



# Linking sovereign debt to climate and nature outcomes

A guide for debt managers and environmental decision makers

## Summary

As countries grapple with the triple crisis of debt, climate change and nature loss, compounded by the impacts of the COVID-19 pandemic, multiple innovative solutions in sustainable finance are beginning to gain traction. These innovations towards an inclusive green recovery offer substantial benefits for developing countries looking to increase their fiscal space, adapt to climate change, reduce their emissions and protect their natural environment.

This guide presents these innovations in an actionable plan that links sovereign debt to climate and nature outcomes. Seven practical steps outline ways for governments to complete a debt transaction linked to their sustainability goals for climate and nature.

Aimed primarily at debt managers and environmental decision makers, the guide also serves as an operational pathway for creditors, international institutions and nongovernmental organisations to work together, using these emerging financing innovations to improve debt sustainability and increase climate and nature investment in the most climate-vulnerable and biodiversity-rich countries.


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The Shaping Sustainable Markets group works to make sure that local and global markets are fair and can help poor people and nature to thrive. Our research focuses on the mechanisms, structures and policies that lead to sustainable and inclusive economies. Our strength is in finding locally appropriate solutions to complex global and national problems.

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# Summary

This guide is part of a concerted effort by the international community to address the triple crisis of high and rising debt levels in developing countries, the climate change emergency, and the accelerated degradation of the natural world. Solutions to tackling this triple crisis holistically and inclusively can be found in the context of the international financial architecture. Multiple innovations in sovereign debt financing are offering numerous benefits to indebted countries. This guide outlines some of these innovations and provides useful information for governments seeking to achieve climate and nature outcomes while simultaneously strengthening their sovereign balance sheets.

Although this document has been compiled in the wake of the COVID-19 pandemic, the practical guidance it provides is intended to remain applicable long after the world recovers from the current health crisis. Development finance has always presented a conundrum, as the countries that need it the most are often the riskiest, which translates into a higher cost of capital and subdued investor interest. Developing countries have historically relied therefore on concessional financing. As those sources diminish, low- and middle-income countries have increasingly turned to non-traditional lenders and to the international capital markets to finance their development needs with consequent higher interest rates and costs of capital. Debt vulnerabilities have risen, and the frameworks that were used in the past to coordinate global debt relief efforts are less effective as creditors have become increasingly diverse.

In response to the COVID-19 pandemic, members of the Group of Twenty (G20) provided debt relief to low-income countries by delaying amortisation and interest payments, but, paradoxically, these measures are also creating **higher** debt service costs in future years. Recognising that some sovereigns would be facing solvency issues, rather than just immediate liquidity needs, the G20 introduced the Common Framework for Debt Treatments beyond the Debt Service Suspension Initiative (DSSI) in 2020. Unfortunately, middle-income countries facing high debt burdens remain ineligible to benefit from these initiatives, and the participation rate among eligible low-income countries has been very low.

At the same time, the international community urgently needs to mobilise unprecedented amounts of public and private sector funds into these overleveraged economies for critical investment in climate change resilience and mitigation, and in the

protection and restoration of natural ecosystems. As climate pollution and the degradation of the biosphere are pressing global issues, it is imperative that we take immediate global action to address them inclusively.

The debt financing innovations that have been emerging are now central to the effort to holistically address these three interlinked threats to human development. IIED, Potomac Group, and their United Nations partners have published this 'how-to' guide for linking sovereign debt to climate and nature outcomes. The goal of this guide is to provide governments and their partners with an actionable plan for taking advantage of these innovations to improve debt sustainability and also increase climate and nature investment.

The guide breaks down the process of executing debt transactions for climate and nature into seven straightforward steps. These are:

1. Create an inter-ministerial taskforce and agree on national objectives
2. Access capacity building and advice
3. Choose type of sovereign debt transaction: debt conversion and/or new instrument
4. Structure climate and nature key performance indicators (KPIs) or other relevant performance criteria
5. Design the financing aspects of the transaction
6. Engage with market participants, including creditors, credit rating agencies and investors
7. Execute debt transaction.

This guide is primarily directed at national debt management offices and ministries of finance, though it should also be useful for other government entities, such as ministries of environment, agriculture, energy, fisheries or forestry. It could also be useful for providing procedural context to other involved parties, including creditors and investors, international institutions, and nongovernmental organisations that would provide external advice and support.

One caveat is that, as of now, there is limited precedent for some of these instruments, but we expect their rapid proliferation in the near future. This guide is intended to drive forward and support that proliferation amongst sovereigns, and so we anticipate a revision of this document after twelve months to incorporate further real-world examples from country experiences.

## List of abbreviations

<b>COP26</b>	26th Conference of the Parties under the United Nations Framework Convention on Climate Change
<b>DFN</b>	Debt-for-nature
<b>DMO</b>	Debt management office
<b>DSA</b>	Debt sustainability analysis
<b>DSSI</b>	Debt Service Suspension Initiative
<b>EMBI</b>	Emerging Market Bond Index
<b>ESCWA</b>	United Nations Economic and Social Commission for Western Asia
<b>ESG</b>	Environmental, social and governance
<b>GCF</b>	Green Climate Fund
<b>GEF</b>	Global Environment Facility
<b>HIPC</b>	Heavily indebted poor country
<b>ICMA</b>	International Capital Markets Association
<b>IMF</b>	International Monetary Fund
<b>JSEG</b>	JP Morgan ESG Index
<b>KPI</b>	Key performance indicator
<b>LDC</b>	Least developed country
<b>MEL</b>	Monitoring, evaluation and learning
<b>MRV</b>	Monitoring, reporting and verification
<b>NBSAP</b>	National Biodiversity Strategies and Action Plan
<b>NDC</b>	Nationally determined contributions
<b>NGO</b>	Nongovernmental organisation
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>PEFA</b>	Public Expenditure and Financial Accountability
<b>RDB</b>	Regional development bank
<b>SIDS</b>	Small island developing states
<b>SLB</b>	Sustainability-linked bond
<b>SPO</b>	Second-party opinion
<b>SPT</b>	Sustainability performance target
<b>UN</b>	United Nations
<b>UNDP</b>	United Nations Development Programme
<b>UoP</b>	Use of proceeds
<b>WB</b>	World Bank



Benin, Ganvie lake village. Photo credit: Agbeko Masseur via Pixabay, CC BY-NC-ND 2.0

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# Introduction: the triple crisis, the green recovery and intended audience

## The triple crisis of debt, climate change and environmental degradation

As countries around the world continue to grapple with the overwhelming humanitarian impact of the COVID-19 pandemic, additional crises are looming as serious impediments to a sustainable recovery:

1. **Debt:** the sharp rise in government expenditure needs required to address the public health crisis has put an unanticipated strain on sovereign balance sheets. With the urgent necessity to prioritise public health expenditure, the international community has mobilised to provide financing and temporary debt relief to many of the countries that require it most. While these emergency measures may have helped prevent a debt crisis in the immediate term, the deferral of debt service payments has resulted in an increase in debt stocks for many countries. Taken alongside other side effects of the pandemic, such as fiscal deficits, low interest rates, and a prolonged period of low economic growth, or even recessions, it leads to a precarious outlook for borrowers that are worried about their long-term debt sustainability. External pressures resulting from an asymmetric global recovery can also mean currency depreciation, which would lead to a rise in interest rates and further exacerbate the situation. Furthermore, fears of diminished credit ratings or the potential loss of market access have inhibited some from renegotiating the terms of their debt. Although a mid-pandemic debt crisis has been averted, the rise in debt-to-GDP ratios is likely to have a prolonged impact on market access and fiscal space, thereby limiting capacity for financing a post-COVID recovery. This growing debt burden urgently requires a comprehensive and forward-reaching solution.
2. **Climate:** worldwide, the effects of climate change have been felt with increasing intensity year by year. Many regions have recorded rising temperatures at an unprecedented level, and climate-related disasters, such as floods, storms, droughts, and wildfires, have been striking with increased frequency all around the world. Countries are struggling to meet their obligations under the Paris Agreement to reduce emissions within the necessary timeframe, and COP26 in Glasgow is aimed at streamlining these efforts by coordinating strategies to accelerate the transition to renewable energy sources. Phasing out fossil fuels when they are so firmly established in all economies will be no easy task, and some countries will find the process more difficult than others, both practically and politically. It is therefore imperative that the international community share the burden by helping to ensure that this transition is feasible for every country. Climate change is a global issue and requires a global solution.
3. **Nature:** the natural world is often critically important in a developing country's economy as a source of livelihood through agriculture, fishing, tourism and other nature-based industries, as well as a provider of cultural and aesthetic value. Nature is also fundamentally and inseparably linked to climate stability. As human activity emits greenhouse gases that heat the world, natural ecosystems, such as forests and oceans, act as natural buffers to regulate the biosphere, absorbing carbon and even mitigating the damage from climate-related disasters. Biodiversity loss and the destruction of natural ecosystems have dramatically reduced the planet's capacity to do this, accelerating the negative effects of climate change. Despite this relationship, nature conservation remains a distinct issue from emissions reduction, therefore requiring specific attention.

