Briefing

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Policy pointers

Ministries of finance and their environment and sector ministries counterparts need to come together to develop a shared approach to a potential debt-for-climate-and-nature swap.

Basing key performance indicators (KPIs) for climate and nature swaps on existing national policies will help to integrate activities into government systems and avoid external conditionality.

Local input through community and other stakeholder engagement helps ensure that climate and nature outcomes (and identified KPIs) for a swap reflect local realities.

There is a real window of opportunity for low-income countries to pursue debt-for-climate-and-nature swaps with creditors, given recent endorsement from multilateral institutions and Cabo Verde's deal with Portugal.

Redesigning debt swaps for a more sustainable future

The recent deal between Cabo Verde and its main creditor Portugal shows that a fresh approach to debt-for-climate-and-nature swaps is possible — and could be key to addressing the 'triple crisis' of unsustainable debt, climate change and biodiversity loss. In this briefing, we outline the approach, which was proposed by IIED in 2020, and highlight six practical lessons that emerged from a pilot with Cabo Verde and Senegal. IIED's work on this project is now concluded, but the use of debt swaps for climate and nature has only just begun. We hope that, in sharing experiences from the pilot's scoping and design process, this briefing will help to inform and encourage other low-income countries interested in exploring the potential of this innovative tool.

Massive debt distress is preventing low-income countries from making crucial investments to support their citizens and address climate change and nature loss. Many of the countries facing debt distress are also those most exposed to the impacts of climate change and biodiversity loss — and the least able to respond and recover given their limited fiscal space.[1] As much as 20% of these countries' revenues goes towards debt repayments,[2] instead of urgently needed social spending, infrastructure and climate and nature investment.

This 'triple crisis' of debt, biodiversity loss and climate change[3] is growing. In 2021, the IPCC issued its "bleakest warning yet" on the need for climate action, saying that a global temperature rise of 1.5°C was "almost inevitable".[4] That same year, global indebtedness reached a record $235 trillion, after the economic impacts of the COVID-19 pandemic prompted the biggest one-year surge in borrowing since the second world war.[5] Meanwhile, recent rises in food and fuel prices — caused largely by Russia's war in Ukraine — have increased balance-of-payments deficits (and the risk of defaulting, as Ghana did at the end of 2022).[6] The proportion of countries in or at high risk of debt distress reached 60% in 2022, double what it was in 2015.[7]

Redesigning debt swaps to address the triple crisis

Low-income countries are increasingly interested in debt-for-climate-and-nature swaps,[8] where a portion of external debt is relieved or restructured in exchange for domestic investment in biodiversity or climate action. If well designed, debt swaps for climate and nature could be a powerful tool in tackling the 'triple crisis'[3,9] giving debtor countries the fiscal space to invest in climate mitigation, adaptation and/or resilience, and biodiversity conservation and/or sustainability.

To date, however, debt-for-nature swaps have been largely ad hoc, small scale and externally driven, without adequate involvement of affected communities.[3,10] This has limited their ability to deliver lasting benefits for debt sustainability, climate or nature.[10]

The proportion of countries in or at high risk of debt distress reached 60% in 2022

Recognising the potential of upscaled debt-for-climate-and-nature swaps, and drawing on the lessons learned from earlier debt relief efforts, IIED proposed a new approach.[3] Table 1 provides an overview of the key differences in this new approach. A separate 'How to' guide, produced by IIED and partners, offers more practical detail on its implementation.[11]

Importantly, this novel approach aims to link debt swaps to government systems (Figure 1), work at a programme rather than a project level and involve communities who are directly experiencing the impacts of climate change and nature loss.[3] The swap is tied to certain outcomes, and as long as these are achieved, debtor countries can use the remaining fiscal space to invest in other development priorities. Meanwhile, the more explicit focus on generating growth and climate/nature benefits may make the debt swap a more attractive proposition for creditors — especially private lenders with net zero and other sustainability targets.

