

Debt-for-Climate Swaps: a controversial tool to unlock climate change mitigation and adaptation in countries with high debt burden

Luisa Weber, Laila Darouich, Igor Shishlov, Axel
Michaelowa

Freiburg, Germany, 23.04.2024



CLIMATE



DEBT

POLICY BRIEF

Perspectives Climate Research

Perspectives Climate Research gGmbH (PCR) is an independent and internationally active research company based in Freiburg, Germany. PCR conducts research for both governments, international organizations, non-governmental organisations and the private sector maintaining high methodological standards. As the research branch of the renowned consultancy Perspectives Climate Group, PCR has extensive expertise in political science, economics and climate science and works on informing international climate policy as well as UNFCCC negotiations.

Authors

This research report was led by Luisa Weber and co-authored by Laila Darouich, Igor Shishlov and Axel Michaelowa (Perspectives Climate Research).

Design and layout

Beatrice King, Rosaria Caddeo

Perspectives Climate Research gGmbH
Hugstetter Str. 7
79106 Freiburg, Germany
info@perspectives.cc
www.perspectives.cc

© Perspectives Climate Research | April 2024
All rights reserved.

Disclaimer

This policy brief was prepared by Perspectives Climate Research and reflects independent views of the authors who take sole responsibility for information presented in this policy brief as well as for any errors or omissions. Neither Perspectives Climate Research nor sponsoring organisations can be held liable under any circumstances for the content of this publication.

Key messages

- Debt-for-Climate (DFC) swaps involve restructuring part of a country's external debt to more favourable conditions in exchange for domestic commitments to climate change mitigation or adaptation measures, to provide public international climate finance without increasing debt burdens.
- To date, the number and scale of DFC swaps have been limited, and thus actions and investments triggered by DFCs did not reach considerable climate impact.
- DFC swap limitations are mainly due to free riding incentives for creditors, insufficient funding for credit enhancement, high transaction costs during the negotiations and structuring, and implementation risks of mitigation/adaptation measures because of generally low oversight and transparency.
- To enhance the potential of DFC swaps, stakeholders should focus on optimizing efficiency by utilizing streamlined processes and indicators, leading to increased transparency and lowered transaction costs. Larger scales of debt swaps can be achieved by broadening the creditor base, e.g., involving private creditors.
- DFC swaps need to be integrated into a wider governance reform of national debt management and the international financial system. Otherwise, indebtedness will likely increase again in the long run after an initial improvement, and climate change mitigation and adaptation will remain structurally underfunded.

1. Debt-for-climate swaps as an innovative financing tool

2024 will be a crucial year for international climate negotiations, as the New Collective Quantified Goal (NCQG) on climate finance post-2025 is set to be decided at the 29th Conference of the Parties to the UN Framework Convention on Climate Change (COP29). The NCQG is superseding the 2009 international climate finance target, in which developed countries committed to mobilise USD 100 billion annually by 2020 to support developing countries in climate change mitigation and adaptation. Stakes are high to deliver an ambitious goal, as current financial flows are insufficient regarding the assessment of needs of developing countries (UNFCCC 2022). As the failure to achieve the USD 100 billion target by 2020 demonstrated, with only USD 83 billion delivered in 2020 (OECD 2023) traditional public climate finance instruments (such as concessional loans and grants) will not achieve the leap from billions to trillions in funding, as many developing countries are demanding (Aragon 2023).

Discussions thus increasingly focus on identifying and leveraging innovative sources and instruments for climate finance, with Debt-For-Climate swaps (DFC swaps) being among the debated options. DFC swaps are theoretically an attractive instrument that converts sovereign debt into local climate change mitigation or adaptation. They can facilitate funding for mitigation or adaptation projects which may be unattractive under traditional financing models. However, the question of the appropriateness of debt swaps to address debt and climate crises has been disputed for many years. Advocates praise them for providing an innovative approach to financing climate action in countries struggling with access to traditional forms of public international climate finance, potentially enhancing the capacity of middle-income and vulnerable nations to implement mitigation and adaptation. Critics highlight their limited scope and inefficiency, often failing to significantly reduce debt levels or merely substituting one form of debt for another, casting doubt on their effectiveness as a sustainable financial solution to address climate change (Aragon 2023, Darouich et al. 2023).

This policy brief is designed to inform policymakers in debtor and creditor nations about the potential of DFC swaps, as well as representatives from financial institutions and the private sector interested in exploring this instrument. It outlines how DFC swaps work and which purposes they can serve, by also giving practical examples. A matrix of actors' interests and challenges, and an overview of possible reforms of current practices can further inform preparations for effective DFC swap design and negotiations.

The interplay of the climate and debt crises

Climate change-vulnerable countries with high debt levels are caught in a vicious cycle of compounding effects of the debt and climate crises. DFC swaps promise to address both issues simultaneously. As the frequency and severity of meteorological extreme events and slow-onset climate change impacts increase, affected countries have to take up debt at expensive interest rates for their recovery efforts. This can further increase sovereign debt to unsustainable levels as the examples of frequently hurricane-hit and climate-vulnerable Caribbean countries demonstrate (Munevar 2018; Persaud 2023). In some cases, debt servicing obligations capture up to 70% of government revenues, shrinking the public budget for social spending and adaptation investments (Rawnsley 2022). Underinvestment in adaptation leads to increased climate vulnerability, higher expected future losses, and even more debt constraints (Gallagher et al. 2023). Even climate-vulnerable countries with lower debt levels among the least-developed countries (LDCs) and small island developing states (SIDS) face significant barriers in accessing concessional finance (De Marez et al. 2022). For both categories of countries, access to finance from private creditors is increasingly constrained because of rising interest rates and perceptions of increased country risk (Michaelowa et al. 2023; World Bank 2023).