## Need for sustainable finance for an inclusive green recovery

The triple crisis of debt, climate and nature has been recognised as an immovable obstacle in the way of development for many of the world's most vulnerable countries (Steele and Patel, 2020). Simultaneously, there is growing global consensus that the climate and nature crises are reaching a tipping point, and that channelling funds to protect these public goods which sit in emerging markets is vital to reversing the situation worldwide. The international community has therefore been emphasising the urgent need for global coordination towards an inclusive 'green recovery' from the pandemic.

Many countries aspire to dedicate resources to climate change, with adaptation being the priority for climate-vulnerable countries with very low emissions. The 46 least developed countries (LDCs) and small island developing states (SIDS) are collectively responsible for a very small percentage of global emissions, but agricultural dependence and the need for stronger infrastructure make them very vulnerable to climate-related disasters. Large middle-income countries, however, are major sources of greenhouse gas emissions. Likewise, heavily forested large countries contribute to global emissions through agricultural expansion and logging, reducing the natural environment's ability to sequester carbon.

Despite these varying climate and nature concerns, all of these countries face budget constraints and competing needs, many of which have a more immediate impact or stronger political demand. As seen during the pandemic, health and other social needs, such as economic stimulus, can take precedence over environmental concerns, which are perceived as longer-term challenges and therefore

crowd out necessary spending on climate and nature policies. For countries with market access, such behaviour has generally been rewarded by investors. International capital markets tend to focus more on governance and social issues than environmental risks when pricing sovereign debt instruments.

In a concerted effort to address the climate and nature crises, as well as the growing debt burden, multiple innovations in the field of sustainable finance have begun to gain traction. The goal of these innovations is to offer substantial financial benefits for countries seeking to reduce their emissions, adapt to climate change and protect their natural environment, beyond simply making these efforts more affordable. In this way, sovereign debt managers, depending on their country's situation, may be able to improve debt sustainability while mobilising new sources of capital with attractive terms and conditions.

## Intended audience for this guide

This how-to guide provides governments with an actionable plan for doing this, explaining how to take advantage of transactions that link sovereign debt to climate and nature outcomes. While primarily directed at debt management offices (DMOs) and ministries of finance in developing and emerging market countries, it should also be useful for ministries of environment, agriculture and energy, and other agencies that have a stake in budget finance and environmental outcomes. Likewise, the guide may serve as an operational roadmap for other involved parties, such as creditors, international institutions and nongovernmental organisations (NGOs) that provide external advice and support.



Bangladesh, preparing to build a road. Photo credit: Scott Wallace/World Bank via Flickr, CC BY-NC-ND 2.0

## How to complete a debt transaction for climate and nature in seven steps

This guide sets out seven clear steps to complete a debt transaction for climate and nature outcomes:

1. Create an inter-ministerial taskforce and agree on national objectives
2. Access capacity building and advice
3. Choose type of sovereign debt transaction: debt conversion and/or new instrument
4. Structure climate and nature key performance indicators (KPIs) or other relevant performance criteria
5. Design the financing aspects of the transaction
6. Engage with market participants, including creditors, credit rating agencies, and investors
7. Execute debt transaction



## Step 1. Create an inter-ministerial taskforce and agree on national objectives

The decision to pursue a debt transaction linked to climate and nature outcomes must be considered in the context of the country's broader national development plan and its post-COVID national recovery strategy. This requires the highest level of cross-ministerial cooperation and collaboration. Frameworks governing fiscal and debt management should be considered, as well as any existing national policy objectives with respect to environmental, social and governance (ESG) standards or meeting the Sustainable Development Goals (SDGs). A thorough understanding of the country's public commitments is also necessary, particularly the Nationally Determined Contributions (NDCs) under the Paris Agreement for climate and the National Biodiversity Strategy and Action Plans (NBSAPs) for nature.

The ministry of finance and the DMO, which may or may not be independent of the ministry of finance, would likely play a leadership role in the feasibility assessment of a debt transaction linked to climate and nature. An inter-ministerial taskforce including the ministry of finance and officials from other key ministries, such as environment, energy and agriculture, would be an effective way to facilitate communication and determine national objectives. Consistent cooperation among all relevant government agencies would remain essential, with the ministry of environment and other relevant ministries providing technical input on the selected climate and nature indicators.

The taskforce will also lead a national exercise for understanding:

- How national and local government entities are involved
- The comprehensive and inclusive consultation and engagement of national stakeholders in determining the climate and nature objectives to be included in the transaction (see Step 2)
- How representatives from the private sector and civil society, including from traditional and community structures, are engaged to contribute to the initiative.

Once established, the taskforce would need a deep understanding of the country's circumstances: the country's 'income status'; the debt profile; ability to access international capital markets and related risk premium; vulnerability to climate change and biodiversity loss; and other aspects of the economy, such as dependence on agriculture, fisheries and tourism. It is also important to verify any borrowing constraints following a debt sustainability analysis (DSA) or certain debt conditionality that may be attached to an IMF programme. For first-time or infrequent issuers this assessment will involve a host of additional macroeconomic considerations. Aside from strong fundamentals and clear objectives, it is important to demonstrate how new commercial debt would fit in with the country's other sources of funding, as well as how the targeted climate and nature outcomes could also reduce sovereign risk and improve long-term growth prospects.

The taskforce would undertake a comprehensive analysis of the government's finances and determine if traditional avenues for closing a financing gap, such as tax revenue mobilisation or expenditure consolidation, have been exhausted. If the government decides that a climate- and nature-linked debt transaction could enhance its debt management efforts and improve its long-term debt sustainability, then this decision must also be made with clear goals for the environmental sustainability outcomes of that potential transaction in mind, carefully identifying the macroeconomic and debt sustainability aspects of such investments. For example, climate adaptation investments may improve future debt sustainability and relax future borrowing constraints.

The taskforce would work to assess the environmental and economic sustainability of the country's operations across all sectors and identify areas for improvement. From that assessment, it would select one or more of these areas and formulate the country's sustainability objectives. To underpin a financial transaction, the objectives should be:

- **Specific:** a quantifiable target with a predefined timeline
- **Credible:** reasonably achievable given the timeframe, politics and technical capacity
- **Ambitious:** material improvement (not something that would have occurred anyway within that period of time) linked to external benchmarks if possible.

For sovereign governments, these targets should represent the country's broader environmental sustainability goals and should be more or less equitable to its NDCs and NBSAP.

In addition to identifying a collection of sustainability targets, the government should have a detailed technical working plan for reaching them, as the success (and repeatability) of an attached financial instrument would depend on meeting these targets (ICMA, 2020). In this sense, targets must be realistically credible if they are to reliably support the country's objectives for a potential transaction and the government's overall strategy should be clear to all parties involved. Once the reasoning for pursuing a transaction has been clearly defined, be it debt relief, new sources of capital, climate resilience or environmental sustainability, the taskforce should begin reaching out to relevant external participants. As with any significant transaction, a clear communication strategy is essential.

## Step 2. Access capacity building and advice

Support from a number of different parties will be a fundamental component of the success of a debt transaction linked to climate and nature outcomes, so it is important to engage the relevant actors early in the process. These participants fall into three overall categories and each plays a key role throughout.

**Financial and legal advisors** are necessary to help design the transaction, coordinate communications between all stakeholders, and guide the process to conclusion. In conjunction with financial advisors, an analysis of the debt portfolio in tandem with a DSA is important in understanding the risk factors faced by the country and the approach it should take to achieve an optimal result. The analysis can also shed light on the type of instrument most suited to the country's needs. Countries will likely already have well-defined data for external debt and other macro indicators (revenue, expenditure needs, etc). The process will require studying the existing debt commitments and then, from a debt management perspective, assessing the sustainable level of annual debt service payments. This should help ascertain what the terms of the instrument should look like.

Advisory fees can generally be incorporated into the greater fee structure of the transaction. Aside from a regular retention fee for the advisors' time, it is also common to link a portion of advisory payments to the success of the transaction itself. This helps to incentivise advisors to achieve the best possible outcome for the sovereign.

**International institutions** are ready to assist through capacity building and may even play a role in facilitating the transaction itself. Additionally, some institutions may offer available funding for engaging other stakeholders, or for the procedure involved in initially identifying sustainability targets (see Step 1). These initial costs should be fairly limited, but as the process develops, additional resources may be required. There are some emerging sources of support:

- **Platform on debt, climate and nature:** the World Bank (WB), the International Monetary Fund (IMF), the United Nations (UN), and the Organisation for Economic Co-operation and Development (OECD) are developing a platform to link debt instruments to climate change and nature outcomes. The platform is intended to have three streams: capacity development; technical assistance (particularly as certain transactions are pioneered in selected pilot countries); and identifying sources of financing for the debt agreement (Reuters, 7 April 2021).
- **UN regional commissions and UNDP:** many countries have already started to approach their UN regional commissions and UNDP country offices to assist with scoping the potential for climate- and nature-linked debt management transactions. In December 2020, the United Nations Economic and Social Commission for Western Asia (ESCWA) launched the Climate / SDGs Debt Swap - Donor Nexus Initiative to assist countries with freeing up fiscal space for meeting essential expenditures, including accelerating an inclusive and green recovery from the impact of COVID-19. This initiative offers an innovative opportunity for middle- and low-income Arab states – in partnership with developed countries and donor institutions – to secure additional climate and SDG finance to support inclusive recovery and resilient livelihoods for a just transition towards renewable energy and circular economy pathways, and to address water, food and climate security threats (ESCWA, 18 December 2020). UN regional commissions and other agencies are well placed to coordinate scoping and dialogues with national actors and to provide technical assistance on sustainable debt financing strategies in the context of achieving the SDGs (UNDP, 1 April 2021; ESCWA 2021).
- **GCF and GEF:** as the biggest climate and nature multilateral funds, the Green Climate Fund (GCF) and the Global Environment Facility (GEF) can provide technical support on climate and nature programming. The GCF has started to examine technical assistance for the development of climate- and nature-linked debt instruments and can also provide initial funding for the actual debt deal.

