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INCLUSIVE RECOVERY PROJECT

The Architecture for a Debt-for-Climate Initiative

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The Architecture for a Debt-for-Climate Initiative

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Abbreviations

CCPA	Climate Change Policy Assessment
CCRT	Catastrophe Containment and Relief Trust
CIF	Climate Investment Funds
CPIER	Climate Public Expenditure and Institutional Review
DCI	Debt-for-Climate Initiative
DRF	Debt Reduction Facility
ESG	environmental, social, and governance
G20	Group of 20
GCF	Green Climate Fund
GDP	gross domestic product
HIPC	heavily indebted poor country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFI	international financial institute
IMF	International Monetary Fund
LTS	long-term low-carbon development strategy
NAP	National Adaptation Plan
NDC	Nationally Determined Contribution
NGO	non-governmental organisation
WB	World Bank

Abstract

The Debt-for-Climate Initiative (DCI) is an effort to provide comprehensive debt relief for eligible countries to generate fiscal space for climate action. The DCI aims at achieving maximum creditor and debtor participation. The DCI consists of three pillars. The first pillar involves debt-stock relief for countries with an unsustainable level of debt and high climate vulnerability and risk of biodiversity loss. The second pillar provides debt flow relief by rescheduling debt maturities with or without coupon reductions for countries facing liquidity problems. The third pillar engages those countries not eligible under the first two pillars that have high climate vulnerability and risk of biodiversity loss through debt standstill agreements. All pillars include debt-for-climate swaps as well. To operationalise the DCI, we propose a multi-level structure to involve relevant debtors and creditors. First, a Climate Investment Trust Fund will support debt swap operations, manage proceeds from debt swaps, and provide financing for climate change projects. Second, swaps can also be managed directly at the regional and national levels through national climate funds or direct budgetary support. For debt relief, we propose two Climate Trust Funds be set up – one at the World Bank and one housed at the IMF – to cover the cost of forgiving debt owed by eligible countries to these organisations. Finally, we also call for a renewal and enhancement of the IDA Debt Reduction Facility to purchase debt owed by eligible countries to private creditors.

Disclaimer: This background paper is a proposal for a possible architecture for a global Debt-for-Climate Initiative and has been commissioned as a contribution to the Debt Relief for Green and Inclusive Recovery Project. The views expressed are those of the authors alone and do not reflect the views of the Debt Relief for Green and Inclusive Recovery Project: Heinrich-Böll-Stiftung, the Center for Sustainable Finance (SOAS, University of London), or the Global Development Policy Center (Boston University).
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Executive Summary

The Debt-for-Climate Initiative (DCI) is an ambitious effort to provide comprehensive debt relief to eligible countries and generate fiscal space to pursue climate objectives. The DCI consists of three pillars and aims at achieving maximum creditor and debtor participation:

Eligible countries	Treatment	Creditors	Instruments
<p>First pillar</p> <p>For countries with an unsustainable level of debt and high climate vulnerability and risk of biodiversity loss</p>	<ul style="list-style-type: none"> – Debt-stock relief – Debt-for-climate swaps 	<ul style="list-style-type: none"> – Paris and non-Paris Club countries – IMF and WB¹ – private creditors 	<ul style="list-style-type: none"> – Under a G20 umbrella agreement, Paris and non-Paris Club countries deliver debt-stock treatment and debt swaps – The IMF and WB forgive their multilateral debt through Climate Trust Funds following the HIPC model – The IBRD/IDA Debt Reduction Facility involves private creditors through buybacks and debt swaps – The Climate Investment Trust Fund supports debt swap operations, manages proceeds, and promotes investment in climate change projects
<p>Second pillar</p> <p>For countries with a liquidity problem and at high risk of climate vulnerability and biodiversity loss</p>	<ul style="list-style-type: none"> – Debt-flow relief (rescheduling of debt maturities with or without a coupon reduction) – Debt-for-climate swaps 	<ul style="list-style-type: none"> – Paris and non-Paris Club countries – private creditors 	<ul style="list-style-type: none"> – Under a G20 umbrella agreement, Paris and non-Paris Club countries deliver debt-flow treatment and debt swaps – The IBRD/IDA Debt Reduction Facility involves private creditors through buybacks and debt swaps – The Climate Investment Trust Fund supports debt swap operations, manages proceeds, and promotes investment in climate change projects
<p>Third pillar</p> <p>For countries ineligible under the first two but at high risk of climate vulnerability and biodiversity loss</p>	<ul style="list-style-type: none"> – Debt standstill – Debt-for-climate swaps 	<ul style="list-style-type: none"> – Paris and non-Paris Club countries – private creditors 	<ul style="list-style-type: none"> – Under a G20 umbrella agreement, Paris and non-Paris Club countries grant a debt standstill and debt swaps – The Climate Investment Trust Fund supports debt swap operations, manages proceeds, and promotes investment in climate change projects

1 Acronyms: IMF (International Monetary Fund); WB (World Bank); IBRD (International Bank for Reconstruction and Development); IDA (International Development Association); HIPC (heavily indebted poor country); G20 (Group of 20).

1 Introduction

This paper offers a menu of options to create an architecture for a Debt-for-Climate Initiative (DCI). The DCI recognises that a core challenge which developing countries have in implementing and enhancing their commitments on climate change is limited fiscal space.

The Covid-19 pandemic has put tremendous fiscal strain on developing-country budgets as governments put together responses and recovery packages. However, without an explicit effort to alleviate the debt burdens of many of these countries, it is likely that the scale of the response will not be commensurate with the challenges.

Furthermore, the need to recover from the pandemic also offers a rare opportunity for governments to direct their investments into specific areas to pursue of climate objectives together with an inclusive recovery. Therefore, the DCI aims to bring together all types of creditors to achieve debt sustainability, create fiscal space, and be more climate-effective.

The three core principles of this initiative are:

1. Real debt relief (some debtors just will not be able to pay)
2. Real climate action with enduring impact
3. No one left behind

The DCI is aimed at debtor countries with unsustainable levels of debt, with liquidity problems and at high risk of climate vulnerability and biodiversity loss.



Kids playing between papaya trees, Peru.