Against this background, debt restructuring has gained critical importance as an increasing number of countries face or are at risk of debt distress, surpassing levels seen during the 2008/9 financial crisis, according to the World Bank (2023). However, debt restructurings have become more complex due to changes in debt composition and the emergence of new creditors. Over the past decade, low-interest rates spurred a rise in private capital market debt, while China emerged as a significant bilateral creditor to developing nations. Meanwhile, the proportion of loans from multilateral development banks (MDBs) and bilateral creditors from the Paris Club—an informal group of major industrialized nations—has decreased in comparison to other creditor groups (World Bank 2022, Ramos et al. 2023). Notwithstanding this shift, MDBs and bilateral public creditors could regain significance if the NCQG negotiation outcome leads to increased provision of concessional finance to developing countries (Ramos et al. 2023).

How do DFC swaps work?

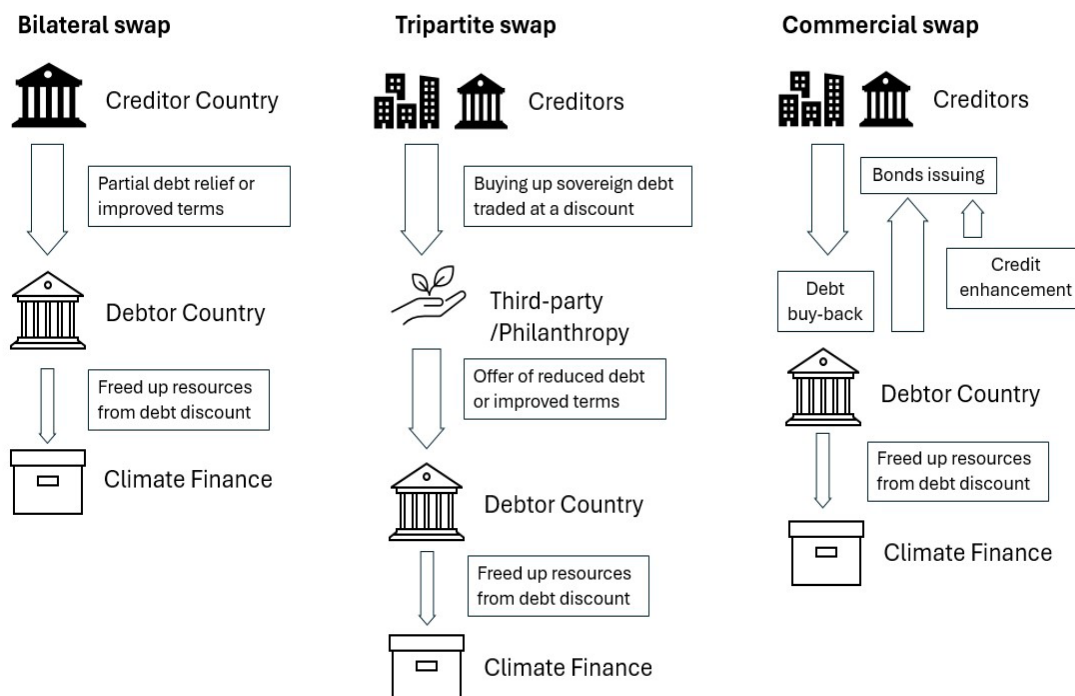
DFC swaps involve creditors and debtor countries – often together with an independent third party – renegotiating debt obligations to more favourable conditions and potentially involving partial debt relief. This in turn creates fiscal space for dedicated adaptation and mitigation investments agreed upon as part of the deal (Grigoryan et al. 2021). DFC swaps are attractive to developing countries as they are the only financial instrument that can be used to provide international climate finance without increasing the recipient country's debt burden – apart from grants, which are usually scarce (Chamon et al. 2022).

Three debt swap models are currently being implemented. Firstly, in the case of bilateral DFC swaps, the creditor country forgives part of the debt and/or offers new debt under better conditions, e.g. longer maturities, lower interest rates, etc. In return, the debtor country commits to allocate freed up funds for climate action. This commitment usually takes the form of a locally financed and managed trust fund but can also involve high-level political commitments.

In a tripartite DFC swap, a third party, usually one or more international non-governmental or philanthropic organisations, purchases (commercial) developing country debt (loans or bonds) on the secondary market at a discount compared to the original value of the debt. In the next step, the third party(ies) lend the debtor country the funds at a below market interest rate and in return receive a commitment that the funds will be invested in local currency in agreed-upon domestic mitigation and/or adaptation measures (WRI 2023). In many cases, mechanisms are set up for the tripartite model to ensure that the agreed investments are made, e.g. through the establishment of a trust fund, usually managed by a committee with representatives of the parties involved (i.e. creditor and debtor country, third party), which disburses funds for mitigation or adaptation projects (Warland and Michaelowa 2015).

Finally, commercial DFC swaps allow developing countries to convert their existing sovereign debt into tradeable securities, namely bonds. This approach was already applied in debt restructuring initiatives in the 1980s and 1990s ('Brady bonds'). The novelty of bonds created through DFC swaps is that the focus is on investments addressing climate change, with "green" bonds financing climate change mitigation and adaptation. These bonds resulting from DFC swaps offer favourable terms to debtor countries, including reduced interest rates and extended maturities. The favourable conditions are made possible through credit enhancement, like guarantees or insurance from development finance institutions (DFIs). These insurances lower the risk rating of the bonds, making them attractive for the financial market where they are bought and traded by private creditors (Chamon et al. 2022, Ramos et al. 2023). Recent examples of this DFC swap type include debt swaps in Belize (2021), Barbados (2022), Ecuador (2022) and Gabon (2023).