- **Regional development banks (RDBs):** RDBs, such as the African Development Bank, the Asian Development Bank, or the Inter-American Development Bank, can play a key role in facilitating the successful implementation of debt instruments for climate and nature by augmenting resources available to achieve climate and nature goals to complement proceeds that may be raised from debt-for-climate and nature transactions.

**Second-party opinion (SPO) providers** are environmental NGOs or private companies that can assist in the design, auditing and final verification of the climate and nature aspects of the transaction, in line with the sovereign's own climate and nature goals. From a transparency standpoint, SPO providers are inherent to this process, as their appraisal is fundamental to providing public validation for any such instrument. The involvement of SPO providers may be facilitated via institutions like the United Nations or the World Bank but could also be independently solicited. Either way, such entities will be heavily involved in the transaction from conception to conclusion.

After identifying and declaring the country's sustainability objectives in the lead-up to a potential transaction, it is essential to obtain second-party validation. For all types of climate and nature-linked transactions, the ecological aspects of the instrument are constructed based on the government's own sustainability goals, and so it is critical that those goals be well-defined and credible. A published, publicly available SPO that outlines the analyst's findings on the validity of the climate and nature elements of the instrument lends heavily to its initial credibility and allows the process to move forward. Likewise, similar SPOs can be published periodically to provide updates on those climate and nature initiatives, with a final assessment required at the end as to whether or not the issuer's sustainability targets have been meaningfully achieved (ICMA, 2020). This may or may not affect the terms of the debt instrument (depending on the type of transaction), but it should certainly influence the sovereign's credibility for future issuances.



Senegal, example of large livestock market in town supplied by the surrounding rural areas.  
Photo credit: Global Water Initiative, West Africa

## Step 3. Choose type of sovereign debt transaction: debt conversion and/or new instrument

Debt instruments linked to climate and nature are ideally part of a comprehensive, global response to tackle the triple crisis of debt, climate and nature (Userree, 2021). The type of climate- and nature-linked debt transaction chosen will depend on the specific needs of each country. This decision is based upon such factors as: risks of debt sustainability; liquidity and available fiscal space; and capacity to expand the country's debt portfolio. According to this position and other contextual factors, the instruments may vary across climate- and nature-linked debt forgiveness, debt restructuring, or the issuance of new debt instruments.

This guide focuses primarily on debt conversions and general-purpose bonds linked to sustainability targets. The latter structure uniquely allows the issuer to allocate the proceeds of the transaction for any budgetary purpose, so long as certain conditions related to climate and nature are met. These bonds

differ from traditional green bonds, which restrict the use of proceeds, partially or entirely, to specific climate and nature projects. The flexible use of funds inherent in the performance-linked structure makes this model particularly advantageous for sovereign issuers, who naturally must consider a broad range of expenditure needs beyond their climate and nature goals.

### Debt conversions: 'debt-for-climate and nature' swaps

Debt conversions or '**debt-for-climate and nature' swaps** are most relevant for countries seeking a treatment of their existing debt portfolios, which may or may not be in debt distress. Some countries may have high, but not necessarily unsustainable, debt burdens, as highlighted by the high-level meeting on 'Financing the 2030 Agenda for

Table 1.

TRANSACTION	SUITABLE FOR	USE OF PROCEEDS	DISCOUNT
<b>Debt-for-climate and nature swap or conversion</b>	Sovereigns seeking a treatment of their existing debt portfolios, with additional benefit of an impactful green or blue project in the country and positive public relations outcomes	Varies – usually restricted proceeds, but with growing possibility for more flexible arrangements with some general-purpose funding	Determined by project funding requirements and terms of the swap; discount is reflective of willingness of creditors to provide debt relief, or the discount captured in the market through a buyback with support of a third party
<b>Traditional sustainable bond</b>	Market-access countries seeking financing for a specific sustainable project	Restricted – transaction limits use of proceeds	Determined by market ‘greenium’ – subject to fluctuation and market saturation
<b>Sustainability-linked bond</b>	Sovereigns seeking to raise discounted liquidity for any purpose, while simultaneously pursuing their own national sustainability goals	Unrestricted – proceeds are for general-purpose use	Determined by embedded credit sweetener – guaranteed discount from vanilla

Note: ‘Greenium’ (i.e. ‘green premium’) is an informal term referring to the difference in yield between a vanilla bond and a nearly identical bond with climate- and nature-based elements. When determined by the market, it essentially represents the amount of return that investors are willing to give up in favour of a sustainable instrument.

Sustainable Development in the era of COVID-19 and beyond’ (United Nations, 2020). Transactions can be conducted as bilateral agreements between the government and its creditors, or they can be sponsored by a third party, such as an environmental NGO. The basic mechanism is to exchange debt service payments with an obligation to channel funds towards climate and nature outcomes. The first debt-for-nature swap was agreed between Conservation International and Bolivia in 1987. Another notable example, which swapped Paris Club official debt, was the Polish ‘Eco Fund’ established in 1992. A more recent example was the Seychelles agreement with certain Paris Club members in 2016, resulting in the creation of a US\$22 million investment in marine conservation. This was supported by The Nature Conservancy (TNC). Whilst crucial developments, these debt-for-nature swaps had been relatively modest in scope and impact, and some countries may have found it difficult to make any required upfront payments, given the equivalent cost in local currency. The government of Belize, however, was recently able to execute a much larger transaction that supported efforts to restore debt sustainability and finance marine conservation (see Box 1). This groundbreaking transaction, supported by TNC, demonstrated that a debt-for-nature swap, with proper scale, can substantially reduce a country’s debt burden if the government is willing to make the necessary environmental commitments.

## BOX 1. THE BELIZE BLUE BONDS FOR OCEAN CONSERVATION

On 24 September 2021, the government of Belize announced the successful results of a cash tender offer to repurchase and retire US\$550 million of the country’s outstanding external debt at 55 cents on the dollar.<sup>1</sup> This transaction, accepted by a supermajority of bondholders, is expected to proceed with funding via The Nature Conservancy’s Blue Bonds for Ocean Conservation programme, with such financing solely provided by Credit Suisse Group AG. The programme uses private capital to refinance public debt of participating countries in order to support durable marine conservation efforts and sustainable marine-based economic activity.<sup>2</sup> If successful, it will be noteworthy both for the size of the transaction, as well as its novelty. For the first time, a debt-for-nature conversion would be an integral part of a substantial sovereign debt restructuring agreement with private sector creditors. Potomac Group acted as financial advisors to The Nature Conservancy.

<sup>1</sup> PR Newswire, 24 September 2021.  
<sup>2</sup> PR Newswire, 13 September 2021.

In order to achieve the necessary scale for a debt-for-climate and nature swap, a transaction must be:

- **Systemic:** undertaken holistically with links to several climate and nature outcomes.
- **Integrated:** worked seamlessly into supportive debt frameworks. Situating the instrument within the international financial architecture can help build its validity and provide an enabling environment for negotiation, which can lower transaction costs.
- **Comprehensive:** engaging as many creditors as possible where the landscape of creditors is increasingly complex, as debt is increasingly held by private creditors and non-traditional bilateral lenders (see Step 6). In order to achieve adequate scale, these creditors need to be encouraged to participate.
- **Programmatically funded:** shifting proceeds to programmes through the use of budget support where funds are paid into a debtor government's own budget (See ESCWA, 18 December 2020).

As innovations progress, it may also be possible to free up more of the proceeds from a swap for general-budget uses, where so long as certain predefined climate and nature conditions are met over time, the transaction proceeds may instead

be spent on other priorities, such as health, infrastructure, or social welfare (see below on **sustainability-linked bonds**).

## New debt instruments: sustainability versus sustainability-linked bonds

Issuing a new sovereign bond can be a preferable alternative to a debt swap for many market-access countries, as it would not affect the existing debt portfolio. Unlike regular vanilla bonds though, debt instruments linked to climate or nature can allow for discounted cost of borrowing.

