021) provides clues.
   - Avoid debtor-conducted bond buybacks in secondary markets. Instead, offer a debt exchange or negotiated buyback, backed by CACs. If must do a buyback, let donor do it.
2. **Lower transactions costs and increase scale (discussed next)**

With respect to comprehensive debt restructuring:

1. **Ensure that the fiscal costs of adaptation/conservation/mitigation are properly accounted for** in the macro baseline on which the DSA is based.
2. When debt relief needs are in part based on such fiscal costs, **include conditionality that ensures that investments actually happen.**

Background slides: Scaling-up debt for climate swaps

Removing obstacles to swaps and climate financing (1)

(1) **Bundling projects to achieve scale**

- Can be tailored around countries' climate agenda (decommissioning coal plants, building renewable power plants, and building more resilient infrastructure and agricultural systems) and can even be complemented with policy reforms (energy and carbon pricing).

(2) **Use of a programmatic approach with specific policy commitments.**

- Depending on PFM and strong institutions, finance climate-related spending in budget. Increases ownership and reduces monitoring costs. IFI conditionality can help.
- Can also be used to support decarbonization strategy through debt swaps as an additional instrument in overall financing mix.

(3) **Standardization of KPIs and development of ESG instruments.**

- Benefit from "greenium" over plain vanilla bonds
- Reduce transaction and monitoring costs

Removing obstacles to swaps and climate financing (2)

(4) **Using carbon credits to incentivize use of swaps and climate investing**.

- Could create “win-win” between debtor and creditor, while also used as enhancement for debt transaction.
- Need to avoid greenwashing.

(5) **Mobilize coordinated official financing for swaps and grants linked to climate action**.

- South Africa’s Just Energy Transition Partnership announced during COP26 could be replicated as part of multi-year initiatives funded by bilateral creditors.
- Debt swaps could be part of financing mix.
- To maximize impact, pool of donor countries should be as large as possible.

Key Takeaways

1. **The economic efficiency case for debt-climate swaps relative to other climate financing instruments is narrow.**
   - There is a case for providing debt relief over and above fiscal support for climate finance.
   - Doing so vis a vis a comprehensive debt restructuring is too difficult or costly.

   (In all other cases, debt-climate swaps are dominated by conditional grants, or combinations of conditional grants and comprehensive debt restructuring).

2. **Debt-climate swaps are worth promoting to the extent that the measures that also benefit other forms of climate finance** (like KPI indexed bonds, or climate-conditional deep debt restructuring).

3. **This calls for measures that:**
   - Reduce transaction and monitoring costs.
   - Allow the use of standardized KPIs in debt contracts.

Additional background slides

What to do when the objective is to provide fiscal support for c/c (but not necessarily solve a debt problem)

Climate-conditional grants generally work better than debt-nature swaps, because they can be more easily structured to avoid sovereign risk.

Conditional grants:

- Pay only upon seeing a bill (or receipt). Debt levels, risks are unaffected. But climate investment does not suffer from sovereign risk.

Debt-nature swaps:

- Replace a debt service commitment with a public investment commitment.
- Debt level declines, but debt still risky. Unless investment commitment is senior to debt service commitment, investment commitment is also risky.
- To make the investment risk-free, would need to lower debt to the point of eliminating sovereign risk. Implies a big subsidy to non-participating creditors.

Conditional grants vs. debt-nature swaps: an example

(Source: Chamon, Klok, Thakoor, Zettelmeyer, IMF Working Paper, forthcoming)

Debt = 100. Resources for repayment: 115 (good state) or 90 (bad state).

Climate investment costs 20—so it is unaffordable.

Alternative modalities of external funding:

1. Conditional grant of 20. In bad state, 20 units of investment; creditors lose 10.
2. Conditional debt relief of 20, lowering debt to 80. In bad state:

- If investment ranks above debt: 20 for investment, 70 for creditors. Lose 10.
- If resources allocated pro rata: 0.2*80 = 18 for investment, 0.8*80=72. Lose 8! Lower investment, subsidy for investors.

Suppose resources are allocated *pro rata*, and a creditor/donor wanted to ensure 20 units of investment via debt relief. Requires **30** units of debt relief, so in bad state, enough resources to pay both investment (20) and creditors (70).

Hence, grant is more efficient, unless investment can be made senior.