Figure 1: Models of DFC Swaps

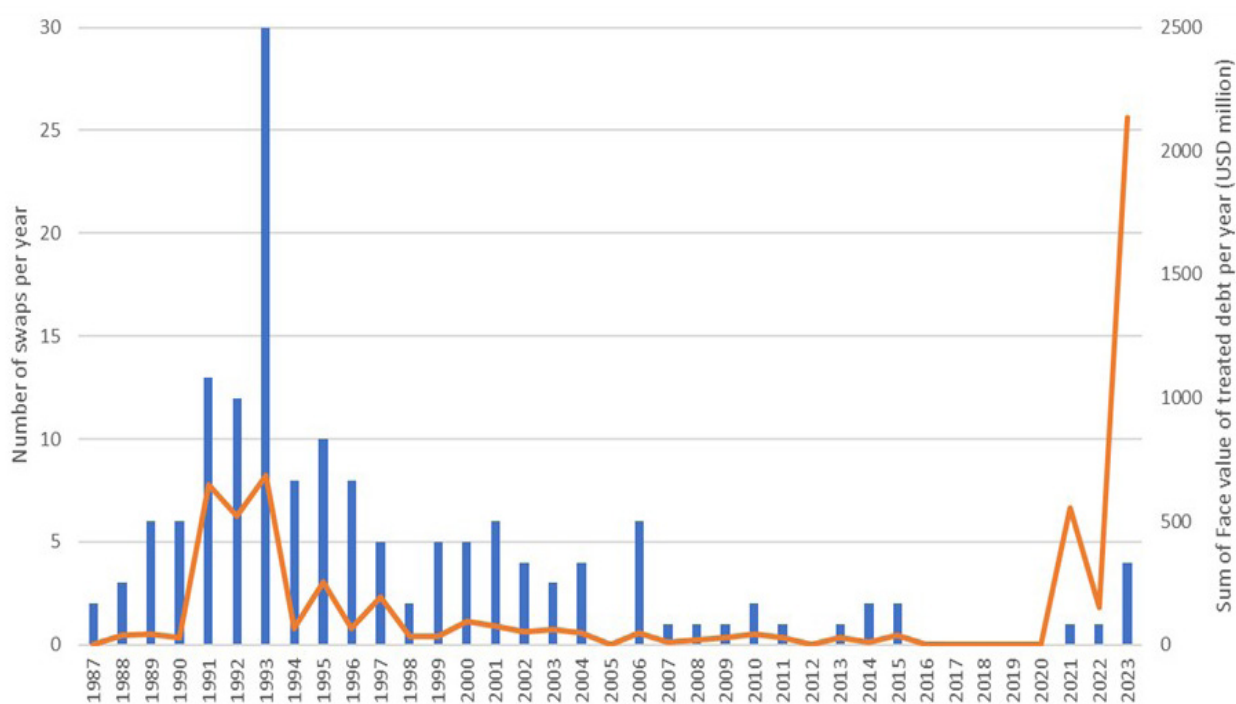


Source: Authors

Implementation so far

Developments in DFC swaps are fairly recent, while there is more extensive experience with Debt-For-Nature (DFN) swaps (focus of swap on nature and biodiversity conservation), which have been carried out since the 1980s. So far, only very few past debt swaps are linked to climate change action while most of them are conservation orientated. Only the Seychelles and Cabo Verde swaps explicitly focused on climate change adaptation and mitigation respectively. However, there is an increasing focus on climate co-benefits in the development and marketing of DFN/DFC swaps (e.g., marine conservation with adaptation co-benefits as in the 2021 Belize swap). Darouich et al. (2023) identified 152 DFN/DFC swaps between 1987 and 2023, totalling USD 6.41 billion in treated debt, of which USD 2.1 billion were directed towards environmental purposes. Most swaps were executed in the late 1980s and 1990s. The decline since then may be due to the shift towards more comprehensive debt relief under the Multilateral Debt Relief Initiative (MDRI) and Heavily Indebted Poor Countries Initiative (HIPC) initiatives (Chamon et al. 2022). It is noteworthy that the value of treated debt has reached a new high in 2023.

Figure 2: Number (blue) and volume (orange) of debt swaps (face value of treated debt in USD million) from 1987 - 2023



Source: Darouich et al. (2023)

Latin American countries which have traditionally been heavily indebted and triggered the first big debt crisis in the 1980s are most frequently involved in debt swaps (84), followed by African (27) and Asian (18) countries (Darouich et al. 2023). On the creditor side, the US, Germany and Switzerland were the main actors. Furthermore, swaps were typically small (average USD 25 million) and mostly involved bilateral debt (64% of all swaps). Tripartite debt swaps were on average even smaller (avg. USD 14.5 million) and most of the time involved US-based international non-governmental or philanthropic organisations. The type of debt swapped shifted from private creditor held debt to bilateral and ODA-related debt in the 1990s. Since 2021, there has been a resurgence in commercial debt swaps, the so called “new wave” of DFC swaps. This tendency is likely due to the increased share of developing countries’ debt held by private creditors (ibid).