Piloting the new approach in West Africa

With support from the MAVA Foundation, IIED and a consortium of partners[12] undertook an 18-month project to test this new approach to debt-for-climate-and-nature swaps. The project reached out to four countries in West Africa that are rich in biodiversity and vulnerable to climate impacts: Cabo Verde, Guinea Bissau, Mauritania and Senegal.[3]

After initial scoping work with governments and nongovernmental organisations (NGOs), two countries — Cabo Verde and Senegal — indicated their interest in pursuing a debt swap, and more detailed work began to design a suitable instrument and confirm nationally relevant climate and nature performance indicators.

Table 1. How does IIED's new approach scale up debt-for-climate-and-nature swaps?

Previous debt swap design	New approach piloted by IIED and partners
Climate and nature goals set by international organisations	Climate and nature key performance indicators (KPIs) aligned with debtor governments' commitments and local stakeholders' priorities
Funds managed by international NGOs, making them less accountable	Programmatic approach using debtor country government systems
Emphasis on conservation benefits	Emphasis on long-term inclusive economic growth as well as climate and nature benefits
Primarily with single bilateral creditors	Comprehensive 'all-creditor' approach to deliver debt relief at scale with lower transaction costs

In January 2023, shortly after the pilot ended, Cabo Verde announced it was entering into a debt-for-climate-and-nature swap with its major creditor, Portugal, making it the first country to agree a deal of this kind.[13] The approach is also now attracting concrete interest from other countries, including Egypt, Kenya and Pakistan.

Although there was no formal evaluation of the pilot, the experience provided valuable learning, which was captured through discussions with national and local stakeholders, project meetings and knowledge sharing between consortium members and the project's international advisory group. In reflecting on and sharing these emerging lessons, this briefing aims to contribute to the efforts of other countries that may be interested in pursuing a debt-for-climate-and-nature swap.

Emerging lessons

Building cross-governmental support

The pilot deliberately sequenced engagement with government ministries, led by the Debt Management Office (DMO) in each country's Ministry of Finance but also involving the Environment Ministry and other relevant government ministries. This helped to build cross-government support for and ownership of the debt swaps approach — and avoided it becoming yet another form of externally led conditionality.

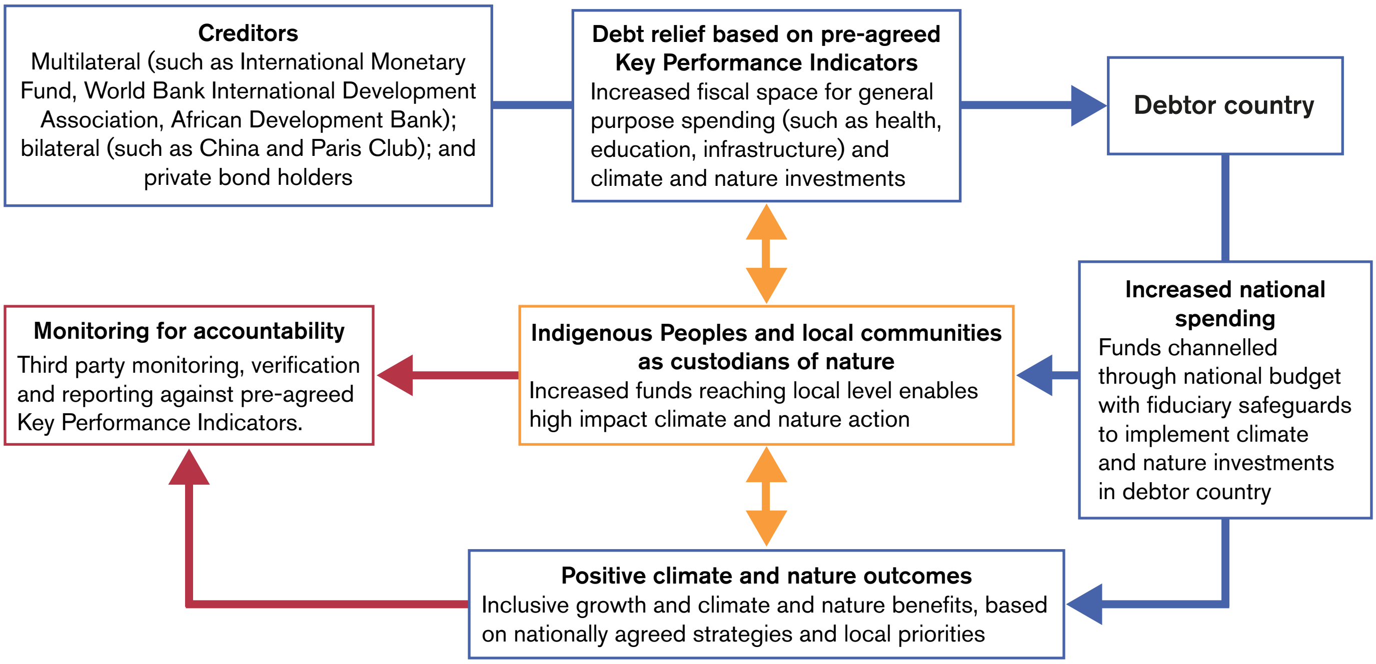
IIED and partners first approached the DMO, given their central role in managing sovereign debt and setting national spending priorities. In turn, buy-in from the Finance Ministry helped the pilot to engage ministries with climate and biodiversity responsibilities (for example, environment, agriculture, fisheries, energy and planning), as it leant credibility to the idea that debt-for-nature swaps could free up funding for their policy priorities.