2 Context

On 15 April 2020, the G20 and the Paris Club launched the Debt Service Suspension Initiative (DSSI) (G20, 2020c), agreeing on official bilateral debt service suspension for low-income countries. On 14 October 2020, the G20 decided to extend the DSSI (G20, 2020a) by six months to June 30, 2021.

Under the G20 DSSI initiative, the debt payments of eligible countries will be deferred by five years with a one-year grace period, but their net present value will be preserved (NPV neutral): Creditors will not only face no losses, but they will be paid accrued interest. Although it will provide breathing space, the DSSI will regrettably only postpone the debt problems of eligible countries.

Only IDA countries plus those classified as least-developed countries by the United Nations (UN) (i.e. IDA countries plus Angola) are eligible to receive debt service suspension. Notably, eligibility is not assessed on the basis of debt sustainability and, as a result, many middle-income and small island developing states at risk of debt distress are excluded from the initiative. The DSSI potentially covers 73 countries, of which 44 have already applied for temporary debt suspension^[2] and 35 have already signed a Memorandum of Understanding with the Paris Club.^[3]

For many countries the larger portion of official bilateral debts covered by the DSSI are owed to non-Paris Club countries, in particular China (Bery et al., 2020). Notably, for the first time, China committed to join the Paris Club, offering equivalent terms, but no data are currently available on the implementation of the initiative; moreover, the China Development Bank and Chinese state-owned enterprises are reported not to be participating in the DSSI (Financial Times, 2020).

International financial institutions (IFIs) and private creditors are being called upon by the G20 to provide debt suspension on comparable terms to the DSSI, but on a voluntary basis.

The IMF is providing parallel debt relief through the Catastrophe Containment and Relief Trust (CCRT). In April 2020, the IMF approved debt service relief for 28 countries (IMF,

2 Check here for updates: <https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative>.

3 Check here for updates: <https://clubdeparis.org/en/traitements>.

2020c) (out of the 29 that were eligible)^[4]; the approval enabled the disbursement of grants from the CCRT for the repayment of debt falling due to the IMF over a period of six months. In parallel, the IMF called for contributions to the CCRT with a view to extending debt relief for a two-year period. Replenishment is crucial, since the remaining CCRT resources are US\$200 million, and the financing need is US\$1.4 billion. In July 2020, the G20 asked the IMF to explore additional tools to address its members' financing needs (G20, 2020b).

The WB and multilateral development banks have not yet adopted a debt relief mechanism that parallels the DSSI due to concerns about the negative impact on their credit ratings and their ability to raise funds.

On 28 May 2020, the Institute of International Finance (IIF) adopted its «Terms of reference for voluntary private sector participation in the G20/Paris Club debt service suspension initiative («DSSI»)» (IIF, 2020a). Participation is voluntary, and the Paris Club comparability of treatment does not apply. Participating private creditors may decide to suspend or defer payments or to make new advance in respect of each deferred amount. However, unpaid interest will be capitalised and accrue interest at an appropriate rate agreed by the parties. In addition, debtor countries are discouraged from seeking forbearance from private creditors by the fact that such requests can trigger a downgrading of their sovereign ratings (as already signalled by some credit rating agencies). To date, private creditors have not received any formal requests of forbearance under the DSSI (IIF, 2020b).

As a result, debt relief provided under the DSSI will most probably be diverted to fulfil payments coming due to private creditors (and multilaterals). To achieve a fair burden-sharing, the participation of private creditors remains essential.

Some experts advocate for a debt standstill (see, among others, Bolton et al., 2020; Gelpern et al., 2020; Hagan, 2020) and for an enhancement of the DSSI initiative beyond low-income countries (e.g. already in May 2020, the UN Independent Expert Yuefen Li (OHCHR, 2020) called for an extension of the DSSI and for the inclusion of debt-distressed middle-income countries). However, the IIF has already expressed its appreciation for «comments from the IMF and Paris Club officials noting that there is no intention to make the DSSI broader in scope» (see IIF, 2020c).

4 CCRT resources are employed by the IMF to provide its contribution in international debt relief assistance when an eligible low-income country is hit (1) by a fast-spreading epidemic (under the Catastrophe Containment window) or (2) by a natural disaster (under the Post-Catastrophe Relief window). In March 2020, the IMF amended the CCRT eligibility criteria: countries eligible for concessional borrowing through the Poverty Reduction and Growth Trust and whose per capita income is below the IDA operational cut-off (currently US\$1,175), or for small states with populations totalling less than 1.5 million, per capita income below twice the IDA cut-off (US\$2,350) qualify for debt service relief for up to two years.

3 The Debt-for-Climate Initiative

The DCI is intended to be an ambitious, concerted, and comprehensive debt relief initiative to be adopted on a global scale under a G20 umbrella agreement. It consists of three eligibility pillars – for countries facing insolvency, liquidity, and other fiscal space constraints which are at high risk of climate vulnerability and biodiversity loss – and aims at achieving maximum creditor and debtor participation.

3.1 Eligibility

Thanks to its three-pillar approach, the DCI can reach low- and middle-income countries, countries with or without market access, countries with balance of payments problems, countries that are the most vulnerable from an adaptation and mitigation standpoint and at high risk of biodiversity loss, as well as high emitters and oil/carbon exporters.

Debt sustainability analysis carried out by the IMF will certainly play a key role in determining what kind of debt treatment the country will receive (with the caveats raised by Hagan (2020) on the predictability of debt sustainability analysis in the current scenario). However, in the current scenario, the assessment of a country's financing needs will be incomplete without integrating climate change risk (Steele and Patel, 2020).

Financing needs for climate investment projects – as identified in Nationally Determined Contributions (NDCs), National Adaptation Plans (NAPs), and long-term low-carbon development strategies (LTSSs) – need to be carefully taken into account. Moreover, the Climate Change Policy Assessments (CCPAs)^[5] undertaken by the IMF and the WB since 2017 for six small island developing states on a pilot basis should be extended to the entire membership and become part of IMF Article IV consultations.

In general, there seems to be a very clear need for an analysis that connects NDCs with debt sustainability. Eligible countries will have to commit ex ante to the highest transparency, accountability, and anti-corruption international standards.