Example: Barbados' debt swap for marine protection

In 2022, Barbados implemented a USD 150 million debt swap to restructure external commercial debt with support from The Nature Conservancy (TNC) and its “Blue Bonds for Ocean Conservation” strategy. Debt service savings allow Barbados to commit an estimated USD 50 million over 15 years for ocean conservation, expanding marine protected areas to 30% (including coral reefs, mangroves, fish spawning sites and other important ocean habitats and species). The swap replaced costly debt with lower cost debt arrangements, including a debt payment suspension clause in case of natural disasters and a pandemic clause. The risk level of the new debt vehicles and consequently their costs were reduced through debt insurance offered by the TNC and the Inter-American Development Bank. The issuing of ‘blue’ bonds financed the buy-back of commercial debt. This showcases the possible design of a ‘new wave’ of DFC swap making the restructuring of commercial debt possible (TNC 2023). The Barbados swap focuses on conservation and promises climate adaptation co-benefits, which supposedly will arise from the conservation activities enabled by the swap.

A connection between the climate and the debt crisis is increasingly made by countries and plays an ever more prominent role at COPs. Discussions on debt and climate change involve multiple parties and institutions but are particularly driven by vulnerable countries (V20 2023). The Bridgetown initiative offers the most vocal proposal for reforms of the international financial regime, aiming at transforming and augmenting the lending capacity of International Monetary Fund (IMF) and MDBs (Government of Barbados 2022). In this context, the latter may support DFC swaps to leverage new sources of public international climate finance. The most recent international climate negotiations at COP28 saw an increased focus on DFC swaps, e.g., with the launch of a global task force for DFC swaps of lender institutions like MDBs and national DFIs. This will play a key role in offering the needed credit enhancement to make debt swaps viable (Jones 2023).

2. Opportunities and challenges for actors involved in DFC swaps

This section provides an overview of the interests of key parties in DFC swaps, namely creditors and debtor countries. Understanding these and the challenges generated by their diversity is valuable when considering options to improve and upscale DFC swaps.

Opportunities: offering benefits to all parties

To engage debtors, creditors and potential third parties in DFC swap negotiations, potential agreements must be attractive for all parties.

DFC swaps are a tool for **debtor countries** to raise funds for the implementation of their climate change-mitigation and adaptation targets, as outlined in National Determined Contributions (NDCs) and National Adaptation Plans (NAPs) (Darouich et al. 2023). This is achieved if old debt is exchanged for new debt that carries lower interest or otherwise more favourable conditions. Consequently, DFC swaps are especially attractive as to reduce financing costs for countries that have limited access to traditional concessional climate finance channels like MDBs. This is the case for many SIDS that are too ‘wealthy’ for official development assistance (ODA) due to their high GDP per capita levels but are still highly vulnerable to climate change. Furthermore, foreign (‘hard’) currency outflows can be reduced when debt servicing obligations are converted to domestic climate investments denominated in local currency (Chamon et al. 2022). Such domestic investments can stimulate the economy and attract further private capital (Warland and Michaelowa 2015). DFC swaps can also improve the sovereign credit ratings of the debtor country if the restructuring is well perceived by the financial market and not interpreted as a credit default (Chamon et al. 2022).

For **creditors**, DFC swaps may be an innovative instrument to meet climate finance obligations under the Paris Agreement or the UNFCCC (Schmidt et al. 2023; Grigoryan 2023). Swapping non-performing loans for climate investments weighs less on donor countries' public budgets than pure grants and is thus attractive. Furthermore, swapping devalued financial securities for new assets with climate change benefits can lead to an increase in value of these securities compared to the old debt held by the creditor (Ahiadorme 2023).

DFC swaps cater to the multifaceted needs of the involved **third parties**. Financial markets have a strong appetite for bonds with environmental attributes resulting from a commercial DFC swap which may allow to reduce the interest rate compared to the rate for standard bonds (WRI 2023, World Bank 2023). For philanthropies like the TNC, DFC swaps are a way to involve multiple funders and authorities from the debtor country to support the implementation of their conservation projects.

Challenges: inconsistent interests and costly safeguards

Challenges arise due to inconsistencies of interests as well as the necessity to build in safeguards that can generate significant costs. Debtor countries want to reduce their debt burden as much as possible while creditor countries want to maximize the value of the debt they are holding. Debtor countries face financial risks and implementation risks for investments agreed under the DFC swap. Regarding the former, swaps are usually too small to significantly lower debt levels and may even adversely impact sovereign credit ratings in case of bad governance. The latter would happen if governments excessively take up new debt because of perceived low costs in the short term (Ahiadorme 2023, Chamon et al. 2022, Warland and Michaelowa 2015). Furthermore, it is uncertain how DFC swaps are perceived by financial markets. Such debt restructuring may be seen negatively, i.e., as a credit default, thus leading to eroded credit rating. However, it may also be regarded positively, as a domestic investment to address climate change and improve economic prospects, making creditors more optimistic regarding the debtor country's governance and future ability to repay debt (Nestmann 2023, Ahiadorme 2023).

Implementation risks arise when a country breaks its investment promises made under the DFC swap. DFC swaps thus involve lengthy negotiations hammering out terms and provisions to ensure the implementation and safeguarding of the adaptation and mitigation investments committed in the agreement (TCD IMF 2022).

Furthermore, identifying scalable climate investments aligned with social and environmental standards and suitable to the local context can be challenging (Grigoryan et al. 2021). The debtor must therefore invest time and effort into preparing investment offers for DFC swaps to demonstrate to creditors that it is able to implement and safeguard the promised adaptation and mitigation over time. The necessary preparations by government agencies and other stakeholders and lengthy negotiations with creditors, involving external consultancies and lawyers lead to high transaction costs which might consume the financial benefits of DFC swaps. Highly debt distressed countries that need immediate and large-scale debt relief may thus shy away from taking this route (Nedopil et al. 2023).

