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Debt Swaps: Go Big or Go Home – the View of the Borrower

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Sovereign debt management during times of economic distress can be particularly painful for small states. In some cases, capacity constraints have prevented these countries from institutionalising debt management grounded in sound macroeconomic and monetary policies. In other cases, these countries have borrowed at high cost and high risk, banking on high returns that were then eroded by economic- and climate-related shocks. The climate crisis, unlike others, is persistent and requires ongoing attention. In a document produced by the United Nations (UN) on the global pandemic and debt (UN, 2020), the UN put forward initiatives that could help developing countries unlock financial flows for health, climate and other initiatives that support the implementation of the Sustainable Development Goals (SDGs). Small islands developing states (SIDS) have joined the discussion by anchoring their focus on increasing climate resilience and reducing debt levels. Several states have published ambitious Nationally Determined Contributions (NDCs) to reduce carbon emissions and have increased their ex-ante and ex-post planning for natural disasters.

The International Monetary Fund (IMF), World Bank and Commonwealth Secretariat have produced several tools and techniques to help countries create fiscal space and secure debt sustainability. The concept of a 'debt-for-climate swap' solves at least three problems with one financial instrument: it provides an opportunity to restructure high-cost and high-risk debt, creates fiscal space to finance climate resilience and growth-generating projects, and it supports improvements in debt management practices pre and post restructuring.

The Government of Antigua and Barbuda is serving as Chair of the Alliance of Small Island States (AOSIS) for 2021–22. It has secured funding from the Open Society Foundation (OSF) for a project titled 'Finance for Acting on Climate in the Eastern Caribbean' (FACE). The project proposes to pilot a debt-for-climate swap for Antigua and Barbuda of approximately 662.5 million Eastern Caribbean dollars (EC\$) (US\$245 million), around 20 per cent of the country's public debt. The project will also make information on debt-swaps concepts publicly available for small states based on the lessons learnt in the Antigua and Barbuda pilot.

In this paper, I will examine some of the challenges faced by SIDS that can be addressed through debt-for-climate

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swaps, while also providing further insights into the advantages of prudent debt management practices in small states. These advantages include the development of sovereign funds to manage climate risks, improvements in debt transparency, and support for medium- to long-term debt sustainability.

Sovereign debt vulnerability

Lars Jensen (Jensen, 2021) in his paper looked at 112 developing countries that were in breach of their solvency threshold because of the COVID-19 pandemic. Among these countries were a few Caribbean small states, including Barbados, St Vincent and the Grenadines, Grenada, and Belize. The paper identifies several factors behind the increase in debt vulnerability, namely, stagnant revenue development, slow growth, and higher exposure to rollover risks from the financial markets. Jensen posits that countries would need to invest significantly to boost growth, but not before some debt restructuring.

In the Caribbean, an analysis of debt dynamics between 2000 to 2018 revealed that Caribbean small states became significantly indebted because of fiscal slippage occasioned by large primary deficits, government funding of off-budget liabilities, and because of hurricanes and other natural disasters (see Table 1).*

* The first pattern characterises those countries that have become indebted because of fiscal slippage – running large primary deficits – was a major source of debt and contributed to the central role played by non-Central Government liabilities. This group includes Belize, Grenada, and St Kitts and Nevis. The circles in the table show the years with major debt challenges.

The second pattern of debt growth applies to countries in which – the government's increased borrowing and the cost of debt servicing, played a significant role in the debt build-up. With Antigua and Barbuda (57% domestic debt) and Jamaica (52% domestic debt), interest cost was a factor in debt expansion, while they also held a high share of domestic debt in total.

The third pattern is in off-budget liabilities, which was a major contributor to debt build-up in Antigua and Barbuda, Jamaica, and St Kitts and Nevis.

- Small states are heterogeneous and therefore the problems facing each country differs. However, some challenges are prevalent and plague debt dynamics (Hope and Spencer-Henry, 2019). They include the following:
- high vulnerability to external shocks;
- high fiscal deficits;
- greater frequency and/or magnitude of natural disasters;
- a high debt service burden, which diverts public resources away from critical social and productive capital expenditures;
- high debt levels that increase the cost of new borrowing through an augmented perceived market risk of newly issued debt;
- limited fiscal space for counter-cyclical spending;
- limited financial capacity to respond to and recover from natural disasters; and
- constrained ability to borrow, which limits the government's ability to leverage private investment through public-private partnerships.