3.2 The three pillars

- 1) Under the first pillar, *comprehensive debt relief will be granted to eligible countries with unsustainable debt levels* (on the HIPC model).

5 There are only six countries that have completed the IMF/WB CCPAs: Tonga, Grenada, Micronesia, St. Lucia, Belize, and Seychelles.

Treatment: Debt-stock relief (i.e. debt cancellation up to a certain percentage) combined with debt-for-climate swaps.

Creditors involved: Paris Club and non-Paris Club countries, the IMF and the WB, private creditors.

Instruments: Under a G20 umbrella agreement, Paris Club and non-Paris Club countries deliver debt-stock treatment and allow for debt-for-climate swaps on bilateral debt; the IMF and the WB forgive their debt through separate Climate Trust Funds, in which donors contribute resources to repay multilateral debt falling due on the HIPC model; the renewed IBRD/IDA Debt Reduction Facility (DRF) facilitates buybacks and debt swaps with private creditors; the Climate Investment Trust Fund supports debt swap operations, manages their proceeds, and promotes investment in climate change projects.

- 2) Under the second pillar, *debt re-profiling will be offered to eligible countries with liquidity problems.*

Treatment: Debt-flow relief (i.e. rescheduling of debt maturities with or without a coupon reduction) combined with debt-for-climate swaps.

Creditors involved: Paris Club and non-Paris Club countries and private creditors (IFIs with preferred creditor status will not forgive their debt to eligible countries).

Instruments: Under a G20 umbrella agreement, Paris Club and non-Paris Club countries deliver debt-flow treatment and allow for debt-for-climate swaps on bilateral debt; the renewed IBRD/IDA Debt Reduction Facility facilitates buybacks and debt swaps with private creditors; the Climate Investment Trust Fund supports debt swap operations, manages their proceeds, and promotes investment in climate change projects.

- 3) Under the third pillar, *countries not eligible to receive debt treatment under the first two pillars but with high climate vulnerability and at high risk of biodiversity loss will be able to request a standstill on bilateral official debt, during which they can negotiate debt-for-climate swaps on a voluntary basis.*

Treatment: Since debt swaps usually require two to four years of preparatory activities (OECD, 2007: 8), interested countries will benefit from a standstill during negotiations with involved bilateral creditors. However, attention should be paid to the fact that a moratorium on the repayment of bilateral debt can constitute an event of default for commercial bank loans (see IIF, 2020d).

Creditors involved: Paris Club and non-Paris Club countries will be involved in both debt standstills and debt swaps, while private creditors will most likely take part only in debt swaps.

Instruments: Under a G20 umbrella agreement, Paris Club and non-Paris Club countries grant debt service suspension; the renewed IBRD/IDA Debt Reduction Facility facilitates buybacks and debt swaps with private creditors; the Climate Investment Trust Fund supports debt swap operations, manages their proceeds, and promotes investment in climate change projects.

In general, debt swaps should be considered additional to other forms of financing, and they should not be double counted as official development assistance (ODA) (only the redirection of interest can be recorded as new ODA). In practice, our proposal relies on existing fora, international organisations, and instruments – such as the G20, the Paris Club, and the IBRD/IDA Debt Reduction Facility – to which a new Climate Investment Trust Fund is to be added.

3.3 Participation of creditors

3.3.1 Official bilateral creditors

a) Paris Club creditors

The Paris Club's Agreed Minutes^[6] frequently contain a clause allowing for voluntary debt swaps to be undertaken on a bilateral basis (i.e. debt-for-nature, debt-for-development, debt-for-equity, or other local currency debt swaps, also in the form of three-party swaps) (Paris Club, n.d.).

The «debt swap clause» was first introduced in 1990 for highly indebted lower-middle-income countries (under the Houston terms), but in 1991 it was also applied to highly indebted low-income countries (under the London terms, which were replaced in 1994 by the Naples terms), and then in 1996 to HIPCs (under the Lyon terms, which were replaced in 1999 by the Cologne terms).^[7]

Although there are no limits on the amounts of ODA claims that can be converted, debt swaps on the non-ODA claims of individual creditors are capped at a certain percentage or at a specific maximum nominal amount (whichever is higher). Initially, the thresholds were set at 10% of outstanding non-ODA credits, or up to 10–20 million special drawing rights (SDRs), but in 1996 they were increased to 20% of outstanding non-ODA credits, or up to 15–30 million SDRs (whichever is higher).

6 The Paris Club will only enter negotiations if the debtor has secured an IMF programme and strictly remains on track in its implementation.

7 Twenty HIPCs have concluded debt-swap operations with Paris Club creditors (OHCHR, 2013, p. 282).

The clause aims at preserving comparability of treatment and solidarity among creditors. However, since the Paris Club clause does not establish a specific discount rate, creditors have adopted different approaches in this specific regard. Paris Club creditors and debtors have to regularly report to the Paris Club Secretariat on the debt swaps they have conducted. Data on debt swaps are not made public though.

Between 2002 and 2007, France, Germany, Italy, Spain, and Switzerland were the most active creditors, with Italy and Spain applying a 0% or a very low discount rate (OHCHR, 2013: 281); 376 swaps were concluded, of which 60% in the form of debt-for-aid and 31% in the form of debt-for-equity, with US\$8.3 billion in debt cancelled.

