

**AFRICATALYST**

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**Upscaling and Upsizing Debt**  
**for Climate & Nature Swaps in Africa**

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## 1. Introduction: A Broader Instrument, a New Mindset

The post-COVID years have seen a renewed emphasis on the need to combat climate change and address its mounting economic and social impacts, especially in developing countries. There have been urgent calls, most notoriously by the Independent High-Level Expert Group on Climate Finance, to “quickly ramp up the financing available to developing and emerging economies for supporting their climate adaptation needs”.

In this regard, a strong focus has typically been put on Africa which is the world’s most vulnerable continent to the effects of climate change despite its very limited contribution to greenhouse gas emissions. At the same time, the debt situation of many developing countries, particularly in Africa, has substantially worsened in the wake of the COVID emergency fiscal response. Based on IMF/World Bank sustainability analyses, it is currently estimated that 21 African countries are either debt-distressed or at high risk of debt distress.

This context, coupled with the growing market for debt-for-nature swaps which is poised to potentially exceed \$800 billion according to Bloomberg, has created a major opportunity for African countries to scale up and size up Debt for Nature and Climate swaps in order to address the challenges of climate resilience and reduce their debt burdens.

To seize this opportunity, however, there is growing awareness that such instruments need to be revamped to reach their full potential. A new generation of swaps would therefore be needed, and can potentially constitute an important means for mobilizing additional climate finance and meeting the climate compensation and solidarity commitments of advanced economies for the benefit of climate-vulnerable African countries and other emerging markets and developing economies (EMDCs).

Such swaps should go beyond narrow conservation objectives and aim to meet a broader set of climate financing needs of developing countries. To this end, a special focus should be put on climate adaptation, as well as including loss and damage expenditures linked to climate impacts, and forgone revenues associated with multiple agreed international climate mitigation and environmental protection goals, including carbon emission reduction, biodiversity preservation, and ocean protection.

This paper builds on a growing number of contributions and fresh ideas on the topic to sketch an operational-level policy framework to better manage risks and overcome the main constraints to the wider use of debt swaps, thus bringing such agenda closer to an actionable stage for the various stakeholders.

*it is currently estimated that 21 African countries are either debt-distressed or at high risk of debt distress.*





## 2. The Political Context: Matching the Urgency of Climate Finance for EMDCs with Actionable Solutions

The various COP agreements on the climate and the environment, together with the accelerating pace of climate impacts on African countries and the deterioration of the debt outlook of many African economies created unprecedented space for Debt for Climate and Nature swaps. Yet, the use of such instruments has so far remained marginal across the continent.

As stated by the Independent High-Level Expert Group on Climate Finance, “climate change is occurring at a faster pace than previously anticipated, the impacts and damage are greater than foreseen, and the time for remedial action is rapidly narrowing. [...] The world needs a breakthrough and a new roadmap on climate finance that can mobilise the \$1 trillion per year in external finance that will be needed by 2030 for emerging markets and developing countries (EMDCs) other than China.”

At the 2009 Copenhagen Climate Conference, developed countries collectively pledged to mobilize \$100 billion per year by 2020 to support climate action in developing countries. This financial support was intended to facilitate policies aimed at mitigation (reducing emissions) and adaptation (building resilience). However, meeting this commitment has been, at best, sluggish and underwhelming, at worst, highly disappointing. As noted by the Independent High-Level Expert Group on Climate Finance: “While there has been progress in both bilateral and multilateral public finance flows since 2013, the commitment to deliver \$100 billion a year by 2020 was not met (with a shortfall of around \$17 billion in 2020) and will likely only be achieved in 2023, largely because of increased financing from the multilateral development banks.

Bilateral public finance, which is the most important indicator of the direct contribution by developed countries, has not increased measurably since 2016 [and has been] the major reason for the shortfall in the delivery of the \$100 billion commitment.” The same report concludes that “Donors must double their delivery of climate finance by 2025 from 2019 levels, including more than doubling finance for adaptation and climate resilience if the package of complementary finances for the delivery of the Paris Agreement, reinforced by the Glasgow Pact, is to be realized.”