Creditors are confronted with disincentives to participate in DFC swaps because of a free-riding effect which rewards "holdout behaviour". Creditors can sit on the sideline and wait for other creditors to engage in DFC swaps, and subsequently enjoy the benefits of a more stable debt situation and improved credit rating of the debtor country after debt-restructurings without doing anything. Public DFIs are therefore more likely than private financial institutions to offer credit guarantees and insurance for DFC swaps thanks to their development mandates. However, these public finance institutions currently show low appetite to offer this kind of credit enhancement as DFIs are not equipped with sufficient capital for this purpose. Both the limited availability of credit enhancement and the reluctance of creditors to participate contribute to an overall limited scale and number of DFC swaps (Ramos et al. 2023; CAN 2023).

A further major challenge of DFC swaps is that monitoring their impact on adaptation and mitigation in the debtor country can be costly (Fuller et al. 2018). That is exacerbated by often complex financial structures of DFC swaps, leading to reduced transparency. Some trust funds set up under DFC swaps are incorporated overseas and opaque (Standing 2023). For instance, the investment vehicle created by a DFC swap with Ecuador, the 'Galapagos Life Fund' was based in Delaware, a low tax area (Ortega-Pacheco 2023a). The fund did not publish information about its project portfolio. This arguably limits oversight and obscures where funding is directed to. Lack of transparency creates reputational risks for bondholders and creditors (Ortega-Pacheco 2023b).

Priorities: Parties' divergent motivations for DFC swaps

Different opportunities and challenges lead to varying priorities of the parties involved, which are important to recognise for successful DFC swap negotiations.

An incentive for **creditors** to participate is to report DFC swaps as public international climate finance for the USD 100 billion target or the NCQG in the future. Given that there are no mandatory international rules for reporting of public international climate finance, some countries may even report the face value of the DFC swap. Ideally, creditors would report the grant equivalent of the DFC swap. NGOs and researchers have argued that DFC swaps should demonstrate a clear link to climate mitigation and adaptation targets and international temperature goals through strict climate conditionality (i.e. funds can only be used for mitigation/adaptation measures), verification of additionality, and strong monitoring and evaluation (M&E) standards tracking the disbursements and impacts of the investments (CAN 2023, Grigoryan et al. 2021).

The **debtor's** overarching priority is to reduce its debt burden. Debtors will look for favourable conditions, including debt cancellation, low interest rates and lengthening of maturities. Ideally all this should come without undermining the countries credit rating (Bourke 2023). To ensure high impact and long-term viability, adaptation and mitigation investments must align with country priorities (Sommer et al. 2020).

Low transaction costs would be beneficial for both parties.

Table 1: Overview of challenges, opportunities and priorities for creditors and debtors in the context of DFC swaps

	Creditor	Debtor
<i>Opportunities</i>	<ul style="list-style-type: none"> – Innovative climate finance instrument – Reputational benefits – Trust building – Value of the debtor’s securities held by creditor may increase 	<ul style="list-style-type: none"> – Saving foreign ‘hard’ currency – Reducing debt burden if transaction costs can be kept low – Access to concessional climate finance even if formally no longer eligible – Improved credit rating if governance is seen as improving due to the DFC swap – Leveraging private finance
<i>Challenges / Risks</i>	<ul style="list-style-type: none"> – Possible free riding benefits encourage “hold-out behaviour” and limits scale of debt swap – Insufficient funding for DFIs offering credit enhancement or debt relief – Lacking oversight of implementation in the debtor country – High transaction costs due to lengthy negotiations may absorb benefits 	<ul style="list-style-type: none"> – Eroding credit rating if perception of bad governance outweighs debt reduction – High conditionality thwarts country ownership – Implementation failure of adaptation/mitigation measures <ul style="list-style-type: none"> o Resources may not be made available o Technical failure o Inability to generate sustainable development co-benefits – Implementation may be outsourced to foreign, opaque stakeholders due to outcome of negotiations – Perverse incentive to take up more debt and again fall into the debt spiral – High transaction costs due to lengthy negotiations may absorb benefits
<i>Priorities</i>	<ul style="list-style-type: none"> – Increase of public international climate finance at low costs – Ensuring adaptation and/or mitigation benefits of the investments – Robust safeguards against misuse of funds – Low transaction costs 	<ul style="list-style-type: none"> – Achievement of access to finance for adaptation or mitigation investments that would otherwise be unavailable – Improving debt situation – Aligning investments with country priorities and national targets – Low transaction costs

Source: Authors based on literature research and Darouich et al. (2023)

3. The way forward: How to improve DFC swaps?

So far, DFC swaps have been limited in numbers, scale and impact (Chamon et al. 2022, Darouich et al. 2023), despite their potential gains they offer to all parties involved. The negotiation of these agreements and their implementation remain difficult endeavours due to the inherent differences in interests and related challenges discussed above. The following section offers a menu of options for addressing these challenges to unlock DFC swaps’ full potential.

Optimizing DFC swaps' efficiency by lowering transaction costs

Use standardized processes, like term sheets and key performance indicators (KPIs). Term sheets are blueprints for DFC swap agreements which serve as a starting point for negotiations. KPIs are quantifiable metrics to evaluate the effectiveness and success of the adaptation or mitigation measures financed by DFC swaps. Both tools could reduce complexity and negotiation time and effort. To this end, DFC swaps could learn from high integrity processes in markets having similar challenges with safeguarding implementation, defining additionality and overcoming long-term commitment risks (Grigoryan et al. 2021, Ortega-Pacheco 2023a), as developed over time in the compliance carbon markets of the Kyoto Protocol and now reflected in the criteria for the Article 6.4 Mechanisms under the Paris Agreement.