Green debt instruments come in a variety of forms. The **traditional sustainable bond**, prolific throughout corporate finance with several sovereign instruments on the market, imposes restrictions on how the bond proceeds should be used. These 'use-of-proceeds' (UoP) bonds include all 'green bonds' and 'blue bonds', which require that some or all of the proceeds be allocated to a specific project with some sort of positive environmental impact. The recent issuance by the government of Benin of an SDG-linked bond is also an example, see Box 2. Green bonds are any type of bond instrument where the

### BOX 2. BENIN'S SDG-LINKED BOND

On 15 July 2021, Benin issued its first Sustainable Development Goal bond (SDG bond).<sup>1</sup> The bond was issued for €500 million (about 91% of which was allocated to ESG investors) over a 12.5-year tenor, with a coupon rate of 4.95% with an estimated 'greenium' of 20 basis points.<sup>2</sup> This is also the first SDG bond issued by an African sovereign and the second issued by a sovereign globally (the first was issued by Mexico in September 2020). In line with ICMA's Sustainability Bond Guidelines, Benin's SDG is a use-of-proceeds bond with both green and social elements.<sup>3</sup> Moody's VE, the SPO provider for the bond, has determined its contribution to sustainability to be 'advanced'.<sup>4</sup>

Benin's SDG Bond Framework for the 2030 Agenda:<sup>5</sup>

- Outlines the structure of an inter-ministerial steering committee, headed by the Minister of Economy and Finance, that will be responsible for monitoring the country's progress towards the SDGs with annual reporting and ensuring the eligibility of projects funded by the SDG bond
- Identifies Benin's SDG targets across several primary categories, as well as an analysis of the potential costs of achieving those targets
- Provides detail on eligible expenditures that would qualify as meaningful uses of green, social and sustainability bond proceeds
- Is supported by the UN Sustainable Development Solutions Network, which will regularly provide second-party technical assistance to help Benin achieve the SDGs.<sup>6</sup>

<sup>1</sup> Republic of Benin, 2021.

<sup>2</sup> Natixis, 28 July 2021.

<sup>3</sup> ICMA, 2021.

<sup>4</sup> VE, 13 July 2021.

<sup>5</sup> Republic of Benin, 2021.

<sup>6</sup> Republic of Benin and the United Nations Sustainable Development Solutions Network (SDSN), 12 July 2021.

proceeds, or an equivalent amount, will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green projects. Similarly, 'blue' bonds require investment in promoting a healthy, productive and more sustainable ocean.

Another type of new money instrument linked to climate and nature outcomes is a **sustainability-linked bond (SLB)**. An innovation from corporate finance, SLBs are designed to make use of coupon and/or principal adjustments that are dependent on the delivery (or lack of delivery) of measurable climate and nature outcomes. The International Capital Market Association (ICMA) has published a set of SLB Principles that have served as reliable, voluntary guidelines for sustainability-linked bonds (See Appendix), with a corresponding set for traditional sustainable bonds. While ICMA principles are primarily intended for corporate issuers, the concepts therein remain integral to any similar climate- and nature-based transaction that a sovereign government may choose to pursue (ICMA, 2020).

Unlike UoP bonds, which come with stipulations on how the proceeds of the bond can be spent, sovereign SLBs are for general budget purposes and instead have financial terms and conditions linked

to one or more key performance indicators (KPIs). With the understanding that governments have a broad array of concerns, responsibilities and projects that require funding beyond their environmental sustainability goals, this structure would allow them the freedom to allocate the proceeds at their own discretion, just as they would be able to do with a vanilla bond.

KPIs are pre-formulated metrics for measuring the issuer's progress towards one or more of the country's sustainability objectives (see Step 1). Note that, in the case of SLBs, ICMA refers to these objectives as 'sustainability performance targets' (SPTs) (See Box 3). A single KPI may track several SPTs, and each is formally evaluated by an outside party at a predetermined reference date. The outcome of this evaluation, published externally as an SPO (see Step 2), would then trigger any previously agreed alterations to the financial structure of the bond (or not, depending on the SPO provider's findings).

The World Bank has additionally supported the development of a new concept for a sovereign SLB structure, which draws upon lessons from the corporate sector (see Box 4). Whereas a corporate

### BOX 3. HOW KPIS MEASURE SPTS: THEORETICAL EXAMPLES

SPTs and KPIs are similar concepts but differ in important ways. The SPT is the target, and the KPI is the metric by which success will be measured. For ease of comparison, several theoretical SPTs are illustrated below next to corresponding KPIs.

SUSTAINABLE PERFORMANCE TARGET (SPT)	KEY PERFORMANCE INDICATOR (KPI)
<b>SPT 1:</b> Reduce emissions by 70% by 2030.	<b>KPI 1:</b> Level of emissions in tCO <sub>2</sub> e*, with base year 2020. If carbon footprint in 2020 is 20,000 tCO <sub>2</sub> e, then the target to be met by the reference date in 2030 is 6,000 tCO <sub>2</sub> e.
<b>SPT 2:</b> Increase share of renewable energy to 85% by 2025.	<b>KPI 2:</b> Renewable sources as a share of total energy production. If renewable sources constitute 30% of nationwide energy production at issuance, an increase of 55 percentage points is needed by the reference date of 2025.
<b>SPT 3:</b> Expand forest coverage by 40% by 2030.	<b>KPI 3:</b> Hectares of forest coverage, with base year 2019. If healthy forests covered 1 million hectares of land in a country in 2019, 400,000 additional hectares will need to be cultivated by the reference date in 2030.

\*level of carbon dioxide equivalent per tonne.

Note: The above targets and metrics are completely arbitrary, standing only to illustrate the relationship between SPTs and KPIs, both key elements of an SLB.



## BOX 4. SLB EVOLUTION IN CORPORATE FINANCE

Following ICMA's publication of the SLB Principles after Enel's initial 2019 issuance of an SLB with a coupon step-up mechanism, multiple variations on that structure have since evolved while still adhering to ICMA guidelines. Despite the current variety in corporate SLBs, it is important to note that an instrument designed for sovereign issuance would likely look very different, utilising an entirely new structure tailored specifically to the needs of governments.

STRUCTURE	TRIGGER POINT	DESCRIPTION
Coupon step-up	Usually at least one year through tenor, about halfway	If KPIs have not been achieved by reference date, coupon payments will increase by a predetermined amount for the duration of the tenor post-trigger point.
Coupon step-down	Usually at least one year through tenor, about halfway	The issuer is rewarded for achieving the KPIs by the reference date. Post-trigger point, coupon payments are lowered by a predetermined amount for the duration of the tenor.
Premium payment	At maturity	If KPIs are not achieved by reference date, bondholders receive an additional payment at maturity, the amount of which is predetermined in the bond documentation.
Weighted coupon adjustment	Varies, with possibility for separate trigger points for different KPIs	KPIs are weighted in the bond documentation according to their impact or importance. The magnitude of any coupon adjustment that may occur post-trigger point will therefore reflect the pre-assigned weight of the KPI it reflects.

Note: The above descriptions are generalised. Although most, if not all, adhere to ICMA guidelines, each SLB on the market includes parameters that are unique to both the issuer and the instrument itself. As such, they should be carefully considered by potential investors.

SLB relies on coupon adjustments or even simple premium payments to penalise failed KPI outcomes, a sovereign SLB could instead offer a much more positive incentive for governments through a donor-based trust structure. If a sovereign SLB were issued with a yield significantly below the market rate, then the difference could be transferred into an offshore trust with each coupon payment. If the sovereign succeeds in meeting all KPIs by the predetermined reference date, it could then receive a payout from that trust, potentially supplemented with additional

donor funding from development agencies or philanthropies. In short, the government will have successfully issued a bond at well below its market rate and possibly even received some additional donor grant money. In the event that the KPIs are not met, the investors would then claim the sovereign's deposit into that fund (without any potential donor portion), effectively giving them a market return on what was essentially a vanilla bond. This lien should act as a credit sweetener for investors, thereby justifying the lower yield at issuance.

The purpose of this instrument is to provide issuers with substantially more budget flexibility than a traditional green or blue bond would otherwise allow – a critical advantage, especially for sovereign issuers. The funds raised through the issuance of an SLB are generally used as budgetary support instruments, rather than being tied to specific projects, such as green bonds or SLBs. In this way, an SLB can be used to refinance a government’s existing debt obligations through the issuance of new debt at a substantially lower rate (assuming KPIs are met). The use of an SLB would thereby allow a government to pursue its sustainability goals while continuing to meet its other expenditure needs.

### Choosing a strategy based on the country’s debt situation

Strategies will differ for countries that enjoy market access and countries that have never had or have lost market access.

Countries **with** continued market access, meaning that they can borrow effectively in international capital markets at an affordable rate, will need to determine the extent of their interest in leveraging international support for efforts to address climate change and biodiversity loss (see Figure 1).

For low-income countries with market access, care should be taken to ensure that the debt sustainability of the country is not undermined as a result of new non-concessional borrowing, even if this borrowing is undertaken to support climate and nature outcomes.

The sovereign SLB debt instrument would initially be most suitable for countries that have market access, are not in debt distress, and are looking to achieve one or more of the following goals:

- Broadening their existing investor base
- Lowering their cost of capital
- Investing in climate and nature outcomes to meet their NDCs under the Paris Agreement and their NBSAPs
- Leveraging international support for their efforts to address climate change and biodiversity loss.

In certain circumstances, debt conversions may also be an option.

Countries **without** market access, including many LDCs, will be divided into two main groups: those that have never had market access and those that have lost market access (see Figure 2).