The cold reality of the political economy in advanced economies suggests that the international community needs to go beyond morality calls and quickly find realistic avenues to unblock higher level of climate finance. The world’s largest economies and largest carbon emitters and major bilateral creditors of African countries, including the United States and China, have not signaled concrete and realistic plans to significantly increase “traditional” concessional finance for adaptation in the coming years. The recent political trends in European countries also make it unlikely to quickly see large increases in bilateral concessional finance for climate adaptation. In this context, a growing number of observers have identified “revamped” Debt for Climate/Nature Swaps, encompassing broader climate objectives, as one of the few instruments populating the intersection of climate urgency, existing financial commitments, and political realism.



Traditional Debt for Nature swaps involve the exchange of debt owed by a developing country to a creditor (often a developed country or a financial institution) for a commitment by the debtor country to protect and conserve its natural resources, either by taking policy actions to protect natural assets, and/or by committing to spend part of the foreign debt service obligations on selected domestic environmental spending programs. Swaps involving official bilateral debts are simpler as they involve only two parties and cover the full amount of debt service.

Swaps on private debt are more complex, as they involve a third party to buy back the debt at the discounted market prices and pass through the saving to the debtor entity. The use of these swaps has been limited since their inception, reaming mainly ad hoc, small scale, and externally driven, without adequate involvement of affected communities.

In this paper, we argue that the main reason for this limited uptake has been the focus of swaps on narrowly defined conservation efforts, on one side, and their characterization as a tool for unilateral debt cancellation in situations of debt distress, on the other side.

Nevertheless, a few more ambitious swaps have been agreed, with a focus on climate adaptation, most notably in the swap agreed between Cabo Verde and Portugal. More recently, a debt-for-nature swap was issued by Gabon to fund marine conservation, switching its debt in international bond markets to a new \$500 million “blue bond” with a lower interest rate and longer maturity.

Overcoming these two abovementioned limitations would go a long way to make the instruments fit for purpose as a potent and broadly applicable climate adaptation finance instrument.



From a political economy perspective, what makes the instruments much more palatable than traditional concessional finance for creditor countries is that debt cancellation is politically, and sometime legally, much easier to achieve than mobilizing fresh grants or concessional loans. In the current context where many creditor countries are struggling to meet their climate commitment or pledges, swaps could boost efforts to achieve their climate finance targets.

They could be designed as climate finance instruments, while addressing the traditional issues of debt distress, whenever relevant, adding to its political relevance. With their specific focus on climate and Nature conservation issues, they would contribute to matching the existing obligations of developed nations and should be more politically readily acceptable.

**In this light, we see merit in revamped Debt for Climate & Nature Swaps with the following features:**

- Alignment with a broader range of climate and environmental goals with a strong focus of financing climate adaptation in Africa and other concerned EMDC.
- Applicability to official debt from developing countries held by public or private creditors, independently from their level of risk of debt distress.
- The potential to count towards the achievement of countries’ climate commitment and pledges, and as such seen as a balanced transaction rather than a unilateral debt cancellation instrument.

The feasibility of the advocated strategy hinges on the two critical issues discussed further in this paper, notably:

- The potential financial scale of the instrument and its relevance in the overall climate finance space and
- The key policy arrangements and negotiation issues allowing operationalization on a broader scale.

### 3. The Financial Dimension: Not a Silver Bullet, but a Bridging Solution

A critical issue that needs to be addressed relates the potential financial scalability of debt for climate and nature swaps. In the current context of climate urgency, the international community would be well-advised to focus its limited political capital and administrative resources on selected climate finance instruments with a significant potential for scalability. The significance of these instruments could be measured based on a number of criteria. At the aggregate level, they would need to help meet a significant proportion of the existing or projected climate finance gap for beneficiary countries. In terms of impact for EMDC and African countries in particular, the significance will also depend on the ability of the instrument to mobilize additional resources (including from the private sector) that can help address the public good nature of climate adaptation needs, and put countries directly in the driver seat.