Table 1: Paris Club debt treatments in the period 2010–2020

2020 Somalia (Cologne terms; no debt swap clause)
2015 Grenada (Classic terms; debt swap limits: 20% or 5 million SDRs)
2015 Chad (HIPC Exit terms; debt swap limits: 20% or 30 million SDRs)
2014 Argentina (ad hoc terms; no debt swap clause)
2013 Comoros (HIPC Exit terms; debt swap limits: 20% or 30 million SDRs)
2013 Myanmar (ad hoc terms; debt swap limits: 20% or 20 million SDRs)
2012 Guinea (HIPC Exit terms; debt swap limits: 20% or 20 million SDRs)
2012 Cote d’Ivoire (HIPC Exit terms; debt swap limits: 20% or 30 million SDRs)
2012 Saint Kitts and Nevis (Classic terms; debt swap limits: 20% or 5 million SDRs)
2012 Guinea (Cologne terms; debt swap limits: 20% or 20 million SDRs)
2011 Cote d’Ivoire (Cologne terms; debt swap limits: 20% or 30 million SDRs)
2011 Guinea Bissau (HIPC Exit terms; debt swap limits: 20% or 20 million SDRs)
2010 Togo (HIPC Exit terms; debt swap limits: 10% or US\$20 million)
2010 Democratic Rep. of Congo (HIPC Exit terms; debt swap limits: 20% or US\$20 million)
2010 Liberia (HIPC Exit terms; no debt swap clause)
2010 Antigua and Barbuda (Classic terms; debt swap limits: 20% or 5 million SDRs)
2010 Comoros (Cologne terms; debt swap limits: 20% or 30 million SDRs)
2010 Guinea-Bissau (Cologne terms; debt swap limits: 20% or 20 million SDR)
2010 Congo (HIPC Exit terms; debt swap limits: 20% or US\$20 million)
2010 Afghanistan (HIPC Exit terms; no debt swap clause)
2010 Democratic Rep. of Congo (Cologne terms; debt swap limits: 20% or US\$20 million)

* Classic and Houston treatments only offer debt rescheduling, whereas Cologne and HIPC Exit treatments also provide for a reduction in the stock of eligible debt.

Although most of the debt swap clauses cap the amounts of outstanding non-ODA credits that can be swapped at 20%, or at 20 million SDRs, variations are possible.^[8] Lastly, it has to be noted that some of the countries that submitted a formal request of forbearance under the DSSI – at the time of writing, Chad, Comoros, Congo, Cote d’Ivoire, Democratic Rep. of Congo, Grenada, Guinea, the Kyrgyz Republic, Myanmar, and Togo – are still under an active Paris Club agreement with a debt swap clause in place.

b) Non-Paris Club creditors

Countries receiving assistance from the Paris Club are required to seek treatment on debt owed to other bilateral creditors on terms that are at least comparable to those agreed with the Club.

Among non-Paris Club countries, China is one of the biggest lenders. Even though data on China’s lending (on both government and state-owned enterprise loans) are not available, recent studies demonstrate that although the largest amount of emerging market and developing-country debt is owed to the private sector and IFIs, China has emerged as the largest bilateral creditor for many countries (Brautigam et al., 2020).

Chinese loans apply commercial rates, are mainly denominated in foreign currency, are often backed by collateral, and often contain debt-to-equity conversion options (which might negatively impact on the debtor country revenue flows in the long term).^[9] Chinese contracts include non-disclosure provisions and arbitration clauses. In recent cases of debt restructuring (on which data are scant), China rolled over debt or extended maturities (Horn et al., 2020; Sun, 2020).^[10]

Recent research reveals that China has indeed been active in providing certain forms of debt relief, restructuring, and re-profiling. However, citing the lack of participation by the private sector, the country has been reluctant to provide more relief than required under its

8 2009 Seychelles (ad hoc terms): «On a voluntary and bilateral basis, the Government of each Participating Creditor Country or its appropriate institutions may sell or exchange, in the framework of debt for nature, debt for aid, debt for equity swaps or other local currency debt swaps: (i) all Official Development Assistance loans; (ii) amounts of outstanding credits, loans and consolidations on debts other than ODA loans, up to 20% of the amounts of outstanding credits after the implementation of the Second Reduction on 1st July 2010 or up to an amount of 5 million SDR, whichever is higher.»

2002 Jordan (Houston terms): «Moreover, on a voluntary and bilateral basis, Participating Creditors Countries may sell or exchange, in the framework of debt for nature, debt for aid, debt for equity swaps or other local currency debt swaps, all the pre cut-off ODA loans as well as the pre cut-off date commercial credits (up to 30% of the amounts of outstanding credits as of December 31, 1991 or up to an amount of 40 million SDR, whichever is higher)» (Paris Club, 2009, emphasis added).

9 Non-Paris Club creditors have shown a general preference for the conversion of debt into equity.

10 See, however, IMF (2020d, p. 17).

commitments at the DSSI. What is more, it is worrisome that China has stated that China Development Bank loans will not be covered by the DSSI (Hodgson, 2020).

c) Debt swaps on official bilateral debt outside the Paris Club framework

Debt swaps on official bilateral debt can also occur on a voluntary basis outside the Paris Club framework if a renegotiation with the Club is not necessary.

However, attention should be paid to the requirements set by national legal frameworks, especially concerning eligibility criteria, applied conditionalities, scope of the projects to be funded, etc. (see, for instance, the US,^[11] Italian,^[12] and Spanish^[13] legislation on the conversion of official bilateral debt). Whether non-Paris Club creditors – and in particular China – have specific legislation in place will have to be assessed to secure their participation in debt-for-climate swaps.

Given these premises, *our proposals* for official bilateral creditors are as follows. Creditor countries will commit at the G20 level to provide debt relief to eligible countries under the three pillars of the DCI, while also committing to full transparency on their official lending.^[14]

Under the first pillar, official bilateral creditors will renegotiate the debt of eligible countries by providing debt-stock treatment (debt cancellation) combined with debt-for-climate swaps.

Under the second pillar, official bilateral creditors will provide debt-flow treatment (debt re-profiling with or without coupon adjustments) combined with debt-for-climate swaps. Under both pillars, debt-for-climate swaps will become part of the standard treatment (they will no longer be implemented only on a voluntary and bilateral basis). Limits on debt swaps of non-ODA claims will be substantially raised. An appropriate balance between debt

11 No appropriations have been authorised for debt-for-nature swaps under the US Tropical Forest Conservation Act from FY2014 to FY2018. In January 2019, the US Congress authorised the appropriation of US\$20 million for FY2019 and FY2020 (22 USC 2431f(a) and 22 USC 2431d(d)).

12 Under the Italian legal framework, debt swaps could originally only be implemented if there was a multilateral agreement among creditor countries at Paris Club level. In 2006 Art. 5 of Law no. 209/2000 was amended to allow debt swaps (debt-for-nature and debt-for-development swaps) to be undertaken even outside the Paris Club framework, if there is «a joint initiative promoted by the international community».

