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Debt-for-nature swaps – no miracle cure

Alexander Kozul-Wright

Long considered a development finance niche, debt-for-nature swaps re-entered the mainstream financial consciousness during the Covid-19 pandemic as lockdowns cratered economic activity and forced countries to take on new debt, while simultaneously reducing the revenues available to pay it back.[1]

The concept of debt-for-nature swaps was first introduced in 1984 by Thomas Lovejoy, vice president of the World Wildlife Fund. Broadly speaking, such instruments allow countries to swap their existing debt with new debt at lower interest rates and/or longer maturities, with some of the difference in proceeds being purportedly allocated to biodiversity projects.

Typically, a third-party organization (a private entity in most cases) purchases international sovereign debt at the prevailing market price, which is usually discounted due to negative market sentiment, on behalf of a targeted government. Funds used to purchase the existing debt will be raised through new issuance. In exchange, the debtor country commits to investing a portion of the savings made from its original debt repayments into biodiversity projects – such as forest and marine protection.

Since their inception, debt-for-nature swaps have been applied in over 30 countries, and from 1987 to 2015, the total value of debt restructured under such agreements was $2.6 billion, of which $1.2 billion was used to fund development or nature-related projects.[2]

[1] https://documents1.worldbank.org/curated/en/801991638297695658/pdf/What-Has-Been-the-Impact-of-COVID-19-on-Debt-Turning-a-Wave-into-a-Tsunami.pdf

[2] https://static1.squarespace.com/static/63571f8389595e7a5ec0dd07/t/647fe5b9689c762c7d5c3b32/1686103494956/Session+4+-+Architecture+of+Sovereign+Financing_Celine_Alex.pdf%20%20%20%20https:/www.reuters.com/sustainability/sustainable-finance-reporting/worlds-top-mdbs-forge-debt-for-nature-swap-task-force-sources-2023-11-30/#:~:text=The%20Nature%20Conservancy%2C%20a%20U.S.,potentially%20%22ripe%22%20for%20swapping.

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Address: 131 Jalan Macalister, 10400 Penang, MALAYSIA Tel: 60-4-2266728/2266159 Fax: 60-4-2264505
Email: twn@twnetwork.org Website: www.twn.my

The Nature Conservancy, a US-based non-governmental organization (NGO) that has been involved in many recent swaps, has made its own calculations that one-third of the $2.2 trillion worth of emerging market sovereign debt globally, or as much as $800 billion of distressed debt, is potentially "ripe" for swapping.[3]

Cheerleaders of debt-for-nature-swaps suggest that these instruments represent an opportunity for international investors and climate change and biodiversity campaigners to coalesce around shared interests, offering up non-public sources of funding to address the climate and nature crises.

Additionally, they claim that such swaps could help developing countries that are in debt distress, a situation that is increasingly urgent. Global public domestic and external debt was $92 trillion in 2022, with nearly a third of low- and middle-income countries at high risk of debt distress.[4,5] Half of humanity live in countries that spend more on servicing their debt than on education or health, let alone biodiversity protection.

However, while debt-for-nature swaps are touted as an exciting new or renewed solution for both the debt and biodiversity crises in developing countries, there is more than meets the eye:

1) The fundamental problem of unsustainable debt is not addressed – evidence shows that the overall impact on country debt sustainability is limited.[6] It may also be argued that viewing debt distress as an "opportunity" for conservation is unethical.
2) Debt-for-nature swaps could distract policymakers from meaningful solutions to the biodiversity crisis. An increasing focus on such swaps distracts advanced-economy governments from the need to fulfill official development assistance (ODA) and biodiversity financing obligations, and to step up greater grant financing for the Global South.
3) Transparent consultation processes in national parliaments and among local civil society groups are typically lacking in the decision-making process on debt-for-nature swaps.
4) Debt-for-nature swaps free up resources for low-income governments on terms defined by private sector creditors, entrenching a system of financialized economic development. What's more, swaps entail "blended finance" – the strategic use of aid funding to de-risk private sector investment in developing countries. This opens up the question: whose interests are debt swaps really serving?

Who's making use of debt-for-nature swaps?

Many of the world's most indebted countries also happen to be biodiversity-rich. To date, most nations which have participated in debt-for-nature swaps are low-income countries with large biodiversity financing needs, and are typically undergoing a debt restructuring. Such countries that are facing a potential default situation are therefore persuaded to swap their sovereign natural assets in return for some debt relief.