As shown in table 1, the total amount of official external debt service up to 2030 due by low- and lower middle-income countries amount to more than USD 9,000 billion. African countries are up for USD 400 billion of external debt service. For sub-Saharan African countries in particular, total debt service up to 2029 would be close to USD 270 billion. African countries in debt distress or high risk of debt distress account for USD 97 billion of the total debt service over that period.

Table 1. Total debt service EMDC 2023-2029			
Projected Total Debt Service 2023-2029 USD			
	Africa	Sub-Saharan Africa	EMDC (LIC & MLIC)
Total	403,174,237,284	269,060,162,995	919,469,682,116
Bilateral	99,731,691,604	72,966,210,284	225,133,580,799
Multilateral	107,098,814,526	72,654,522,152	288,075,500,198
Private	196,343,731,153	123,439,430,559	406,260,601,119

**Source: World Bank, International Debt Statistics.**

Although only a fraction of this overall envelope would be expected to be available for treatment under Debt for Climate & Nature swaps, it would potentially make a big difference. Bilateral debt service which is amenable to debt for Climate & Nature swaps, amounts to USD 225 billion, of which USD 72 billion pertain to sub-Saharan African countries. Such headline number can therefore give only a broad idea of the order of magnitude of what is potentially feasible: assuming for instance that one third of all bilateral debt could be eligible would give us an overall envelope of around USD 70 billion at the global level and around USD 25 billion for Sub-Saharan Africa.

The additional climate finance that could thus be mobilized over the next 7 years would contribute to closing the financing gap on the annual USD 100 billion target. These resources would increase significantly the component of climate finance that had increased the least, i.e. concessional bilateral funding for climate adaptation. The potential amount of climate swaps for Africa valued at about 24 billion is also quite significant, given that in 2019/20, the amount of total climate finance for Africa is estimated at around USD 26 billion of which USD 4.2 billion of bilateral DFI funding. That amount would also go a long way towards the objective mentioned above of more than doubling finance for adaptation and climate resilience.

Beyond the scope for mobilizing additional concessional finance, debt for climate and Nature swaps have the potential to significantly boost private sector financing for climate action. A more granular financial analysis by Sejal Patel (2002) estimated that, for EMDC countries with some level of debt distress, innovative climate and nature-linked debt instruments could make available between USD 84.7 billion and 104.5 billion from debt relief for climate and nature financing, once all debt resolution costs and deductions have been accounted for.

Overall, it seems that the debt for climate & Nature swaps have the potential to help close the short to medium-term gap in climate finance for several EMDCs. They can therefore help bridge the adaptation and mitigation financing needs, while more comprehensive and sizable climate finance solutions are devised, and quickly boost the financing for climate action and conservation in countries suffering the most the current and forthcoming climate impacts.

## 4. How to Make this Work: A Proposed “Programmatic” Framework

Operationalizing a revamped debt for climate and Nature instrument requires overcoming the constraints that have limited a wider use of debt swaps in the past. The objective is to devise a relatively simple and flexible framework that addresses heads-on one critical issue which, we argue, relates to the profile mismatch between the two parts of the deal, debt relief and climate measures. Debt relief tends to be a discrete, often one-shot event, while climate measures to be effective often require a stream of policy and financial actions spread over many years.

Past swaps have addressed this time mismatch either by restricting climate action to one or two upfront measures (e.g. Seychelles), or by creating a domestic public fund (e.g. Cabo Verde) to hold the maturing debt obligations which will be used later for the financing of the climate program.

The upfront approach has been applied mainly to narrow conservation objectives, built upon project-type activities such as the creation of protected natural reserves in specific areas. This upfront, project-type approach is ill-suited to specific climate action and other urgent climate objectives. For instance, climate adaptation involves a range of interventions designed to reduce vulnerability and increase resilience to the effects of climate change, such as building climate-resilient infrastructure, modifying agricultural practices for enhanced crop resilience, improving water management both for water preservation and for reducing flooding risk. This kind of activities requires well-structured multi-year spending programs that very often rely on State intervention due to their public good nature.