13 Ley 38/2006.

14 Disclosure is, in fact, of essence for the compilation of debt sustainability analyses. The DSSI requires beneficiary countries to disclose data on their public debt, but the same should apply to all G20 creditor countries; see the «Term Sheet of the DSSI» (G20, 2020c) and the «Statement of the G7 Finance Ministers on Debt Transparency and Sustainability» (US Department of the Treasury, 2020).

relief and debt-for-climate swaps must be found. Debt-to-equity swaps will be restricted to climate friendly activities.^[15]

Under the third pillar, official bilateral creditors will agree on debt service suspension to allow for the negotiation of debt-for-climate swaps on a voluntary basis and for a better assessment of their debt vulnerabilities (Hagan, 2020).

If not already in place, all creditor countries will have to adopt domestic legislation to enable debt-for-climate swaps. The Climate Investment Trust Fund (see more about this below) will provide technical assistance to debtor countries and promote investment in climate change projects.

3.3.2 Preferred multilateral creditors

The IMF, the WB, and multilateral development banks enjoy preferred creditor status. Borrowing countries are expected to grant them priority over other public or private creditors. The assumption is that, by shielding these organisations from the risk of non-payment and restructuring, they can provide financing when other lenders are unwilling to do so, and their reserve assets will remain risk-free.

This highly guarded status was preserved even when debt relief was granted to HIPCs under the HIPC/MDRI (Multilateral Debt Relief Initiative) initiatives. By resorting to trust funds (e.g. the HIPC Debt Initiative Trust Fund administered by the IDA) (see Guder 2009), the IMF and the IDA were still repaid, not by the debtor but by using funds largely made available by industrialised and middle-income countries.

Our proposal under the first pillar of the DCI is to establish separate Climate Trust Funds (one for each international organisation) to buy back or repay portions of the debt owed to the IMF and the WB by eligible countries, similar to what happened for HIPCs.

Countries will donate dollars or on-lend/donate SDRs (e.g. committing to disburse annual contributions). These resources would be used to repay the debt that eligible countries owe to the IMF/WB on the condition that the resulting fiscal space will be targeted towards a certain amount of climate-risk alleviation.

The attached green/blue conditionality could be based on IMF/WB Climate Change Policy Assessments and linked to the achievement and enhancement of NDCs, NAPs, and LTSs.

15 In the past, debt-for-equity swaps were part of the menu of options of the Brady Plan. In some cases, funds investing in distressed debt have entered into debt-for-equity swaps, not always successfully. In September 2002, for instance, Donegal Int. attempted to swap US\$30 million in debt for investments in Zambia; as the attempt was unsuccessful, it started litigation against the country.



3.3.3 Private creditors (banks and bondholders)

According to a recent study (Stiglitz and Rashid, 2020), 58 low- and middle-income countries out of a list of 111 owe more than US\$480 billion to bondholders and US\$55 billion to commercial banks and other private lenders. Their participation in the DCI is therefore key.^[16]

Private creditors can be involved through three-party debt-for-climate swaps and debt buyback operations. One of the applicable models for securing the involvement of private creditors could be the IBRD/IDA Debt Reduction Facility, which played a key role in fostering private creditors' participation in the HIPC initiative, allowing for greater burden-sharing and also limiting litigation.

The DRF was established in July 1989 to help IDA-only countries with high levels of public debt, a strong reform programme and a satisfactory debt management strategy (also including an agreement with Paris Club official bilateral creditors) to reduce their external commercial debt.^[17] It was funded with IBRD net income transfers and IDA resources.

Since its inception, the DRF has supported operations that have extinguished a total of US\$10.3 billion in external commercial debt, and more than US\$3.5 billion in interest arrears owed by 22 IDA-only countries, among which were many HIPCs. DRF grants supported the preparation and implementation of buyback operations at high discounts (debt was repurchased for a price in the range of 4 to 20 cents on the US dollar, with an average 88% discount). DRF operations occasionally combined debt buybacks with other modalities,^[18] including debt-for-development swaps (e.g. in the case of Zambia 1994).^[19]

In some cases, DRF-supported buyback operations raised questions about the comparability of treatment principle, under which countries that have restructured their debts with the

16 A group of private creditors has already been formed to negotiate with African countries. See the statement issued by the Africa Private Creditor Working Group in May 2020 basically rejecting the G20 call for debt relief: <https://www.africapcwg.com>.

17 See IBRD Resolution No. 89-13 and IDA Resolution No. 89-4, «Debt Reduction Facility for IDA-Only Countries», dated 1 August 1989.

18 See DRF operations for Albania, Bolivia, Niger, Senegal, Tanzania, and Zambia.

19 Zambia's commercial creditors were offered three possible options: first, a plain vanilla buyback; second, they could sell or donate their debt to a non-governmental organisation (NGO), which would use it for a debt-for-development swap; or, third, they could exchange their debt for long-term bonds redeemable at a premium in privatisations for equity (no creditor chose this option though). In addition to resources from bilateral donors, the DRF provided a grant to finance the repurchase of the debt. For the debt-for-development swap option, it was agreed that NGOs would purchase eligible debt from creditors at the same price offered by the government. NGOs would then redeem the debt with the Zambian Bank in domestic currency at a 50% premium to finance development projects in the country. This was the first DRF operation to fully incorporate a debt-for-development swap.

Paris Club commit to obtaining comparable relief from private creditors (and non-Paris Club official creditors) (Rieffel, 2003: 280).

The DRF expired in July 2017, but a renewed mandate and an extension of the scope of its activities are currently under discussion. We recommend that debt-for-climate swaps are included in the new mandate of the DRF and that a broader group of countries will become eligible to benefit from its activities.

In the context of the DCI, *our proposal under the first and second pillars* is for the renewed DRF to support a broader group of eligible countries in the organisation of buybacks and debt-for-climate swaps, providing them with technical assistance and the necessary funding.

Beneficiary countries will commit to putting the resources towards climate change objectives. Where national climate funds exist (see more on this below), beneficiary governments can direct the freed-up resources to a national climate fund for programming and implementation. In turn, the national climate fund will provide financing for climate change projects in the beneficiary countries. Where beneficiary countries use the freed-up resources directly through their budgets, expenditure monitoring will be critical. To achieve extensive participation and efficiency, a replenished and enhanced DRF will be helpful in managing the buybacks.