Figure 1. Decision tree for countries with market access

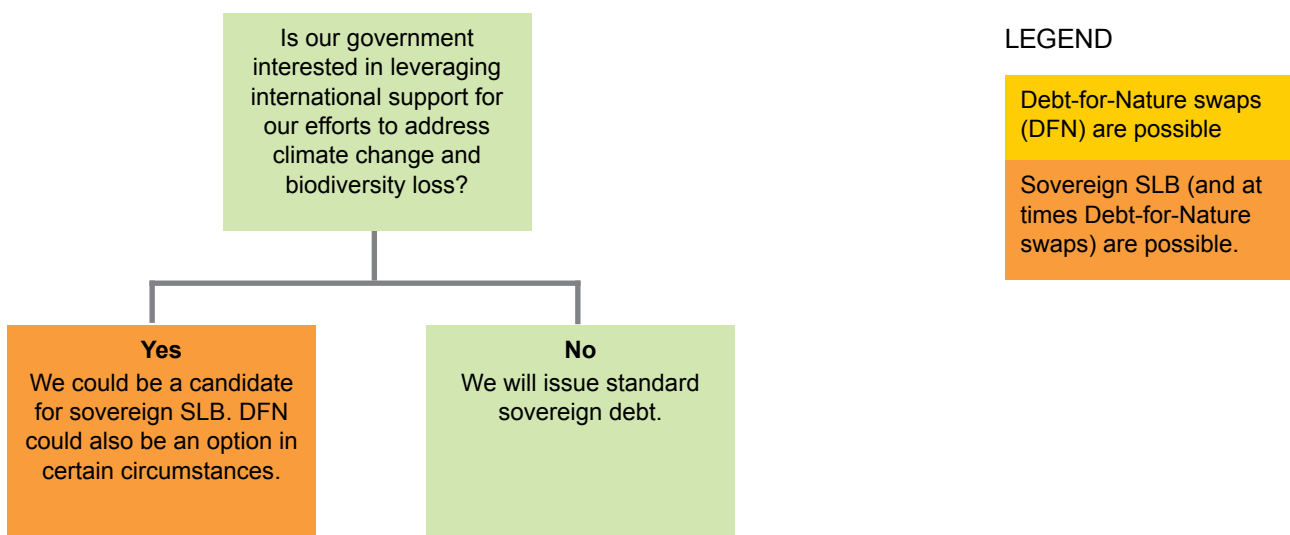
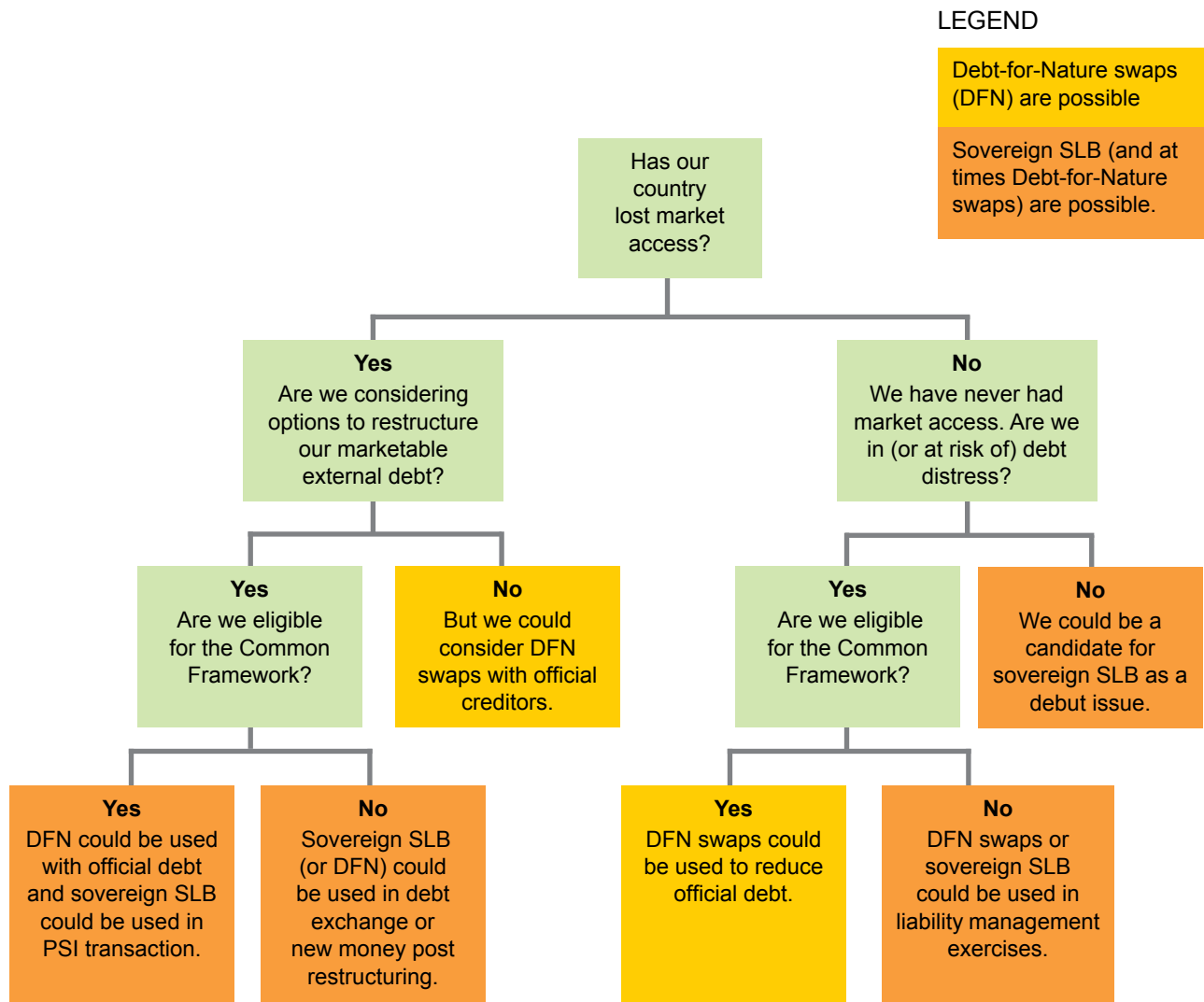


Figure 2. Decision tree for countries without market access



Sovereigns that are looking to restructure their debt with private sector creditors – either ad hoc or within the Common Framework – could use the sovereign SLB debt instrument either as part of a debt exchange or as a ‘new money’ element.

Lower-rated sovereigns or countries that are debut issuers could also be candidates for the sovereign SLB given the high level of financial and technical support from the donor community. This would, however, need to be considered carefully on a case-by-case basis.

While reviewing and deliberating on the type of instrument that would suit the country’s needs, sovereign debt managers would benefit from technical assistance and independent financial advice provided by multilateral partners, NGOs and other private sector professionals with specialist knowledge and expertise.

## Step 4. Structure climate and nature key performance indicators (KPIs) or other relevant performance criteria

In parallel to the debt portfolio and risk analysis stage, the government's inter-ministerial taskforce would also need to consolidate information on the status of the country's previously determined climate and nature commitments (the national sustainability objectives or SPTs, which were agreed upon in Step 1). With the help of its advisors and SPO providers, the taskforce can then select and prioritise which sustainability targets are most suitable for underpinning the financing instrument.

**In the case of a UoP transaction**, this would entail designing a project that would meaningfully advance the chosen SPT(s), and then earmarking a portion of the transaction proceeds for that purpose. It is essential that clarity is established on which climate and nature projects and related activities are expected to receive funding following debt swaps, debt reduction, or debt refinancing. Sustained involvement from an SPO provider, including periodic auditing throughout the life of the project, will lend heavily to the credibility of this element, allowing the government to issue similar instruments more easily in the future. For more detailed information on the nuances of a traditional sovereign UoP bond, the International Finance Corporation (IFC) has published a handbook outlining lessons learned from previous sovereign green bond issuances (IFC, 2018).

**In the case of an SLB**, the chosen SPTs are not necessarily funded by the transaction proceeds, but will instead advise the creation of specific metrics for measuring the country's progress towards those goals. Known according to the ICMA guidelines as KPIs (see Box 3), these metrics are designed to evaluate whether the issuer has made sufficient progress towards a given SPT by a predetermined 'reference date' in the life of the bond (ICMA, 2020). Thereafter, the SPO provider, often the same external institution that helped design the KPIs in the first place, will publish a decision about the issuer's success in meeting the required KPIs. Known as a 'trigger point', this decision will set in motion any pre-agreed changes to the bond structure in response to the issuer's success or failure in meeting the KPIs.

KPIs are useful for national accountability and transparency. They should be developed in consultation with country stakeholders, who can then use them to ensure that the activities are financed as planned. The KPIs also provide a means of communication with the country's creditors and investors, as they measure and monitor the climate and nature processes and outcomes that were agreed upon in the negotiation of the instrument. Adapted for sovereigns according to that rationale, KPIs should be quantifiably measurable, externally verifiable and of material significance to the country's broader climate and nature goals (ICMA, 2020).

The national climate and nature commitments may be expressed in various national plans and strategies including: the NDCs for climate; the NBSAPs for nature; and national development plans and strategies for agriculture, fisheries, energy, and other sectors.

High-level information on climate and nature commitments should be collected, including the expected results, baseline, target, means of verification and assumptions for each process, outcome, or policy commitment, as well as the inputs – activities and costs.

Country climate and nature policies and commitments, and the status of their progress, should then be developed in a KPI framework that will form the basis of the climate and nature commitments within the transaction.