The fund approach is better suited to the distributed nature of climate adaptation interventions and can be a useful modality to structure a debt swap. Large public earmarked funds, however, suffer from other shortcomings which make them less likely to be effective and trusted in EMDC contexts. Public funds can be established in a variety of ways, and with varying governing arrangements. Earmarked funds with a significant mismatch in the profiles of their revenues and expenditure can operate as pay-as-you go, where the revenues are appropriated in accounting, and actual cash transfer occur only when expenditure are due, or as fully funded, where revenue are transferred to the fund, which manages its balances directly.

Pension funds are typical of this typology, and Climate & Nature funds because of the mismatch between debt service and climate adaptation programs would also fall in one of these two categories. The management of these funds even in countries with strong governance frameworks has not been good, as countries have found it difficult not to reallocate the funds to other competing priorities or to help maintain fiscal and macroeconomic stability. Experience suggests that it is unlikely that large, earmarked funds for climate adaptation would therefore be widely adopted. Furthermore, once a fund is created, the need to design spending plans and implementation modalities raises additional challenges.

In this paper, we argue that a framework based on a programmatic approach, buttressed by an explicit debt rescheduling mechanism, can address the shortcomings of existing Debt for Climate & Nature Swaps. Climate & Nature swaps should ideally hinge on a country medium-term program of climate investments and policy measures. Such a program would be designed by the debtor countries' authorities and its funding raised among public and private creditors. It would be scalable by flexibly integrating new climate areas or sub-areas. On the creditor side, debt relief would be partly granted upfront and the rest rescheduled to broadly match the timing of the corresponding financial outlays or policy actions of the country's climate program. In line with creditors' preferences, such rescheduling could be made in accordance with the climate program implementation.

Climate programs should translate national adaptation plans and other national climate initiatives into structured spending plans and policy measures. As much as possible they would use existing budgetary and financial management arrangements, whether at central or local government level or at the level of other public entities. Such a programmatic approach would incentivize the development of capacities to develop and implement large climate adaptation programs in many African countries. This would encourage a broad spectrum of actors to contribute to the design, negotiations, implementation and monitoring of such programs. At the design stage, domestic and international NGOs, relevant UN agencies, the World Bank's Country Climate and Development Report, the IMF Resilience and Sustainability Facility could all provide significant inputs for such country climate adaptation programs, as well as provide resources to strengthen the countries' own capacities. Early involvement of the affected grass root communities should also be the norm.

In countries with weak capacities, these programs should be designed in a modular and flexible way, starting with a core adaptation program to which other components can be added as needed. For instance, they could include climate disaster components or clauses, allowing the country to flexibly respond to pre-identified climate shocks. Depending on countries circumstances and priorities, the modular nature of the program would help accommodate mitigation (e.g. energy transition) and various other environmental objectives agreed by existing or new international conventions, such as on biodiversity, oceans or plastic pollution.

The funding of such program through debt swaps can rely on an agreed debt rescheduling and cancellation schedule that is congruent with the profile of expenditures and policy measures of the country program. This would involve matching debt relief with specific levels of expenditure under the country climate program. The main advantage of this approach is to provide immediate fiscal space to recipient countries, while also providing climate stakeholders, domestic and international, with a credible incentive framework for implementation. To achieve scale, such an approach would work where there is a dominant creditor, or where creditors can work together under an umbrella arrangement (such as the European Union and the Paris Club in the case of official creditors and the Institute of International Finance (IIF) in the case of private creditors). The matching of program expenditure involves a degree of earmarking of the amounts of debt write-off. The broader earmarking would allow any expenditure under the program to be eligible, while a finer earmarking may select a sub-program or a sector.

Debt resolution issue may or may not be included in such deals. In fact, in the beginning, one could argue that it would be beneficial to pilot the instrument in a context without debt sustainability issues, as to emphasize the novelty of the concept and focus on the core element of the swap. By rooting the instrument on creditors countries climate obligations or climate objectives, the instruments lose its one-sidedness, which helps do away with traditional debt cancellation issues such as free-rider problems of the remaining creditors. That said, if debt resolution were not to be a core motivation for the debt swap, creditors would have to strike the right balance between using a debt swap mechanism or another financing instrument to fund the countries' climate and environment program given the transactions costs associated with a debt swap.