Include seniority clauses for the treated debt. This means that the debtor country uses the freed-up funds first to finance the agreed upon mitigation or adaptation measures before fulfilling other debt servicing obligations. Otherwise, the freed funds could be repurposed to repay outstanding debt, effectively subsidizing non-participating creditors – thus encouraging free-riding – and jeopardizing the promised adaptation and mitigation benefits (Chamon et al. 2022).

A platform for DFC swaps could facilitate transparency, knowledge sharing, peer-to-peer learning and scientific guidance. The IMF is well positioned to support the dissemination of DFC swaps knowledge. However, it struggled to deliver on that so far (TCD IMF 2022; Shalal 2021). An alternative host for such a platform could be the Glasgow Financial Alliance for Net Zero (GFANZ) building on the experience of its members with debt platforms. Another alternative would be a multi-country-driven platform orchestrated by the OECD like the Effective Institutions Platform (n.d.). Higher transparency and improved access to information through such a platform could bring down costs, since fees for consultancies make up a major part of the transaction costs which could be further reduced by more competition in the field. Higher transparency also enables local communities and civil society groups to exert influence on the implementation of the financed climate measures (Latindadd 2023, WRI 2023).

Upscaling DFC swaps by broadening the creditor base and coverage

Attracting a broad creditor base to participate in DFC swaps may be achieved by putting supporting policies in place. The IMF or national governments could introduce policy instruments to overcome creditors' hold-out behaviour. These can be of regulatory nature or consist of monetary "carrots" and "sticks". Precedents for these measures exist, e.g., when the IMF threatened to withhold financing until creditors abandon their stalling behaviour and participated in comprehensive debt restructuring in the 1990s (Ramos et al. 2023). Similarly, the US offered tax and accounting incentives to commercial banks to broaden the participation base in DFN swaps in the 1990s (United States General Accounting Office 1991).

Public finance institutions to engage in credit enhancement. By changing junk debt into green bonds that are the result of a DFC swap, public finance institutions can support debtor countries to change the image of their debt portfolio and thereby improve their credit rating. The attractiveness of such bonds for private buyers could be enhanced by guarantees and credit insurances for the issuers of such bonds (TCD IMF 2022).

Construct DFC swaps as sectoral approach focusing on large-scale adaptation and mitigation consistent with the conditional target of the NDC. Instead of piecemeal implementation inherent in small-scale project-by-project DFC swaps (Patel 2023), DFC swaps should be integrated into NDC investment plans. The debtor government would allocate funding from DFC swaps according to the priority list of activities defined in the investment plan for the conditional part of the NDC – focused on those activities for which no direct public climate funding is available so far. The involvement of multiple ministries ensures that the interests of different domains are considered when negotiating DFC swaps. That way, a cross-governmental approach increases the viability of the agreed climate targets and measures (Patel 2023). The more specific the plan,

the better – as in the Just Energy Transition Partnerships (JETP) where the utilization of DFC swaps should be brought into the Resource Mobilization Plans (see Example 1).

Example 1 for sectoral approach: Using DFC swaps for Just Energy Transition Partnerships

Energy transition strategies are ideally suited for DFC swaps as they entail clear political commitment and sector specific actions (Chamon et al. 2022). Since COP26, Just Energy Transition Partnerships (JETPs) have been concluded with Indonesia, Senegal, South Africa and Vietnam and seen as a strategic priority for the G7 countries (G7 2022). However, support from the recipient countries is dwindling as JETPs are heavily criticised for mainly offering commercial loans (Ferris 2023). For example, in Vietnam the Ministry of Finance blocks all loan funding for JETP-related measures. While among these countries only Senegal has an extreme level of external debt with 120.4%, and the others range between 35 and 45% (World Bank 2023), DFC swaps could be used to overcome hurdles related to opposition against debt burden increase.

Example 2 for sectoral approach: using DFC for adaptation finance

DFC swaps could be one of multiple financial tools to fill the adaptation finance gap, with public finance being the main source for adaptation finance so far. However, funding remains ten to 18 times below the adaptation finance needs (UNEP 2023). To follow the programmatic approach, debtor countries' NAPs could be used as a basis to negotiate debt-for-adaptation swaps (DFA swaps).

DFA swaps are especially attractive for countries that are struggling to access concessional finance while being highly vulnerable to climate change. This is the case for many SIDS having very high external debt ratios and facing high costs of lending, partially due to climate change risks (Buchner et al. 2021). In this regard, DFA swaps could have a twofold positive effect, by offering below-market costs finance and having a beneficial impact on lending risks. Investments in adaptation also reduces climate change vulnerability which potentially can improve investment conditions and the debtor country's sovereign credit rating (Chamon et al. 2022).

Some debt swaps with adaptation components have already been carried out, such as the debt swap of the Seychelles in 2015, which enabled projects for marine conservation and adaptation measures in the coastal area (coastal management and mangrove conservation).

4. Conclusion

There are some promising examples of DFC swaps, demonstrating the theoretical merits of DFC swaps as innovative climate finance tool that does not increase debt burdens. However, the overall practical evidence shows that DFC swaps fall short of their potential so far, with low volumes of finance generated and only a handful of purely climate focused swaps. So far, DFC swaps do not represent the quickest nor the most effective means of delivering climate finance.