In May 2023, Ecuador struck the largest debt-for-nature swap of its kind, refinancing $1.6 billion of commercial debt (with support from Credit Suisse) at a discount in exchange for a revenue stream for conservation projects. As part of the deal, an Ecuadorian government special purpose vehicle (SPV) sold a new marine conservation bond which was designed to funnel $12 million a year into conservation of the Galapagos Islands.[7,8]

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3 https://www.reuters.com/sustainability/sustainable-finance-reporting/worlds-top-mdbs-forge-debt-for-nature-swap-task-force-sources-2023-11-30/#:~:text=The%20Nature%20Conservancy%2C%20a%20U.S.,potentially%20%22ripe%22%20for%20swapping.

4 https://unctad.org/news/un-warns-soaring-global-public-debt-record-92-trillion-2022#:~:text=A%20growing%20burden%20to%20global,affecting%20developing%20countries%20in%20particular.

5 https://unctad.org/publication/trade-and-development-report-2023

6 https://ueaeprints.uea.ac.uk/id/eprint/81984/1/Accepted_Manuscript.pdf

7 https://latindadd.org/arquitectura-financiera/galapagos-deal-an-ignominious-legacy/#:~:text=The%20deal%20is%20structured%20by,Credit%20Suisse%2C%20a%20private%20bank.

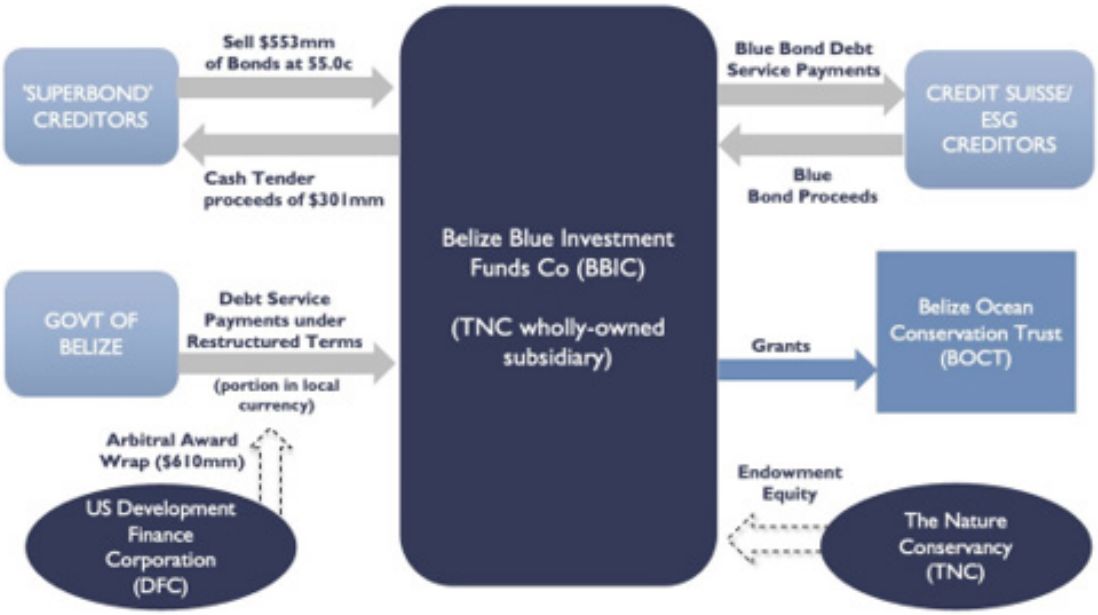
8 https://gggi.org/ecuador-debt-for-nature-swap-in-the-galapagos-islands-launched/#:~:text=On%20May%209th%202023,40%20cents%20on%20the%20dollar.

In August 2023, Gabon signed off on a $500 million deal which lowered the interest rate on its debt and gave it a longer repayment schedule.[9] Cheaper financing was secured on the back of a public guarantee, a clear example of blended finance, made by the International Development Finance Corporation (DFC), the US government's development finance institution which provides loans and other financial services to developing countries. In exchange, the African nation promised to spend at least $125 million to widen a marine reserve and strengthen fishing regulations, which will putatively help protect endangered humpback dolphins.

The Belize example

A step-by-step process of Belize's debt-for-nature swap is illustrated below, highlighting the complexity of such arrangements.