In a KPI methodology document, Steele et al. (2021) lay out proposed steps for developing a KPI framework. The process of choosing and prioritising KPIs should be undertaken as a consultative process with inclusive involvement of national stakeholders, including government agencies, civil society and the private sector and, where appropriate, parliamentarians and local government. An initial framework should be developed and taken to national consultation workshops. These workshops should engage various government stakeholders (ministries of finance, environment, fisheries, agriculture and

others as relevant), and civil society, private sector and parliamentary stakeholders to verify priority areas for investment, and then the details of the activities, processes and costs of the priority areas. For further guidance on how to begin developing this initial KPI framework, debt managers may refer to the World Bank's upcoming paper on how existing indicators may be applied to the design of both KPIs and SPTs (Flugge et al., forthcoming). Regardless of which SPTs they seek to measure, the selected KPIs should show additionality (i.e. an improvement in climate and nature outcomes from a predetermined baseline) and relevance for national stakeholders.

In undertaking the process of developing debt instruments for climate and nature, there is tension between the urgency of dealing with the country's debt situation and the need to ensure both a consultative and inclusive process for identifying, prioritising and validating the climate and nature KPIs.

Another key part of the KPI framework is the elaboration of the monitoring, reporting and verification (MRV) processes. It will be important to use existing national monitoring, evaluation and learning (MEL) systems to avoid putting extra burden on the country for this process, but also to ensure independent verification, which is of particular importance to creditors and the international community. This independent MRV process could include: NGOs; international entities, such as the UN, GEF or GCF; or international financial institutions, such as the WB, IMF, or RDBs. There may also be a role for local participatory monitoring mechanisms.

Once agreed upon by in-country stakeholders, the KPI framework would then, as an integrated part of the financial instrument proposed, be put forward as the subject of discussion, review and agreement during negotiations with the creditors. When designing the KPI or other performance criteria, it may be instructive to consider the requirements of certain ESG indices. Most existing ESG indices include a limited number of emerging market countries, though they are largely restricted to investment grade sovereigns.



Cabo Verde, sea turtle near Felicite Island. Photo credit: Stéphane Enten via Flickr, CC BY-ND 2.0

## Step 5. Designing the financing aspects of the transaction

Evaluating the likely terms and conditions of a new debt instrument or transaction structure, along with its inherent risks, will be a key task for debt managers before attempting to go to market. Longer-term financing needs, risk mitigation and overall debt sustainability will be important factors to consider for each climate and nature transaction. For new bonds, the use of proceeds, amount needed, cashflow schedule and other bond features will need to be part of a broader fiscal and debt management strategy. Understanding how a country's overall balance sheet is exposed to exogenous shocks will be important to determine what types of incremental risks should be tolerated. Currency risk, duration exposure, rate exposure, and timing of cashflows are key risks. Amortisation schedules should be aligned with existing principal repayment schedules with the goal of smoothing out cashflow needs in future years.

### Link to budget financing and need for effective public financial management

Budget support is where debt finance is channelled directly through the debtor government's budget. This can allow for larger volumes of funds to be mobilised, as well as increasing debtor government ownership and shifting accountability to national citizens (Steele and Patel, 2020). In using budgetary support, effective public financial management and fiduciary standards to avoid leakage and corruption are key factors. Public expenditure and financial assessments, as well as accountability frameworks, such as PEFA assessments, can support countries in identifying where their systems need to be strengthened. Multilateral institutions may be of particular use in this exercise through the provision of technical assistance and capacity building.

The climate and nature funds can be tracked through a process known as climate and biodiversity expenditure tracking. This will ensure that the funds are integrated into the budget whilst also ensuring transparency for creditors and investors. Many countries have started to put in place climate budget tracking systems, and the WB and UNDP have both issued guidance to countries on past experiences and best practices. A smaller, but growing number of countries are beginning to undertake biodiversity expenditure tracking programmes with UNDP support through the BIOFIN programme.

When full transparency is needed for climate and nature funds in the case of countries with weak public financial management systems, there may be a case for supporting the development of a 'virtual climate and nature fund'. While many countries have developed separate climate funds or conservation funds outside this budget process, these funds are generally seen as counterproductive by ministries of finance, as they go against the principle of good financial management, which would suggest that all public funds should pass through the checks and balance of the overall budget process as part of a larger fiscal strategy. A virtual fund is a compromise on this point, as it allows greater transparency of debt financing for countries with weak financial systems, whilst ensuring that the funds still pass through the proper channels. There is experience with virtual funds in the case of poverty reduction under the heavily indebted poor country (HIPC) process, wherein Uganda set up a virtual poverty alleviation fund.

## Impact on debt sustainability

### Debt swap

Climate and nature transactions aim to achieve positive outcomes for climate and nature while also improving the country's debt sustainability. The exact mix of these outcomes will be highly dependent on the individual country's circumstances, the nature of the transaction chosen, how the proceeds are used over time, and how the market ultimately reacts to the transaction. With these generalised truths as a backdrop, it is possible to speculate, to a degree, on how such a transaction would affect the country's DSA.

- **Debt relief:** if the climate and nature transaction includes any amount of debt write-offs, then this would have a positive impact on the DSA, as the country's debt stock would be reduced, thus lowering its debt-to-GDP ratio. However, this effect will depend critically on the ratio of the relief provided compared to new spending commitments.

- **Currency operations:** a climate and nature transaction that converts a portion of the outstanding liability from foreign currency units to local currency units should have a positive impact on the country's debt vulnerabilities as it would reduce its foreign currency exposure. The exact degree to which this vulnerability would be lessened will depend on a variety of factors, including: the existing balance of foreign to local currency debt; the country's existing foreign currency assets; the correlation between local and foreign currency movements; and the amount of foreign currency obligations being converted into local currency.
- **Fiscal multipliers:** a climate and nature transaction that diverts debt service payments from external creditors to fund local investments will result in improved macroeconomic outcomes for the country. Not only would the transaction bring about improved climate and/or nature outcomes that create a more resilient climate and nature situation for the country in the future, it would also lead to higher expected growth rates (i.e. climate adaptation investments). This is driven by the fact that domestic investments result in payments being made to residents who are then likely to spend their additional earnings within the local economy, ultimately leading to higher expected GDP growth rates.
- **Country risk:** a climate and nature transaction could lead to an overall reduction in sovereign risk by increasing resilience and improving long-term growth prospects. Consequently, the cost of issuing new debt could decrease, lowering the cost of refinancing and improving debt sustainability.

As previously mentioned, the exact impact that a climate and nature transaction will have on a country's DSA will be highly dependent on a wide variety of factors. The three primary channels of debt relief, currency operations and fiscal multipliers should all lead to positive outcomes for a country's debt burden. Although debt swaps can be useful for countries in debt distress, it is important to note that they are only one tool in the toolkit and are likely to be part of a more comprehensive debt restructuring.

## Sovereign sustainability-linked bond

The use of a sovereign SLB can help to improve a country's debt sustainability through decreased debt service payments as a result of meeting the designated metrics. Unfortunately, however, the reverse scenario also needs to be considered prior to issuance; that is, the resulting impact on a country's DSA if the designated metrics are not achieved. Prior to selecting a sovereign SLB as the financing instrument of choice, a discussion between the DMO and other relevant ministries should take place in order to determine the likelihood that the designated metrics will be met and what impact missed targets would have on the DSA.

## Use-of-proceeds bond

Evaluating the impact on a country's DSA of a UoP bond is likely more challenging; while the increase in debt stock would mirror the impact that a traditional bond issuance would create (the numerator in the debt-to-GDP ratio), the effect on the denominator (GDP) would be more challenging to evaluate. Traditional bond issues are typically associated as general budget support instruments, where proceeds can be freely used by the government to fund continued operations, projects, or even cover existing debt service payments. UoP bonds, however, require that the funds generated by the issuance are used for specific purposes, i.e. ones that deliberately target climate and nature outcomes. To determine the ultimate effect that these proceeds would have on the country's GDP, a comprehensive study of the economic impact of the specific project would need to be conducted. The given impact would then need to be compared to the estimated economic impact that a traditional bond issue would have had; in the absence of this issue, however, analysts will be left to speculate on counter-factual scenarios that are impossible to observe. As a result of these challenges, UoP bonds are better suited to be analysed in the context of their environmental impact, rather than their impact on a country's DSA like a traditional bond.

## Terms and covenants

Additionally, the terms and covenants included in the new bond will need to be thoroughly understood and should be customised to provide an optimal amount of leverage for the sovereign debtor. Debt managers should consult legal advice and ICMA standards, and generally be aware of what the latest customary provisions are in recent market transactions. Additionally, debt managers should be fully aware of previous bond terms and covenants in any prior debt issuances.

Some basic terms and provisions to focus on:

- Trust indenture or fiscal agency agreement
- Governing law
- Modification clauses/collective action clauses (CACs)
- Definition of reserved matters/non-reserved matters
- *Pari passu* language
- Submission to arbitration
- Cross defaults
- Events of default.

## Index eligibility

The most broadly followed indices for emerging markets are the JP Morgan Emerging Market Bond Index (EMBI) and the EBMI Diversified, which includes a broader array of sovereigns. JP Morgan has launched the ESG EMBI, with returns running back to 2012. Similar to the parent EMBI index, this includes fixed and floating rate bonds but excludes convertibles and inflation-linked bonds.<sup>1</sup>

ESG indices are typically a re-weighting and/or narrowing of the parent index. Evaluators start with criteria from the original index (say MSCI Emerging Markets Index) and add additional ESG criteria (to arrive at the MSCI Emerging Markets ESG Focus Index). This means that understanding the criteria of the original indices remains the most important step when thinking about index inclusion.