It follows then that for a borrower country, the concept of 'debt for climate' ticks many boxes. However, I posit here as well that the concept could be equally beneficial for countries seeking to advance debt transparency and debt sustainability.

Regarding credit rating, Fuller et al. (2018) note that except for The Bahamas, all Caribbean states are rated below investment grade. They argue that this leaves countries more vulnerable because of their inability to attract necessary financing. With limited fiscal space and the inability to borrow affordably, this exacerbates the crisis SIDS face when a climate event occurs.

Debt-for-climate swaps

According to the International Institute for Environment and Development (IIED):

debt for climate and nature programme swaps are where a creditor allows the debt to be reduced – either by conversion to local currency and/or paid at a lower interest rate or some form of debt write-off – and the money saved is used to invest

Table 1. Caribbean debt dynamics 2000–2018: change in debt/GDP ratios

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Antigua and Barbuda	0.1	13.3	8.3	-1.1	-5.0	-27.5	-3.5	-11.3	-1.8	24.9	-11.5	2.0	-4.8	8.2	7.6	-3.8	-12.7	1.7	0.5
Barbados	7.5	6.2	3.5	-0.1	-0.3	2.8	2.5	1.7	5.9	16.6	8.1	4.5	11.0	11.5	4.0	7.5	2.4	8.4	-33.0
Belize			7.7	14.3	-6.0	-0.9	-6.8	-2.2	-7.6	7.9	-4.2	-5.8	-4.0	-1.5	-1.3	2.5	13.9	1.2	0.3
Dominica	7.0	29.6	-0.6	-3.0	-8.8	-4.2	-4.6	-5.6	-7.4	-1.9	4.3	2.9	2.7	7.8	-1.4	-3.5	-3.2	6.5	4.6
Grenada	7.1	3.0	34.5	0.5	15.1	-7.4	5.6	-3.9	-5.1	7.2	5.8	3.8	2.6	4.7	-6.3	-11.7	-8.5	-11.7	-6.8
Jamaica	9.1	16.2	10.4	4.8	-3.3	4.7	-7.5	-2.6	12.5	14.9	-0.1	-1.4	4.6	-6.3	-0.9	-16.6	-7.7	-12.5	-1.7
St Kitts and Nevis	4.6	7.7	14.4	20.1	10.7	1.8	-9.3	-11.6	-5.4	11.0	10.7	-9.0	-8.3	-32.8	-18.5	-9.2	-4.5	-0.4	0.9
	9/11, US recession									Global financial crisis, lagged effects									
Notes:																			
	Natural disasters																		
	Accelerating debt, contingent liabilities, fiscal slippages, negative-low real GDP																		
	Debt restructuring, debt relief, economic adjacent programmes, favourable real GDP growth																		

Source: Presentation by Kevin Hope and Nadia Spencer-Henry (2019)

in poverty-reducing climate resilience, climate emissions mitigation or biodiversity protection initiatives. (Steele and Patel, 2020)

For the borrower, this means that its existing debt is exchanged for a cheaper alternative or that it is significantly reduced, improving its debt sustainability over time. It is important to identify the type of debt to be swapped and the type of creditor. Usually, the debt is external, so that the savings are both in nominal terms and in terms of debt service obligations. The conversion to local currency allows for foreign exchange savings and reduces the exchange rate risks associated with debts denominated in fluctuating currencies. The new obligation is domestic, because the assumption is that the country will invest in a climate resilience project in-country or will provide replenishments to a special fund to finance climate adaptation and mitigation. The country would need to identify a clear climate investment mandate to absorb the savings from the reduction in debt obligations. The country could also seek support from a climate agency to verify the use of the savings generated from the swap and assistance with the implementation of the climate mandate.