We found that bringing all ministries with climate and nature responsibilities into the discussions together helped build trust and cooperation between ministries, rather than them competing for resources.

Involving experts from the outset

DMO officials needed to see how a swap would work in practice. It was therefore important that discussions with them also involved local partners with expertise in climate and nature (and an in-depth understanding of the context) as well as sovereign debt advisors, who could provide detail on possible mechanisms. Presentations by debt experts helped DMO officials see the potential for debt swap instruments to provide new resources and relieve financial pressures.

Figure 1. Overview of climate and nature debt relief

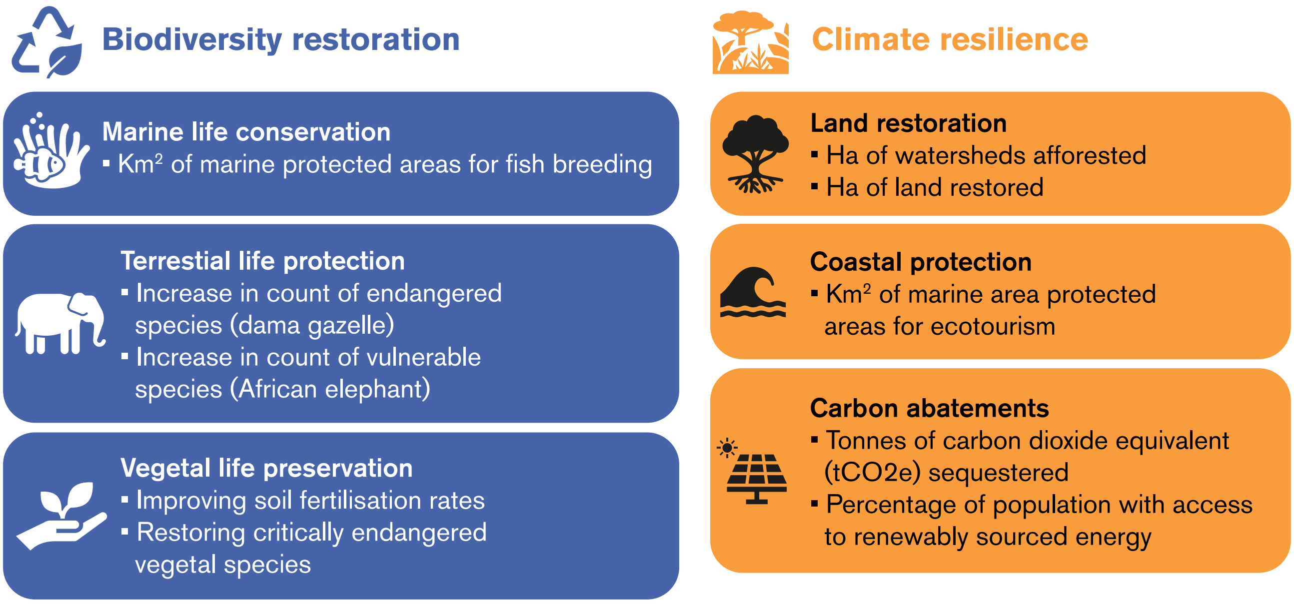


Blue arrows show flow of finance; red arrows show show monitoring, verification and reporting; orange arrows show contributions and engagement of Indigenous Peoples' and local communities