We see different reform options and investment opportunities for DFC swaps. Notably, DFC swaps can be improved by streamlining processes and negotiations through standardized tools and improved transparency. They can further be upscaled by mainstreaming private creditor involvement and shifting away from project-by-project swaps towards a sectoral approach, as in the case of Just Energy Transition Partnerships.

Consequently, DFC swaps should not be generally dismissed as fundamentally flawed or as “false solutions”. There are cases where DFC swaps are an attractive option for countries to access climate finance especially when other ‘traditional’ means (e.g. concessional loans, grants or debt cancellation/comprehensive debt restructuring) are not feasible. Improving DFC swaps is possible if all involved parties apply the necessary political will to harness them as climate finance that generates a real adaptation and mitigation impact.

References

- Ahiadorme, Johnson Worlanyo (2023): Unpleasant Surprises? Debt Relief and Risk of Sovereign Default, in: *Journal of Financial Economic Policy*, 15, p. 47–74
- Aragon, Illari (2023): A new climate finance goal is in the making: what must happen in 2023? International Institute for Environment and Development (accessed March 14, 2024)
- Bourke, India (2023): What if debt was written off to protect climate and nature?, BBC, December 13, 2023, <https://www.bbc.com/future/article/20231212-what-if-the-world-cancelled-debt-for-climate-and-nature> (accessed March 14, 2024)
- Buchner, Barbara; Naran, Baysa; Fernandes, Pedro; Padmanabhi, Rajashree; Rosane, Paul; Solomon, Matthew; Stout, Sean; Strinati, Costanza; Tolentino, Rowena; Wakaba, Githungo et al. (2021): *Global Landscape of Climate Finance 2021*, Climate Policy Initiative, San Francisco
- CAN (2023): Position on Debt Swaps, <https://climatenetwork.org/resource/climate-action-network-position-on-debt-swaps-may-2023/> (accessed February 23, 2024)
- Chamon, Marcos; Klok, Erik; Thakoor, Vimal; Zettelmeyer, Jeromin (2022): *Debt-for-Climate Swaps: Analysis, Design, and Implementation*, IMF Working Paper 2022/162, Washington
- Darouich, Laila; Shishlov, Igor; Schmidt, Max; Pássaro, Pedro; Michaelowa, Axel (2023): *Debt-for-climate swaps as a tool to tackle climate and debt crises: Opportunities and challenges*, Perspectives Climate Research, Freiburg
- De Marez, Laetitia; Bee, Skylar; Bartle, Benjamin; Chintulga, Odgerel; Nguyen, Cindy (2022): *Accessing Climate Finance: Challenges and opportunities for Small Island Developing States*, United Nations, https://www.un.org/ohrlls/sites/www.un.org.ohrlls/files/accessing_climate_finance_challenges_sids_report.pdf (accessed March 28, 2024)
- Effective Institutions Platform (n.d.): History, <https://www.effectiveinstitutions.org/en/about-us/2> (accessed March 28, 2024)
- Ferris, Nick (2023): JETP: Don't write off the Just Energy Transition Partnership just yet, *Energy Monitor*, September 18, 2023, <https://www.energymonitor.ai/policy/just-transition/dont-write-off-the-jetp-just-energy-transition-partnership-just-yet/> (accessed February 23, 2024)
- Fuller, Frances; Zamarioli, Luis; Kretschmer, Bianka; Thomas, Adelle; De Marez, Laetitia (2018): *Debt for climate swaps: Caribbean Outlook*, Climate Analytics, Berlin
- G7 (2022): *G7 Chair's Summary: Joining Forces to Accelerate Clean and Just Transition towards Climate Neutrality*, <https://www.mofa.go.jp/mofaj/files/100364066.pdf> (accessed January 21, 2024)
- Gallagher, Kevin; Bhandary, Rishikesh; Ray, Rebecca; Ramos, Luma (2023): Reforming Bretton Woods institutions to achieve climate change and development goals, in: *One Earth*, 6, p. 1291–1303.
- Government of Barbados (2022): *Urgent and Decisive Action Required for an Unprecedented Combination of Crises: The 2022 Bridgetown Initiative for the Reform of the Global Financial Architecture*, <https://pmo.gov.bb/wp-content/uploads/2022/10/The-2022-Bridgetown-Initiative.pdf> (accessed March 28, 2024)
- Grigoryan, Erik (2023): *Debt-for-Climate Swaps: A Tool to Supporting the Implementation of the Paris Agreement*, speech held at COP 28 side event, Dubai, December 4, 2023

Grigoryan, Erik; Hasannudin, Zenathan Adnin; Isgut, Alberto; Martin, Patrick; Morris, Deanna (2021): Debt-for-Climate Swaps as a Tool to Support the Implementation of the Paris Agreement, Policy Brief 121, Economic and Social Commission for Asia and the Pacific (ESCAP), Bangkok

Jones, Marc (2023): Exclusive: Top development banks to launch debt-for-nature swap 'task force', Reuters, November 30, 2023, <https://www.reuters.com/sustainability/sustainable-finance-reporting/worlds-top-mdb-forge-debt-for-nature-swap-task-force-sources-2023-11-30/> (accessed March 14, 2024)

Latindadd (2023): Debt and climate justice organizations identify major pitfalls in the Galapagos debt-for-nature swap, <https://latindadd.org/arquitectura-financiera/organizaciones-que-trabajan-en-deuda-y-justicia-climatica-denuncian-problemas-con-el-canje-de-deuda-de-galapagos/#posicioningles> (accessed March 14, 2024)

Michaelowa, Axel; Shishlov, Igor; Wallis, Olivia; King, Beatrice (2023): The Impact of High Interest Rates on Sustainable Investments, Al-Attiyah Foundation, Doha