Some of financial structures are as follows:

- 1. Bilateral debt-for-climate swaps.** These usually include debt forgiveness by bilateral creditor countries. The swaps generally form part of debt restructuring, accompanied by an IMF Upper Credit Tranche (UCT) Programme. The Paris Club has provided this type of relief to small states like Seychelles.* This engagement requires a debt workout mechanism involving more than one bilateral creditor. However, it can also be undertaken with a single creditor.
- 2. Commercial debt-for-climate swaps.** Similarly, these mechanisms require at least three parties, the borrower, the financier of the buyback and the creditor. The borrower would typically contract a cheaper source of financing to buy back the commercial debt at a discount. This would require the support of the commercial creditor or creditors. Then the borrower would support two obligations: one to the new creditor purchasing the debt and the other in the form of budget allocations for climate resilience. To provide credibility to the climate resilience programme, the borrower would generally work with a donor agency or non-

* Seychelles completed a debt-for-nature swap to protect its marine ecosystems with the Paris Club in 2015.

governmental organisation (NGO), such as The Nature Conservancy (TNC) in the case of Seychelles and Belize.*

3. Multilateral debt-for-climate swaps.

Multilateral creditors have preferred creditor status in any debt restructuring activity. However, they provide a critical role in supporting the initiative by providing technical assistance for the structuring of the new debt instrument, supporting debt sustainability analysis (IMF) or providing new financing to support the climate resilience initiatives of the country. A partial credit guarantee is a credit enhancement arrangement where the international financial institution (IFI) promises to settle debt service payments up to a predetermined amount in the event of a default, and this can then be used to support ongoing climate investments post a debt-for-climate swap. Such an operation could improve the creditworthiness of the instruments and can have more than a psychological effect on bondholders in a commercial debt restructuring. The Commonwealth Secretariat has been proposing a workout mechanism specifically for multilateral debt since 2010 (Commonwealth Secretariat, 2015).

The country would need to identify a clear climate investment mandate to absorb the savings from the reduction in debt obligations, while also enlisting support and developing capacity for implementation. The country may also want to consider use of debt advisers to support negotiations with the creditor.

There are several options to approach the transaction:

Principal Option

1. The borrower identifies an agency willing to purchase the debt at a discount.
2. The purchaser purchases the debt at a discount from the creditor.

3. Then the borrower has two new obligations: one to the purchaser of the debt and the other to the investment in a climate resilience project.
4. There should be calculated savings (Net Present Value (NPV) savings) on the debt obligation to allow for a larger amount of cash flow to the climate resilience project.

The option outlined is generally used by most countries and has been typically supported by all the creditor groups. However, I would also like to posit some other options below for consideration.

Alternative Option 1

1. The borrower uses its own resources to purchase the debt at a discount.
2. The borrower buys back the debt at a discount from the creditor.
3. Then the borrower has one new obligation via investment in a climate resilience project.
4. There should be calculated savings on the debt obligation to allow for a larger amount of cash flow to the climate resilience project.

Alternative Option 2

1. The borrower negotiates with the creditor and they both agree to a debt conversion for climate resilience. The creditor would agree to a debt write-off or debt reprofiling with cost savings.
2. The borrower continues to pay a reduced debt obligation to the creditor and the savings from the debt conversion are paid into a climate resilience fund.

Alternative Option 3

1. The borrower negotiates with the creditor for a debt conversion into a new credit arrangement that could refinance the old credit in addition to new financing for climate resilience. This option would increase debt.

Responsibilities of the borrower

The guide provided for debt managers by the International Institute for Environment and Development (IIED), offers seven steps for executing debt-for-climate swaps:

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

* Belize completed a debt-for-climate swap with the support of the TNC in 2021.

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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.* (IIED, 2021)

More specifically, the borrower country is required to carry out the following debt management and fiscal management operations:

1. Identify debts in the external debt portfolio that could generate savings through a debt-for-climate operation.
2. Calculate the optimal reprofiling of these debts to support debt sustainability.
3. Reconcile outstanding obligations with creditors and ensure that the communication channels are open. This may require a communication strategy targeting the creditors who will be participating in the swap, as well as other creditors. This helps to clarify information for participants in the domestic and international capital market, who may react adversely to the announcement of a debt-for-climate swap.
4. Channel savings from the debt restructuring into the national budget and ensure that there are appropriate mechanisms for controlling this expenditure.
5. Adopt mechanisms to institutionalise a comprehensive approach to climate resilient development. This could include ensuring that climate investment plans are included in development planning and national adaptation plans (NAPS) and are supported by ambitious NDCs.
6. Improve debt management capabilities through the medium-term debt strategy and the annual borrowing plan.
7. Improve debt management operations to maintain debt sustainability post restructuring.