Understanding each country's creditor profile

The consortium's finance experts also analysed the debt profiles of both Senegal and Cabo Verde. This detailed analysis helps identify the scale of resources potentially available for a swap, the different creditors, and if a swap is likely to be workable. In the case of Senegal, the analysis determined that a debt swap may not be the most effective transaction to pursue — as the country's debt burden remains sustainable — but that a performance bond for climate and nature (PBCN) could be useful in enabling Senegal to attract new sovereign investments linked to the delivery of climate and biodiversity benefits. In the case of Cabo Verde, the debt analysis identified Portugal as the main creditor both in official and commercial loans.

Figure 2. Potential climate and nature KPIs for a PBCN for Senegal



Align KPIs with existing initiatives, such as Emerging Green Senegal Plan

Source: Bankers Without Borders, unpublished, adapted with permission.

Aligning with national nature and climate priorities

Key performance indicators (KPIs) are a defining feature of the IIED approach to debt-for-climate-and-nature swaps. The idea is that, instead of tying the swap to externally imposed conditionalities, debtor countries identify KPIs for national climate and nature priorities. The how-to guide recommends that countries start by identifying existing policies — such as National Action Plans for Climate and National Biodiversity Action Plans[12] — which was the approach taken by the pilot. Figure 2 shows some of the potential KPIs identified in Senegal. We found that this alignment with national plans and processes not only strengthened the KPIs but also provided an opportunity to engage other stakeholders in important discussions about debt swaps for climate and nature. For example, in Senegal, the pilot was able to link up with the national Green Senegal Plan (PSE Vert) and 'roadshows' they were holding around the country with business and community organisations.

The value of local engagement

In both countries, pilot partners organised stakeholder consultations with civil society to gather feedback on the KPIs that had been identified for a potential debt swap. This is important, as national plans do not always seek the perspectives of local communities.

In Cabo Verde, local NGO the Association for the Defense of the Environment and Development organised consultations with stakeholders on the KPIs identified from the national climate and biodiversity plans across three of the archipelago islands: Santiago, Boa Vista and Santo Antão. While this was challenging in terms of logistics and cost, consortium partners reported that events were well attended with lively discussions and local media coverage, highlighting the importance of the issues to local communities.

Given the high level of engagement in both Cabo Verde and Senegal, local partners produced reports on the process and the potential KPIs, which they provided to government officials and local stakeholders to help inform future swaps or new performance bond issuance.

Innovative deals take time

The pilot with Cabo Verde and Senegal ran for only 18 months, which was not long enough to scope, design and close a debt swap deal. The project did manage to garner cross-government support for a deal, identify locally owned and verifiable climate and nature KPIs, and begin a programme of engagement with communities, creditors and other stakeholders.

As mentioned, local-level consultation can be logistically challenging and time consuming but is important for generating real ownership. Engaging creditors can also be slow and complex — particularly given an increasingly diverse landscape that includes traditional multilateral and bilateral donors, as well as private lenders and China (now the largest bilateral holder of developing country debt).

As well as offering to support Cabo Verde and Senegal's direct engagement with their respective creditors, the pilot also participated in the emerging international debate on debt-for-climate-and-nature swaps. This has resulted in greater understanding about the concept and more discussion about its potential benefits among creditors and institutions advising them, including the International Monetary Fund and the China Society of Finance and Banking.[14]

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Knowledge Products

The International Institute for Environment and Development (IIED) promotes sustainable development, linking local priorities to global challenges. We support some of the world's most vulnerable people to strengthen their voice in decision making.

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Notes

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