Buybacks would then be used as part of a strategy to prevent a debt crisis while at the same time encouraging expenditures in climate change mitigation and adaptation projects. However, attention should be paid to the fact that both buybacks and three-party debt swaps can be successfully implemented only if sovereign bonds issued by eligible countries are traded well below par on the secondary market, as a higher return is the main incentive for private creditors' participation.

For countries with market access, securing the participation of private creditors would therefore be a challenge. Moreover, data are not readily available, since bonds issued by low-income countries are mainly traded over-the-counter.

A price ceiling may be set to avoid pushing up prices on the secondary markets.

When a significant amount of public debt is in the hands of domestic private creditors (i.e. bonds that are issued under national law in the domestic currency and mostly held by domestic banks), a solution could be to proceed with a debt exchange and issue new bonds, the proceeds of which would be earmarked for green/blue/climate change projects. The new bonds will have state-contingent features providing for the adjustment or postponement of payments in certain economic conditions or for interest payments being linked to the green performance of the issuer.

Alternatively, domestic private creditors can be involved in debt-for-equity swaps (ECLAC, 2016: 5).

It is worth noting that some experts (Stiglitz and Rashid, 2020) have suggested that a new facility^[20] – partly funded with the donations of newly issued SDRs – could be established at the IMF to fund the buyback of outstanding sovereign bonds. In this case though, the IMF will not be able to leverage the capital of the Trust Fund by issuing bonds without an amendment to the IMF Articles of Agreement.

Even without the creation of a dedicated facility to support buybacks, the IMF can incentivise private creditor participation by making access to its resources conditional on a debt standstill (Hagan, 2020). This will prompt private creditors not to risk increasing the debtor country’s chances of default by failing to agree to a debt standstill, absent which IMF financial assistance would not be available. Moreover, the debtor country’s concerns about the loss of creditworthiness associated with a debt standstill will be offset by the catalytic effect of IMF lending.

3.4 The instruments of the Debt-for-Climate Initiative

The institutional arrangements used to manage the DCI will consist of four elements.

Table 2: The DCI’s instruments

Entity	Source of funding	Creditors
Climate Investment Trust Fund	- Debt swap proceeds - Grant contributions - SDR donations	- Official creditors - External private creditors
IMF/WB Climate Trust Funds	- Bilateral donor contributions	- IMF - IBRD/IDA
Debt Reduction Facility	- IBRD/IDA income - A new replenishment round (Note: Climate Investment Trust Fund manages resulting savings/investment in climate programmes)	- External private creditors
National level	- Debt swap proceeds - Contributions from donors - Private-sector contributions (e.g. Seychelles)	- External private creditors - Domestic creditors

20 The IMF can introduce special facilities (or lending windows) to address specific balance of payments problems with the approval of Executive Directors representing at least 85% of the IMF voting power.

- 1) The Climate Investment Trust Fund is the main pillar of the DCI. It supports debt swap operations, manages proceeds from debt swaps undertaken both with bilateral and private creditors, and provides financing for climate change projects in beneficiary countries (see also UNCTAD, 2019: 93). The Climate Investment Trust Fund would have an investment function. It will need to be equipped with expertise in programming on climate change so that the freed-up resources from debt renegotiations can be used effectively.
- 2) Similar to what happened in the case of the HIPC/MDRI initiatives, two separate Climate Trust Funds will be established at the IMF and the WB, respectively, to cover the cost of forgiving debt owed by eligible countries to these organisations. Only countries with unsustainable debt will be eligible to receive debt relief from the IMF and the WB under the first pillar of the DCI. Funding will come from undisbursed contributions to the HIPC/MDRI trust funds and from bilateral contributions. Debt relief will be provided on condition that the benefitting countries establish and implement climate change policies.

Resorting to a trust fund structure will preserve the preferred creditor status of the IMF and the WB: In practice, debt owed to the IFIs will still be repaid, even if it will not be paid by the debtor but by donor countries on behalf of the debtor. Debt cancellation provided by the IMF Climate Trust Funds will effectively scale-up the debt service relief temporarily granted by the organisation through the CCRT to a subset of DSSI countries.

- 3) The IDA's Debt Reduction Facility would help to buy back and swap debt owed by beneficiary countries from private creditors. As mentioned above, we propose a renewal of the mandate for the DRF. The DRF will help to reduce the amount of debt owed to private creditors. As one of the key principles of the DCI is broad participation, gaining the buy-in of private creditors is crucial.

Furthermore, in advocating for an enhancement of the DRF, we are also seeking to build on existing institutions. However, in case the DRF enhancement does not materialise, the Climate Investment Trust Fund could also be vested with the responsibility of engaging with private creditors.

- 4) Finally, swap proceeds can be managed directly at the regional and national levels. Regional and national climate funds can be important complements to the Climate Investment Trust Fund in two ways.

First, the Climate Investment Trust Fund can make use of national climate funds, akin to the Green Climate Fund's (GCF) model of using accredited entities (national). The key principle is country ownership, which the trust fund can help achieve through devolution of programming. Second, national climate funds can also play a role if there is no need to manage proceeds multilaterally. There may be swap agreements in which beneficiary countries agree to make payments in local currency to national institutions.

Debt-for-nature swaps led to the creation of a number of conservation trust funds, especially in Latin America. More recently, a number of countries have set up climate funds such as the Yasuni Fund, the Amazon Fund, Indonesia Climate Change Trust Fund, and so on. These funds can be held by an international trustee if no domestic agent meets the fiduciary requirements. National climate funds may also be attractive if the swap involves the debtor country making investments in local currency. The experience of Seychelles could offer a model: Three-party institutions bought a portion of sovereign debt, and the debtor government agreed to make payments to a nationally-based fund. A key consideration will be the legal status of these funds. As national climate funds have mostly handled grants, they might not be legally equipped to deal in debt/reflows.