Munevar, Daniel (2018): Climate change and debt sustainability in the Caribbean: Trouble in Paradise?, background paper prepared for the Intergovernmental Group of Experts on Financing for Development, UNCTAD, Geneva

Nedopil, Christoph; Yue, Mengdi; Sun, Tianshu (2023): (Re)Orienting Sovereign Debt to Support Nature and the SDGs: Instruments and their Application in Asia-Pacific Developing Economies, UNDP, Bangkok

Nestmann, Thorsten (2023): How debt-for-nature swaps can affect sovereign credit, OMFIF, <https://www.omfif.org/2023/08/how-debt-for-nature-swaps-can-affect-sovereign-credit/> (accessed March 14, 2024)

OECD (2022): Aggregate Trends of Climate Finance Provided and Mobilised by Developed Countries in 2013-2020, Climate Finance and the USD 100 Billion Goal, OECD Publishing, Paris

OECD (2023): Climate Finance Provided and Mobilised by Developed Countries in 2013-2021. Aggregate trends and opportunities for scaling up adaptation and mobilised private finance, OECD Publishing, Paris

Ortega-Pacheco, Daniel (2023a): Galapagos Deal: An Ignominious Legacy, <http://dx.doi.org/10.2139/ssrn.4455918> (accessed March 14, 2024)

Ortega-Pacheco, Daniel (2023b): Debt-for-climate (DFC) swaps as an innovative and underused instrument of climate finance? Speech held at COP 28 side event, Dubai, December 10, 2023

Patel, Sejal (2023): A Programmatic Approach to Debt for Climate and Nature Swaps', presentation held at COP28 side event, Dubai, <https://www.youtube.com/watch?v=YLYdYGF9T4Y> (accessed March 14, 2024)

Persaud, Avinash (2023): Breaking the Deadlock on Climate - The Bridgetown Initiative, in: GREEN, 3, pp. 99-103

Ramos, Luma; Ray, Rebecca; Bhandary, Rishikesh; Gallagher, Kevin; Kring, William (2023): Debt Relief for a Green and Inclusive Recovery: Guaranteeing Sustainable Development, Boston University Global Development Policy Center; Centre for Sustainable Finance, SOAS, University of London; Heinrich-Böll-Stiftung, Boston, London, Berlin

Rawnsley, Jessica (2022): Debt burden traps global south in a vicious circle, Financial Times, November 8, 2022, <https://www.ft.com/content/f4b04f39-8b9d-463d-8e95-ebb0d1514e21> (accessed March 14, 2024)

Schmidt, Max; Ombuya, Sherri; Shishlov, Igor; Michaelowa, Axel; Pássaro, Pedro (2023): Loss and Damage Finance: an assessment of the most promising instruments, Perspectives Climate Research, Freiburg

Shalal, Andrea (2021): IMF struggling over long-awaited 'green debt swap' push as COP26 nears, Reuters, October 29, 2021, <https://www.reuters.com/business/sustainable-business/imf-struggling-over-long-awaited-green-debt-swap-push-cop26-nears-2021-10-29/> (accessed March 14, 2024)

Sommer, Jamie; Restivo, Michael; Shandra, John (2020): The United States, Bilateral Debt-for-Nature Swaps, and Forest Loss: A Cross-National Analysis, in: *The Journal of Development Studies*, 56, p. 748–764

Standing, Andre (2023): Sovereign ESG bonds in the global south: 10 questions for those concerned about debt and climate justice, Eurodad, Brussels

TCD IMF (2022): Meeting the Moment – The IMF, Debt-for-Climate swaps and development, Task Force for Climate, Development and the International Monetary Fund, Boston

TNC (2023): Case Study: Barbados Blue Bonds for Ocean Conservation, The Nature Conservancy, <https://www.nature.org/content/dam/tnc/nature/en/documents/TNC-Barbados-Debt-Conversion-Case-Study.pdf> (accessed March 28, 2024)

UNEP (2023): Adaptation Gap Report 2023: Underfinanced. Underprepared. Inadequate investment and planning on climate adaptation leaves world exposed, UNEP, Nairobi

UNFCCC (2022): Summary and recommendations by the Standing Committee on Finance: Fifth Biennial Assessment and Overview of Climate Finance Flows, https://unfccc.int/sites/default/files/resource/J0156_UNFCCC%20BA5%202022%20Summary_Web_AW.pdf (accessed March 15, 2024)

United States General Accounting Office (1991): Developing Country Debt: Debt Swaps for Development and Nature Provide Little Debt Relief, Report to Congressional Requesters, Washington, DC

V20 (2023): Accra-Marrakech Agenda, Vulnerable Group of Twenty, <https://www.v-20.org/accra-marrakech-agenda> (accessed March 14, 2024)

Warland, Linde; Michaelowa, Axel (2015): Can debt for climate swaps be a promising climate finance instrument? Lessons from the past and recommendations for the future, Perspectives Climate Research, Freiburg

World Bank (2022): International Debt Report 2022, Washington

World Bank (2023): International Debt Report 2023, Washington

WRI (2023): Paying for Paris Interviews with Kevin Bender: Debt-for-Climate Swaps, World Resource Institute, <https://www.wri.org/videos/paying-paris-interviews-kevin-bender-debt-climate-swaps> (accessed March 14, 2024)



CLIMATE



DEBT

CONTACT

Perspectives Climate Research gGmbH Freiburg
Hugstetter Strasse 7 | 79106
Freiburg | Germany
Phone: +49 761 590 33 823

info@perspectives.cc
www.perspectives.cc