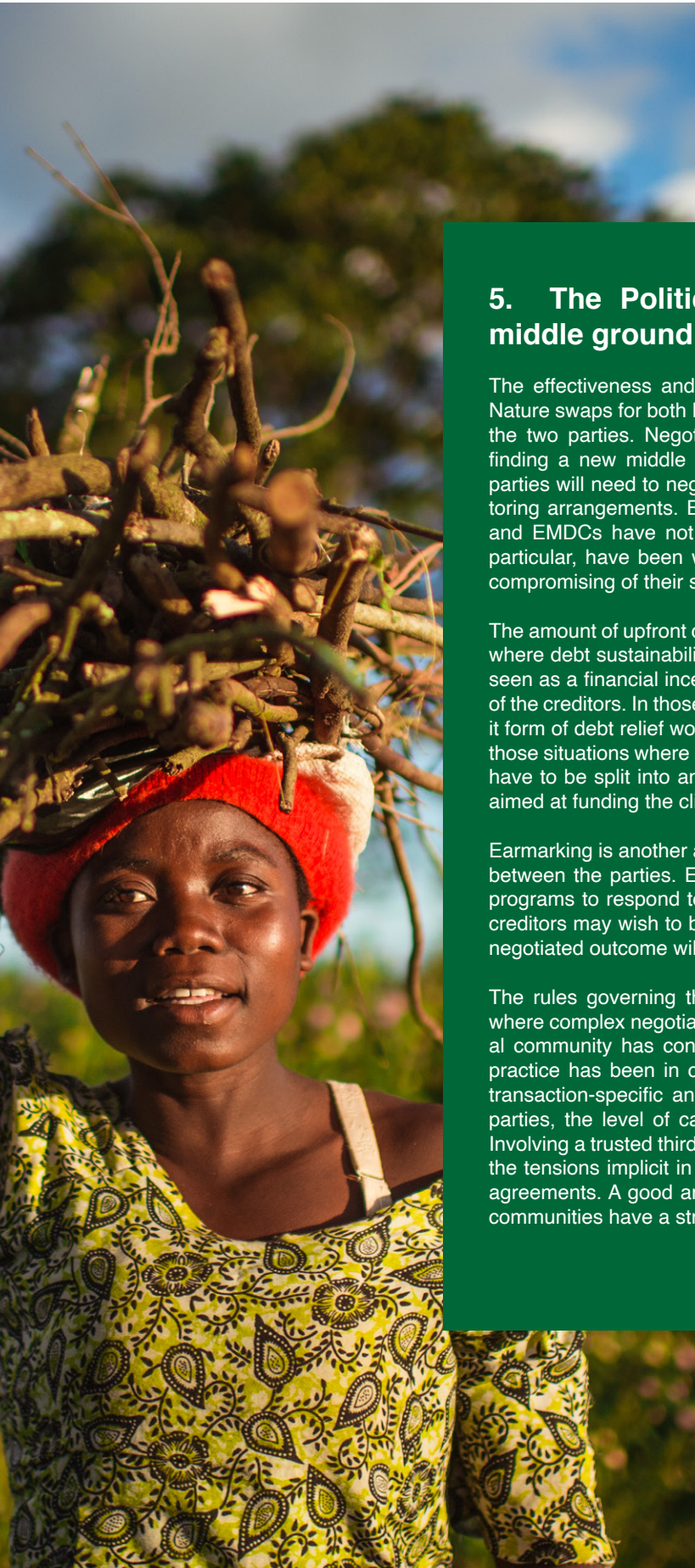
Including debt resolution issues to the instrument adds a familiar layer of complexity, but the broader Debt for Climate approach also has the potential to make some of the debt resolution issues more tractable. For instance, to the extent that debt distress is associated with the time profile of debt service, the rescheduling inherent with debt for nature swaps might ease the sustainability issues. Also, to the extent that some of the climate actions are policy actions, the instrument would lead to lowering the country debt service with no or little financial burden.