3.5 The Climate Investment Trust Fund

3.5.1 *Host of the Climate Investment Trust Fund*

In selecting where to house the Climate Investment Trust Fund, a few criteria may be helpful:

- Ability to deal with a large range of financial instruments, including SDRs;
- Optimise administrative costs;
- Ensure coherence with development strategies;
- Guarantee transparency and accountability;
- Avoid additional bilateral conditionality or tied aid;
- Ease of access to beneficiary countries; a devolved approach may also be useful, where appropriate (at the regional/national levels), building on the «direct access» modality that the GCF, the Adaptation Fund, and the Global Environment Facility allow.^[21]

Based on these criteria – and since the Climate Investment Trust Fund will have to coordinate its activities with the IBRD/IDA Debt Reduction Facility – a trust fund administered by the WB could be a viable option. Two other options include the GCF and the Climate Investment Funds (CIF). Both of these funds enjoy extensive climate programming expertise. However, their ability to engage in debt-for-climate swaps may require board-level guidance and modifications to their risk management frameworks. The GCF and the CIF offer varying strengths and weaknesses in terms of their levels of experience, financial

21 Under direct access, a beneficiary country does not have to go through a multilateral development bank or an authorised UN agency to access resources. For example, national institutions that have accreditation with the GCF can take on executing and implementing responsibilities.

instruments offered, governance arrangements, and the range of beneficiary countries where they operate.

For example, membership of the CIF is not universal, however. As a result, debtor countries may be unwilling to use the CIF as the investment arm. The most expedient and efficient option may be to create a new trust fund, within a CIF, with a board that includes representation from these countries. The GCF's strength lies in working with a range of implementing entities. Furthermore, the balanced representation of developed and developing countries will also appeal to many beneficiary countries.

3.5.2 Funding

The sources of funding for the Climate Investment Trust Fund could include proceeds from debt swaps, grant contributions from donors, SDR donations, and investment income from the funds. The Climate Investment Trust Fund would leverage resources to offset the temporary nature of swaps and ensure funding for long-term projects. There have been calls to use SDRs as a way to finance climate change. For example, in an IMF staff note in 2010, the authors identified SDRs as a way to capitalise a «Green Fund» and advocated issuing green bonds to mobilise more resources (Bredenkamp and Pattillo, 2010).

Contributions from the private sector are discussed as an additional source of funding (e.g. national corporations that contribute donations to the SeyCCAT (Seychelles Conservation and Climate Adaptation Trust) benefit from an offset of 0.25% of their corporate social responsibility tax liability at the national level). NGOs can be involved in fundraising together with beneficiary countries. For example, Conservation International and The Nature Conservancy have supported the implementation of debt-for-nature swaps through the US Tropical Forest Conservation Act.

3.5.3 Governance of the Climate Investment Trust Fund

Building on the review of past experiences as well as on the latest developments in climate finance, governance options could include:

- Balanced representation of creditors and debtors;
- Individuals who represent a broad range of environmental non-governmental organisations from, or active in, the beneficiary country; local community development non-governmental organisations of the beneficiary country; and scientific, academic, or forestry organisations of the beneficiary country;
- External and independent asset manager to invest part of the Trust Fund's resources.

3.5.4 Projects to be funded and selection of projects

An overarching investment framework will be necessary for the Trust Fund. Beneficiary countries will be expected to create an investment plan that will include climate mitigation and adaptation programmes and projects aligned with national development plans, NDCs, and NAPs (to strengthen country ownership). As a core principle of the initiative is not just to facilitate the implementation of already existing climate plans but also to raise the level of ambition, the investment plan that countries design could also directly feed into enhanced and strengthened NDCs.

The Trust Fund should allow direct access for eligible entities. One important innovation in the delivery of climate finance has been the ability of host institutions to directly access multilateral resources. That is, rather than international institutions (UN agencies, regional development banks, etc.) taking the responsibility to implement projects and programmes, host institutions do so. Both the Adaptation Fund as well as the GCF have such provisions. More research needs to be done on the effectiveness of direct access as a modality, but the underlying principle of country ownership is compelling.

The Climate Investment Trust Fund will establish pre-defined criteria (indicators). Country ownership should be a key guiding principle, in line with the Paris Declaration on Aid Effectiveness. Specific projects should be in line with an investment plan that a country puts together based on the resource envelope available. Participatory processes, both at the fund level as well as the national level, will be important, and domestic civil society organisations can play an important role in ensuring that the investment plan and projects reflect the needs of communities and other stakeholder groups.

3.5.5 Monitoring and accountability

Monitoring will be required at two levels.

- 1) The first level involves the need to monitor debtor country expenditures, investments, and outcomes following swap operations. For example, Climate Trust Funds set up at the IMF and the WB under the first pillar will help to reduce debt for eligible countries in exchange for climate commitments, and those commitments will have to be tracked. The options for monitoring are provided below.

Investment plan

Building on NDCs and NAPs, beneficiary countries will put together investment plan that outlines how the freed-up resources will be used. In spirit, this plan would be similar to the Poverty Reduction Strategy Papers under the HIPC Initiative. Country ownership is vital. NDCs and NAPs will be the starting points. However, beneficiary countries will also have the opportunity to exceed their NDCs by articulating more ambitious targets. Furthermore, given the wide variations in the levels of precision of the targets and goals in the NDCs, this investment plan will afford an opportunity to

identify indicators that can be tracked. The options below identify tracking inputs (expenditures), outputs (results), and payments to funds for investment. If a debt-for-climate swap is contingent on the beneficiary country achieving results, what those results are and when payments will be triggered will also form a part of the plan.

Schedule of payments

If the structure of the debt swap involves a commitment from the debtor government to channel savings into a fund, parties need to agree on a schedule of payments. Holding the government accountable in making these payments will have to be the responsibility of national parliaments, civil society groups, and other stakeholders.

Monitoring public expenditure on climate change

As an alternative to the ring-fenced trust fund approach, it is also possible to operationalise the debt-for-climate swap as budgetary support to the beneficiary country. In other words, as a part of the debt-for-climate agreement, the beneficiary country agrees to direct spending towards climate objectives directly through its budget (Steele and Patel, 2020). Often, countries do not have budget codes on climate change. Similar to «virtual poverty funds», an option may be to tag budget line items. Climate budget tagging has been piloted in a number of countries. Climate Public Expenditure and Institutional Reviews (CPEIRs) have sought to ascertain the «climate relevance» of public spending. Given the lack of budget codes related to climate change, the methodology used for CPEIRs involves estimating the climate relevance for each expenditure item. Although it is exhaustive and thorough, a more efficient approach will be necessary.