- In 2021, Belize signed a debt-for-climate swap with The Nature Conservancy (TNC)
- A TNC subsidiary lent funds to Belize to buy back a $553 million "superbond" – the government's entire stock of external commercial debt, equivalent to 30% of GDP – at a discounted price of 55 cents per dollar
- The new debt instrument was partially guaranteed by the US International Development Finance Corporation (DFC)
- Savings were channelled into a $23.4 million endowment fund for marine conservation projects
- Overall, the debt-for-nature swap had minor impacts on the serviceability of Belize's debt, and diverted a modest stream of finance for marine conservation. It overpromised and underdelivered; according to the London School of Economics, it resulted in "higher transaction costs, less conservation-for-your-buck".



Source: Third World Network

[9] https://www.reuters.com/sustainability/sustainable-finance-reporting/gabon-buys-back-500-mln-nominal-debt-for-nature-bond-tender-2023-08-08/

Size of the market

According to Bloomberg, the market for debt-for-nature swaps is approximately $800 billion. For context, the sums being discussed are a fraction of the $125 trillion that the United Nations estimates must be spent globally to reach net-zero emissions by 2050 and avert the worst consequences of climate change.[10]

In any event, the potential amounts involved are beginning to prompt competition between banks, as the demand for green investment increases. Goldman Sachs, HSBC, Citigroup, BNP Paribas, Standard Chartered and Barclays have all signalled that they are exploring similar transactions. Financial counterparties can charge high fees for facilitating debt-for-nature swaps (see more below).

Who are the developed-country actors?

Just a few years ago, Credit Suisse was the only commercial bank arranging debt-for-nature swaps, bringing in private investors to help sovereign refinancing tied to nature conservation commitments. Last year, Bank of America became the second global lender to join the market when it completed a deal for Gabon.

As mentioned above, debt-for-nature swaps are a form of blended finance, where private investors are persuaded to enter risky investments with guarantees and other de-risking tools provided by development finance institutions such as the DFC, which has provided a number of insurance mechanisms to countries undertaking such swaps. Elsewhere, The Nature Conservancy is often involved in facilitating debt-for-nature swaps.

Critique of debt-for-nature swaps

Debt-for-nature swaps have come under criticism from various angles:

1. Questionable environmental impacts

- The overall environmental impact from these arrangements has been questioned because governments are given years to show conservation progress and are often not required to impose strict limits on human activity in their jurisdictions as part of debt-for-nature swaps.
- In a note circulated to clients last January,[11] Barclays Bank questioned the green credentials of debt-for-nature swaps – often sold as ESG (environmental, social and governance) investments – because only a small fraction of the deal size ends up with conservation. The labelling of the bond issued (to buy back the old debt) as "sustainable" or "green" is thus raising major associations with greenwashing.[12]
- In Belize (see box), for instance, while only $84 million of the $553 million went to actual marine conservation,[13] up to $86 million was allocated to intermediaries and service providers such as reinsurers, advisers and credit providers (all of whom hired large numbers of agents charging high advisory fees to the government).

2. Limited (or even negative) impact on debt

- The history of debt swaps shows that the overall impact on debt levels has been rather limited. Essers et al. (2021) argue that "traditionally, swaps have been piecemeal operations with a negligible effect on overall debt burdens (involving millions rather than billions of US dollars)".[14]

[10] https://climatechampions.unfccc.int/whats-the-cost-of-net-zero-2/

[11] https://www.bloomberg.com/news/articles/2023-01-23/barclays-sees-real-risk-of-greenwashing-in-esg-debt-swap-market?leadSource=uverify%20wall&sref=T4zDKGrK

[12] High-Level Expert Group (HLEG) on scaling up sustainable finance in low- and middle-income countries. Mandated by the European Commission. Final Recommendations April 2024.

[13] https://assets.nationbuilder.com/eurodad/pages/3225/attachments/original/1701693052/debt-swaps-report-final-dec04.pdf?1701693052

[14] https://ueaeprints.uea.ac.uk/id/eprint/81984/1/Accepted_Manuscript.pdf

- Over the past three decades, debt swaps have led to roughly $8.4 billion of debt treated,[15] which is only 0.11% of total debt payments by low- and middle-income countries during the same period. As such, debt swaps cannot be seen as a way to restore debt sustainability.
- At the regional level, Sub-Saharan Africa's external debt amounted to $702.4 billion in 2020; according to a report of the African Development Bank published in October 2022,[16] debt treated through debt swaps amounted to less than $320 million in the entire continent.
- Debt swaps carry risks of negative impacts on a country's perceived creditworthiness.[17] The fiscal space gained through a swap becomes larger when the discount/interest rate reduction is higher; at the same time, the risk of negative creditworthiness perception increases. This would potentially have negative consequences on the country's future access to public and private finance.