<sup>1</sup> Another newer index is the Bloomberg Barclays MSCI Global Aggregate Sustainability Index, which broadly follows the same general criteria as the Bloomberg Barclays Global Aggregate Index, but includes issuers with ESG ratings greater or equal to BBB and a ESG controversy score greater than 0. This index also excludes non-investment grade issuers, floating-rate bonds, equity type features (warrants, convertibles, preferred, etc.).



## Step 6. Engage with market participants, including creditors, credit rating agencies and investors

Once the basic structure, terms and cashflow needs are fully understood and prioritised, the debt manager should begin sounding out the credit agencies' likely reaction to the structure and form of the climate and nature transactions. For both new debt instruments and other transactions, the impact on credit ratings can be a key determinant in how a debt manager proceeds. Private soundings with both creditors and ratings agencies are therefore a key step before preparing to move forward with a climate and nature transaction.

### Impact on credit rating

The impact of a climate and nature transaction on a country's credit rating has not been fully established, as the primary credit rating agencies are still adjusting their scoring metrics to account for these newly emerging instruments. There are, however, reasons to be optimistic about the positive impact that climate and nature transactions should have on ratings. As previously discussed in Step 5, if a climate and nature transaction leads to positive outcomes as measured by a country's DSA, then this should be a direct reflection of the country's improved capacity to repay its outstanding obligations. A country's ability to repay its obligations is another factor worth considering. In this regard, a climate and nature transaction operation should also result in a positive impact, as any external liability that is converted into a domestic investment should become a more appealing use of proceeds, thus increasing the country's willingness to repay.

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*Ratings for lower-income countries are primarily driven by two factors: income and governance (Gratcheva et al., 2020).*

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One argument for a rating downgrade would be a climate and nature transaction that results in write-offs on private creditors that would likely be viewed as defaults (OECD, 2007). This would only be the case in very unique circumstances, however, wherein haircuts are imposed on creditors and the country is not already in default. In such situations, the climate

and nature transactions would effectively serve as a pre-emptive default.

In both cases, it would be advisable to initiate discussions with rating agencies prior to any transaction that is undertaken in order to gauge the resulting action. Additionally, a financial advisor can aid in liaising with rating agencies to avoid an unforeseen downgrade (see Step 2).

### Engaging with creditors and emerging creditor dispositions

Engaging with various potential creditors to gauge their reception of a potential offering is a key step before executing the transaction. Creditor views of debt instruments linked to climate and nature outcomes are evolving, and different types of creditors are likely to approach a potential transaction with varying interests in mind. It will also depend on the circumstances of the issuing country. A debt swap carried out in the context of a debt restructuring, such as the recent Belize transaction, is very different to a country with market access seeking to issue a sovereign SLB.

It is also important to keep in mind recent developments in the international financial architecture. The COVID-19 pandemic accelerated reform of the mechanisms for coordinated global debt relief efforts for low-income countries and the G20 has emerged as a new platform for such efforts.

Below we highlight key features of the major sources of finance for sovereigns and their general stance towards finance linked to climate and nature outcomes.

### Multilateral creditors

As countries struggle to remain on course with their SDG agendas, the international financial institutions are increasingly prioritising research into the applications of climate- and nature-linked debt instruments as potential methods of facilitating an inclusive 'green recovery' from the pandemic. Multilaterals such as the World Bank are positioning themselves to help facilitate transactions linked to climate and nature outcomes (see Step 3 on the sovereign SLB). The IMF is also increasing its

research into the impact of climate change and biodiversity loss on countries' long-term growth prospects and debt sustainability. These institutions, as well as RDBs, also provide capacity building and are well positioned to facilitate and endorse debt transactions with climate and nature outcomes, whether they are executed as new instruments or within the context of a restructuring.

### Bilateral creditors

Bilateral creditors have traditionally been divided between those countries that are members of the Paris Club and other emerging creditor countries, such as China and Saudi Arabia. Even though Paris Club countries hold a comparably small portion of global outstanding sovereign debt following years of successful restructurings under the enhanced HIPC initiative, they are major stakeholders seeking sustainable ways to provide development assistance to developing and emerging markets. Given its long history of providing coordinated debt relief, the Paris Club played a key role in the development of the G20 Debt Service Suspension Initiative (DSSI) and the subsequent Common Framework (see Box 5).

Major bilateral creditors without permanent membership in the Paris Club, such as China, India and Saudi Arabia, now represent the majority of outstanding external sovereign debt for developing countries. As members of the G20, they are participating in the design and implementation of the DSSI and Common Framework:

- **China:** China has a crucial role to play in debt instruments for climate and nature as the largest holder of bilateral developing country debt. This debt portfolio arises partly as a result of China's investments in the Belt and Road Initiative (BRI) by both public and private Chinese institutions. China has been showing growing commitment to both climate and nature outcomes so may have some willingness to consider debt instruments linked to climate, nature and SDG outcomes. For climate, the Chinese government has made a national commitment to achieve net zero emissions by the year 2060 and is looking at innovative financing ways to achieve this. For biodiversity financing, at the 15th Conference of the Parties (COP) to the Convention on Biological Diversity (CBD), China announced a new biodiversity fund of 1.5 billion RMB to support developing countries. With biodiversity finance as a major goal of the Convention and China as the likely host to the follow-up negotiations in March 2022, it presents an important opportunity for rescheduling Chinese-held debt to align with the SDGs and achieve climate and nature outcomes. While these intergovernmental processes are important contexts for China to provide support to developing countries with debt instruments for climate and nature, China is likely to continue to pursue a policy of bilateral negotiations with debtor governments in addition to its multilateral cooperation.

## BOX 5. THE G20 COMMON FRAMEWORK FOR DEBT TREATMENTS BEYOND THE DSSI

The Common Framework brings together G20 and Paris Club creditors to coordinate and cooperate on debt treatments, on a case-by-case basis, initiated at the request for a debt treatment by an eligible low-income country (LIC).

Negotiations start with the establishment of a dedicated creditor committee and conclude with the signing of a memorandum of understanding by the debtor country and its creditors. Negotiations are also supported by the IMF and the WB, including through their DSA.

While the Common Framework represents a step change for official creditors, this new approach will also encourage the participation of private sector creditors through the comparability of treatment clauses included in the multilateral agreement, which will require debtor countries to secure a debt treatment from their private creditors on at least as favourable terms as from their official sector creditors.

To date, three countries have asked for Common Framework treatment: Chad, Ethiopia and Zambia.

Source: [www.g20.org/g20-common-framework-for-debt-burden-relief-dialogues-for-low-income-countries.html](http://www.g20.org/g20-common-framework-for-debt-burden-relief-dialogues-for-low-income-countries.html)

\*level of carbon dioxide equivalent per ton

Note: The above targets and metrics are completely arbitrary, standing only to illustrate the relationship between sustainable performance targets (SPTs) and key performance indicators (KPIs), both key elements of an SLB.

- **European Union:** the EU is a strong advocate for finance linked to climate and nature and is a leader in developing markets and instruments. **France** plays an important role as Secretariat of the Paris Club and is a strong advocate for coordinated and transparent global debt relief initiatives. **Germany** is likely to be sympathetic to debt instruments for climate and nature, given the recent elections and the strong performance of the Green Party.
- **United Kingdom:** the UK position on debt instruments for climate and nature is still evolving with the UK Treasury taking a relatively conservative position, whilst the ministry of environment is inevitably more sympathetic.
- **United States:** the US government has been involved in debt swaps for nature since the early 2000s following the enactment of the 1998 Tropical Forest Conservation Act (TFCA). One of the Act's key objectives was to provide developing countries with debt relief in exchange for increased local conservation of tropical forests. More recently, the country's 2020 climate plan states a commitment to "provide 'green debt relief' to developing countries that make climate commitments" (Biden, 2020; White House, 27 January 2021).

### Commercial private sector creditors

Preliminary market soundings from potential investors will be critical, particularly for the issuance of a new debt instrument, such as an SLB. Investor appetite for ESG instruments has been growing in recent years. In the case of sovereigns, 'ESG' has tended to be driven by the 'G' or governance, however, climate and nature aspects of a new sovereign debt instrument may entice impact investors who may be looking for higher-yielding instruments that deliver outcomes.

## Step 7. Execute debt transaction

### Market sounding

Armed with the views of the ratings agency and fully understanding their likely impact on the country's marketable and non-marketable debt, banking sector and corporate sector, the country can now sound out a market view from creditors and investors, while at the same time informing key market participants regarding the benefits of the transaction. While debt managers may have strong preferences for a structure and terms that work best for the government's financing plans and debt management strategy, there is significant value in an informal price discovery process that provides feedback to the debt manager on which terms and structure the market is most willing to fund at the lowest cost of capital.