Monitoring outcomes

In addition to monitoring inputs (public expenditure), countries could also report on outcomes. As discussed in the results-based payments below, structuring a contract that involves payments for results/outcomes may be appealing for a number of countries. Outcomes to be measured could include greenhouse gas emissions, generation-capacity installed, forest area, and so on. Mitigation metrics are well-defined and easier to track than adaptation and resilience metrics. How best to identify and track the latter continues to be debated.

Results-based payments

Results-based payments would unlock payments to the debtor country once it is able to prove that it has achieved pre-specified results. The participating countries would agree on a baseline, against which the results are tracked. Results-based payment programmes have already been implemented at the national level in Brazil and Indonesia, and more countries (with tropical rainforests) are in the pipeline. The advantage of a results-based payments programme is that the implementing countries have full policy autonomy over how they reduce their emissions. The finance providers are liable to make payments only upon verified results. In the climate realm, results-based payments have been used to incentivise countries to avoid deforesting. However, the general setup of the programme is applicable for sectors

and areas beyond forest loss as well. Countries may require significant capacity-building to ensure that they have the capabilities needed to track deforestation rates and produce reliable estimates on a regular basis (geospatial data). The lack of such monitoring frameworks has created a bottleneck and impeded the ability of countries being able to claim results-based payments. Apart from bilateral donors, such as Norway, the GCF has also initiated a programme that pays for verified results for reducing emissions from deforestation and forest degradation (REDD+).

- 2) The second level involves the accountability of the Climate Investment Trust Fund. Accountability mechanisms will depend on where the Climate Investment Trust Fund is housed, its investment framework, risk management processes, and so on. To ensure a responsible financing model, investments made will apply the WB Environmental and Social Framework (protection of indigenous peoples, civil society involvement, etc.) The International Labour Organization has produced just transition guidelines (ILO, 2016), which will be useful. Engaging civil society members will be critical for accountability. Funds such as the Climate Investment Funds have made provisions to include civil society representatives as observers in board proceedings.

3.6 Additional incentives linked to climate investment projects

Countries benefitting from the initiative will be able to issue new bonds with green features (Zadek, 2020).

Genuine savings-linked bonds

Akin to gross domestic product (GDP)-linked bonds, where payouts from the debtor are tied to changes in the debtor's GDP, an option could be to issue a portion of bonds tied to the WB's genuine-savings indicator. This provides an incentive to the issuers, as it helps meet environmental, social, and governance (ESG)/net-zero targets. The debtor also generates global public goods. Genuine savings can also be a useful predictor of future well-being (Greasley et al., 2014).

An alternative version would be state-contingent debt contracts for bilateral debt. GDP-linked coupons have been discussed in other places. Similar to that setup, debtors could have access to lower rates if they can prove that their emissions have dropped below certain rates. In the restructuring process, parties would agree to a cascade model with lower rates as climate targets get more ambitious.

ESG, green, sustainability, and just transition bonds

A number of institutional investors have ESG targets. If sovereign issuers can guarantee that the underlying projects fit the requirements for green/sustainability/just transition bonds (Robins, 2020), they may have access to those institutional investors. Using SDRs as

the capital base, the Climate Investment Trust Fund can issue bonds (green+), mobilise more resources, and invest in the beneficiary countries.

Carbon credits

The Paris Agreement has carried forward much of the infrastructure on carbon credits designed under the Kyoto Protocol. Although the details of carbon markets (Paris Agreement, Article 6) have not been finalised yet, carbon credits can be an incentive to engage with a broader range of actors. A pure offset to carbon credits is no longer tenable, given the necessity of achieving deep de-carbonisation, because it simply displaces emissions. However, carbon credits may still be useful for two purposes: increase ambition and expand the scope of the NDCs.

First, the current round of NDCs are far short of what is needed to put us on track to achieve 1.5–2°C degrees of warming. Climate pledges need to be enhanced. Second, many developing countries have non-economy-wide pledges. Therefore, expanding the scope of these pledges could help to transition into a system in which emissions from all sectors are accounted for. So, carbon credits can still be an important incentive if used in the following ways:

- a) Use carbon credits as collateral to reduce the cost of debt servicing; the carbon credits may never be «cashed»; it is simply collateral;
- b) The Climate Investment Trust Fund proposed above pays for debt buybacks. As a part of the package deal, the country agrees to cancel carbon credits; or the trust fund takes them and cancels them;
- c) Cancellation rates. In the climate negotiations, those worried about the environmental integrity of carbon credits under the Paris Agreement have proposed cancellation rates. Having a cancellation rate would mean that the purchaser needs to buy a multiple of the credits that it wants to use towards its own emissions reductions obligations. In order to ensure environmental integrity, we recommend using carbon credits in a steeply discounted way.

Three ways carbon credits could help to deliver leverage:

Lower interest rates	When debt is backed by carbon credits, debtor countries may be able to receive more favourable terms
Higher revenue for the debtor country	If achieving targets specified in the swap involves generating credits, creditors will be willing to pay more (Norway pays US\$5/unit without credits)
Carbon credit liquidity management	Debt swaps can remove a portion of the carbon credits from circulation. Incentivise the removal of bad money chasing good and adjust supply

Source: Authors

There are valid concerns about the use of carbon credits in debt swap agreements. Accounting standards will be the Achilles' heel. The recommendation to use carbon credits here comes from the goal of expanding participation in the DCI. There is a possibility that the introduction of carbon credits may also help to achieve deals much larger than debt-for-nature swap agreements. If structured appropriately, with some of the caveats above, carbon credits may help to address concerns about debt-for-climate swaps being too limited in scale and scope.

The Shola Grasslands and forests in Western Ghats (India) is one of the 25 biodiversity hot spots in the world.



4 Conclusions

Further analytical work is needed in a number of areas. First, NDCs and debt sustainability. Second, to enable consistent and uniform tracking of public expenditure as an input, further work is needed to sharpen the methodological tools used to track climate-related expenditures.

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