3. *Distraction from the real need to address the debt crisis and provide financial resources*

- Debt-for-nature swaps should not be substituting for comprehensive debt restructuring (where needed), including debt cancellation. The developing-country G77 grouping recently stated that,[18] while debt-for-nature swaps can help to address the Sustainable Development Goals financing gap, "debt swaps cannot replace broader debt treatments in unsustainable debt situations".
- An increasing focus on debt-for-nature swaps can give the impression that the biodiversity financing gap is being adjusted through this mechanism, detracting attention away from the need to fulfil the existing ODA and biodiversity finance commitments, and to step up both unconditional grants and highly concessional finance to all countries in the Global South.

4. *Complex and burdensome process*

- Debt-for-nature swaps are complex instruments, time-consuming and burdensome to implement.[19] In the case of Seychelles, for instance, it took five years to close the deal. The complexity of the process also induces high transaction costs, particularly in relation to the amount of debt involved. The balance is skewed, with a disproportionately high amount of guarantee required when compared with the fiscal space created on the one hand and the amount that goes into sustainable projects on the other hand.

5. *Conditionalities*

- Debt swaps will not happen if the debtor country does not agree to invest freed-up resources in the area or project to be approved by the creditor. This entails a risk that they will be used by creditors to impose their own interests and priorities over those of the borrowing country.

6. *Lack of participation and untransparent governance*

- While debt swaps have occasionally incorporated the participation of citizens, civil society or other local entities, this is rarely the case.
- There is often little to no public information about the precise role of large conservation NGOs in debt-swap arrangements. Moreover, consultation and participation of national parliaments is typically non-existent in the initial stages of these processes.
- Linked to the above, management of debt-for-nature swap projects (or protected areas) is often overseen by a collection of foreign advisors and organizations, leaving little agency to the country in question.

15 https://assets.nationbuilder.com/eurodad/pages/3225/attachments/original/1701693052/debt-swaps-report-final-dec04.pdf?1701693052

16 https://sdg.iisd.org/news/afdb-report-assesses-feasibility-of-debt-for-nature-swaps-in-africa/

17 HLEG (2024).

18 https://unctad.org/system/files/official-document/ares77d153_en.pdf

19 HLEG (2024).

Some reflections

For countries without access to grants or concessional financing, debt-for-nature swaps may play a role in mobilizing extra resources for biodiversity or climate projects. However, with their high transaction costs, complex governance structure and use of conditionality, debt swaps are a less efficient form of fiscal support than grants or concessional finance.

On this point, it should be recalled that developed countries have not yet met their 2009 pledge of mobilizing $100 billion a year to meet the climate needs of developing countries. For context, an average of $892 billion per year was invested in fossil fuels over 2019–2020, while global fossil fuel subsidies amounted to $450 billion over the same period. Similarly, there is concern that targets for financial resources to developing countries for the implementation of the Kunming-Montreal Global Biodiversity Framework will not be met.[20]

Ultimately, debt-for-nature swaps are part of an ideological approach to financing environmental action that assumes that public resources are nearly exhausted, and that any remaining public funds should be used to leverage private involvement to achieve public priorities.

Instead, we should focus on, among others, addressing sovereign debt distress in developing countries in an equitable manner. Equally important is the creation of an international tax convention capable of a fair redistribution of wealth (from rich to poor countries) to support investment in nature and climate objectives.[21] This reform is essential for addressing the scarcity of public finance in the Global South, where the levels of comparative biodiversity remain the greatest.

In this vein, countries in the North should recognize their historical responsibility in perpetuating economic models which keep low-income countries tied to debt dependency. Current economic and political systems are built on inequality, extraction and biodiversity loss.[22] Moreover, policy autonomy in developing countries is subordinated by financial conditions imposed on them by financiers in wealthy countries. The time is ripe for reorienting financial practices to stave off ecological crisis.

Simply put, debt-for-nature swaps are no panacea.

Alexander Kozul-Wright *is a senior researcher with the Third World Network.*

[20] https://www.twn.my/title2/biotk/2024/btk240601.htm
[21] https://www.nature.com/articles/s41559-021-01619-5
[22] https://www.twn.my/title2/biotk/2024/btk240504.htm