### Swaps, structured solutions, and climate and nature as part of a debt restructuring

Where the envisioned climate and nature transaction is more complicated than a straightforward new money solution, the path to executing a transaction will likely be as well. Countries that have lost market access or are already in debt default will have very different steps in completing a transaction than those seeking new money to simply diversify their investor base and reduce the cost of capital with climate and nature debt instruments. For example, debt-for-nature swaps have historically been used as a tool for countries with unsustainable debt burdens to reduce the nominal amount of debt as well as reduce debt service and extend maturities. When used in this context, there may be a number of key third-party stakeholders that will play an important role in the lead-up to any transaction. The efficacy of the transaction improves with the input and support of third-party stakeholders, such as:

- **Bondholders/creditors**

Any transaction which attempts to alleviate burdensome debt service payments or reduce the quantum of debt will require an agreement from creditors.

- **Government financial and legal advisors**

Given the complexity of these types of transactions, financial and legal advisors will play a key role in formulating a negotiating strategy and advising on the paths to a successful outcome.

- **Donors/NGOs**

Concessional funding and a credible nature and climate strategy will be a pivotal to any complicated transaction with climate and nature outcomes.

Where market access has been lost, concessional support from donors can be offered to creditors in exchange for a below-market cost of capital instrument or a negative net present value (NPV) transaction for creditors.

- **Multilateral agencies**

Buy-in on the positive impact of any transaction from the IMF, World Bank and other key multilateral institutions will be essential to its success.

Additionally, where debt sustainability is in doubt (which is frequent where debt default or debt service reductions are needed), a macroeconomic programme from the IMF is crucial to anchor investor expectations and support financial sustainability.

- **Investment banks**

Similar to a new money issuance, an investment bank can help facilitate any transaction, but will need to be selected using a competitive process to ensure value for money (see below).

### New-money climate and nature debt instruments

Investment banks are typically the best-positioned third party to assist in sounding out financial markets before launching a transaction. Given the large number of investment banks frequently offering commoditised services, it is typically helpful to create competitive pressure through a selection process that allows for banks to bid for the opportunity to assist on any climate and nature transaction. Certain banks will have specialities in areas that may be helpful or may have deeper relationships with end-investors that will differentiate their offerings and can justify higher fees. All of this can be vetted with the assistance of a financial advisor to help understand the key gating items and provide insight into market standards for the choosing of a lead manager.

Once a lead manager, and typically additional bookrunners, are chosen it is usually advisable to arrange for meetings with investors in a roadshow format. Investors will require a detailed update on the overall 'story' of the country. Detailed macroeconomic, fiscal and other topics will need to be thoroughly addressed. For complicated transactions, debt managers and bankers may need to spend significant amounts of time with investors to ensure they understand the costs and benefits of the structure or transaction and will be able to price it accordingly. These meetings will be an invaluable opportunity for debt managers to receive feedback on their ideas and understand how investors view the various features. They will allow the debt manager to reconcile the desired structure and transaction-type with the reactions from market participants on what they are willing to commit capital to and at what price.

## Launching the transaction

Once the structure and form of any transaction has been thoroughly sounded out through market participants, the debt manager should have enough information to launch a transaction. It can be initially launched with a range of pricing, which can fluctuate as orders to participate are received (or fail to materialise). As the 'book-building' process reaches critical mass, the debt manager can typically improve pricing and utilise the competitive process to drive down the cost of capital or increase flexibility around key terms and features. Finally, as a full book is reached, debt managers will need to begin prioritising the allocation of participation to key investors whose continued presence is most beneficial to the government's longer-term financing strategy. Once this is finalised and the deal is completed, partner-investment banks should be used to understand pricing and trading activity after the close of the deal. If pricing worsens significantly in the secondary market, or if there is significant risk transfer from those investors allocating deals to new investors, it will be important to understand the drivers to take into consideration in any subsequent transaction.

## Communication strategy

A strategic media and public relations campaign should be run in parallel to any transaction. The targets can be numerous, but typically fall into three buckets: domestic actors; bondholders/investors; and multilateral institutions.

## Domestic

Within this bucket, there are numerous scenarios where a targeted media campaign would be needed. Important transactions involving government debt are lightning rods for criticism on political grounds and are likely to be attacked from several angles. Staying one step ahead and thwarting these political efforts will increase the probability of a successful transaction. For example, domestic political forces may be organised in opposition to the climate and nature transaction on the grounds, real or imagined, that there is a violation of sovereignty or an imposition of restrictions that will stifle economic activity. Additionally, there may be a need to gain key legislative support in order to pass laws that will allow the climate and nature transaction to be successful. Various issues are likely to be raised that will require a proactive and creative media strategy.

## Bondholders/investors

In situations where bondholders are being asked to provide debt relief or below-market funding, it will be important to use a careful communication strategy to encourage these institutions to share the burden. Climate and nature transactions have positive impacts that go far beyond enhancing debt sustainability or providing liquidity to governments. These benefits need to be clearly articulated and explained to bondholders and their end-investors, which are typically government pension funds, sovereign wealth funds and other organisations sensitive to political arguments.

## Multilateral institutions

Where donor funds are potentially available and/or assessments of debt sustainability or vulnerability are key parameters for unlocking concessional financing, there should be a public relations push to make sure that the benefit of the proposed transaction is communicated and understood. Eliciting the support of multilateral institutions for a given transaction can be done through a thoughtful media strategy.



Belize, Orange Walk. Photo credit: Cinzia Cimmino

## Conclusion: next steps for delivering on climate and nature outcomes

Linking sovereign debt to climate and nature outcomes provides a host of new strategic options for governments seeking to re-evaluate or optimise their sovereign balance sheets. Whatever the purpose, be it restructuring unsustainable debt, refinancing to expand fiscal space, investing in climate and nature for sustainable development, or simply expanding the investor base, green financial instruments are becoming increasingly prolific and could represent a permanent alteration to the global financial architecture.

Following the completion of any climate and nature debt transaction, the government's continued commitment to these themes will remain vital to ensuring that the transaction has a meaningful and lasting impact on both the sovereign balance sheet and the country's sustainability goals. This may require additional financing for climate and nature in the future, as well as policy, budget, or institutional reforms.

Following through on KPIs or other associated obligations is critical, as failure to do so could result in the nullification of the favourable terms established at issuance. Aside from the financial downsides of neglecting a KPI, doing so could stymie the government's efforts to meet its climate and nature targets, including its NDCs under the Paris Agreement and its NBSAPs. Regular external auditing is also a key component of remaining steadfast on any climate- or nature-based commitments. Transparency is of paramount importance to ESG investors, and allowing the periodic publication of SPOs will not only enhance the credibility of the instrument in question, but also of the sovereign issuer as a whole, effectively bolstering both the 'environmental' and 'governance' components of the sovereign's ESG rating.

Overall, the benefits of linking debt to climate and nature outcomes go far beyond short-term balance sheet management. These methods help to streamline non-concessional development finance such that debt remains affordable and has a meaningful, measurable impact within the borrowing country. The SLB, in particular, catalyses targeted and impactful climate and nature action, while allowing the government to continue funding social programmes without restricting expenditure. This general-purpose spending approach provides countries with the most flexible way to tackle both debt and environmental issues simultaneously.

Debt transactions linked to climate and nature may be complex, and the process of structuring and issuing them may be daunting, but the potential positive impact on the country's debt and environmental sustainability can be substantial. If done correctly, these transactions can also contribute to a positive narrative about the country's governance, which in turn can improve credit rating and cost of borrowing, ushering in new sources of capital for development. Finally, the process of pursuing a climate and nature transaction should help to move inclusive green development into the heart of a country's sovereign debt management and broader economic decision making. This represents a fundamental change in institutional priorities, which may be the most long-lasting payoff of this approach.

## Appendix: ICMA principles for corporate sustainability-linked bonds

<b>SELECTION OF KPI</b>	Verifiable by an external party, failure to meet these metrics alters the financial structure of the bond in such a way that the terms become somehow less favourable to the debtor.
<b>CALIBRATION OF SPT</b>	The ICMA stresses that sustainability performance targets should be ambitious in scope, beyond 'business as usual'.
<b>BOND CHARACTERISTICS</b>	The methodology behind the KPIs and what constitutes success should be detailed in the bond documentation. In the event of failure, the adjustments to the bond structure should be meaningful.
<b>REPORTING</b>	All of the above information should be periodically evaluated and communicated regularly (at least annually) to the market.
<b>VERIFICATION</b>	This entire process should be audited by an external expert, with reviews occurring at least once every year until the final trigger event, and also during any significant phase, such as validating SPTs and devising KPIs to support them.



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Knowledge  
Products

# Toolkit

November 2021

## Economics; Climate change

*Keywords:*

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As countries grapple with the triple crisis of debt, climate change and nature loss, compounded by the impacts of the COVID-19 pandemic, multiple innovative solutions in sustainable finance are beginning to gain traction. These innovations towards an inclusive green recovery offer substantial benefits for developing countries looking to increase their fiscal space, adapt to climate change, reduce their emissions and protect their natural environment.

This guide presents these innovations in an actionable plan that links sovereign debt to climate and nature outcomes. Seven practical steps outline ways for governments to complete a debt transaction linked to their sustainability goals for climate and nature.

Aimed primarily at debt managers and environmental decision makers, the guide also serves as an operational pathway for creditors, international institutions and nongovernmental organisations to work together, using these emerging financing innovations to improve debt sustainability and increase climate and nature investment in the most climate-vulnerable and biodiversity-rich countries.

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