The viability of such a framework would rest on credible monitoring arrangements. While there are various options to design these arrangements, there is a growing consensus that affected communities should be meaningfully involved in such monitoring and have an important voice in the process.

Debt swaps have also been used to treat private government debts although there is still ample scope for recourse to such schemes in Africa. These private sector-oriented deals tend to be more complex as they may involve a third party buying back private debt at market value on secondary markets, and then passing on the savings to the EMDC government who commits to spend part of the saved amounts on pre-agreed environmental projects. Yet the potential benefits associated with these deals are considerable. At end-June 2023, the face value of African sovereign eurobonds outstanding was estimated to be about \$143 billion. Given the elevated African Eurobond yields, there is significant room for countries to reach more debt for climate and nature swap deals, as illustrated by Gabon in recent months.

The modularity of the programmatic approach would allow stakeholders to include financing deals that leverage such private sector participation. The initial bilateral agreement between governments, based on a core adaptation program can help build a track record, which can then lead to additional agreement that involve private sector debt swaps, using guarantees or green bonds refinancing. Such transaction could also be used to strengthen international carbon markets, if, as proposed by the IMF Managing Director, private creditors were allowed to trade in carbon credits arising from the transaction.





## 5. The Political Negotiation Arena: Finding a new middle ground

The effectiveness and attractiveness of a new generation of debt for climate and Nature swaps for both EMDCs and creditors will depend on fair balance of interests of the two parties. Negotiating acceptable Climate & Nature debt swaps will require finding a new middle ground between these interests. The main issues on which parties will need to negotiate include financial terms, earmarking of funds, and monitoring arrangements. Experience with *qui pro quo* financial deals between creditors and EMDCs have not led to a generally accepted model. African governments in particular, have been wary that IFIs' conditionality remains inflexible, intrusive, and compromising of their sovereignty.

The amount of upfront debt relief can be an issue to be negotiated even in those cases where debt sustainability is not an issue. Some level of up-front debt write-off can be seen as a financial incentive to engage in the deal, and a sign of goodwill on the part of the creditors. In those cases where debt swaps involve debt rescheduling, an implicit form of debt relief would be rescheduling at face value without NPV equivalence. In those situations where debt distress is an issue, the amount of debt to be swapped will have to be split into an amount written off to restore debt substantiality and another aimed at funding the climate program.

Earmarking is another area where a good upfront understanding needs to be reached between the parties. EMDCs may want sufficient flexibility in earmarking to climate programs to respond to evolving climate circumstances and political priorities, while creditors may wish to be able to account for delivery on specific climate outcomes. A negotiated outcome will need to respond to both necessities.

The rules governing the monitoring arrangements of the program is another area where complex negotiations might be expected. This is an area where the international community has considerable experience under development programs, and the practice has been in constant evolution. The shape of these arrangements is very transaction-specific and depends on the broader political relationship between the parties, the level of capacity, and the complexity of the deal, among other things. Involving a trusted third party in the monitoring arrangements can help diffuse some of the tensions implicit in the exercise of monitoring compliance with the programmatic agreements. A good and useful practice in this regard is to ensure that the affected communities have a strong voice in the process.

## 6. An Instrument Which Time Has Come

In the midst of current calls for the reform of the global financial architecture, including the context of the Bridgetown Initiative, the proposals made in this paper could provide a welcome opportunity for mobilizing additional financing for green and just transformations in Africa.

At a time when it is estimated that African countries need an average of USD 2.7 trillion to implement their Nationally Determined Contributions by 2030, debt for climate and Nature swaps offer innovative solutions for unlocking private and official climate finance for conservation efforts, climate-vulnerable countries, and those with large debt vulnerabilities.

The aim of this paper has been to show that it is possible to design, scale up and quickly deploy such swaps to help overcome the related financing gaps facing African countries and other EMDCs. While the approach laid out in it could contribute to achieving this goal, strong political commitment will be critical to broadening the range and use of innovative financing instruments and developing necessary risk mitigation tools.

The clock is ticking in view of the urgent need for climate action and nature conservation.






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