For a borrower, the process can be lengthy and while the idea is to generate savings, there may be some costs involved in the negotiation process. These costs could include costs for contracting a debt adviser and interest accumulation on the outstanding debt – if there is no 'debt standstill' in place during the negotiation. Therefore, it would be more beneficial for countries to approach the debt-for-climate swap on a larger scale, to ensure impact both on the debt sustainability side and on the side of combating climate change. Steele and Patel (2020) propose that the swap should be a swap for climate programmes instead of a project. Climate Programmes are broad based and can target diverse outcomes across several projects. Climate programmes show greater ambition and create more impact. They argue that this approach would increase goodwill for the creditors; however, it also creates goodwill for the borrower when the debt is already in default.

For SIDS, this would require significant support both for the debt negotiation as well as for the programme development and a budget support mechanism. Support would also be required in building capacity to develop and monitor the use of funds. Countries that have already defaulted on their debts to be swapped are likely to find the process more tedious than those seeking to expand their debt portfolio. Once a borrower has defaulted the process of negotiation is lengthier and more complex as the borrower has the duty to show renewed credit worthiness, while at the same time making the case for debt conversion, gaining approval from the creditor for using debt savings to support climate initiatives.

A debt swap may not be an option for every country, depending on the size and composition of the debt and the type of borrowers. It is also important to note that a country may consider making specific budget allocations a more beneficial option than advancing a debt for climate swap initiative. Planning and detailed analysis provides the information necessary to support the transaction.

Debt transparency and debt-for-climate swaps

Debt transparency covers the availability of debt data and borrowing processes that are legitimate, rule-based, and traceable. (Rivetti, 2021)

Debt data should be available for policymakers, citizens and civil society, and creditors. The debt-for-climate swap instrument supports the publication of debt data for the benefit of all the parties involved in the restructuring, because it is a comprehensive debt workout mechanism that involves several groups of creditors. For example, the Paris Club requires debt comparability for the debt treatment it provides, and this encourages creditors to share data with the Club's secretariat and with each other.

Countries seeking to advance a debt-for-climate swap would also need to provide information to the capital market to support improvement in their credit rating and credit risk assessments. This step is particularly important to avoid an automatic lowering of the credit rating due to a debt restructuring. The borrower has the responsibility to ensure that the debt is being reported accurately and comprehensively, to support the negotiation process and to encourage as many creditors as possible to back the transaction.

The negotiation and small states

There are several factors that have propelled debt-for-climate swaps as a viable option for developing countries and have increased the negotiating power of small states. First, at the 26th meeting for Convention of the Parties (COP26), developed countries were criticised for not reaching the US\$100 billion climate target of the Paris Agreement. Since then, countries and financial institutions have been ramping up access to climate finance.

Second, investing in and lending to small states has always been a risky endeavour. In the 1960s and 1970s, countries like Antigua and Barbuda borrowed from bilateral creditors who secured their debt with export credit guarantees. Over the last decade, countries like Grenada and Barbados have used 'hurricane

clauses.' 'Hurricane clauses' allow borrowers to defer principal payments or entire debt service payments following a natural disaster. These clauses have been endorsed by the international financial community and are referred to as 'state-contingent debt instruments' (IMF, 2017). While small states defaulting on their debts does not pose a systemic risk to the international financial system, creditors recognise the risks and are showing a greater willingness to enter negotiations.

Third, interviews undertaken with Antigua and Barbuda's creditors* have indicated that there is some willingness by creditors to consider debt-for-climate swaps due to the perceived risk of debt default. Creditors recognise the severity and intensity of climate and economic events. They also understand the lag in economic regeneration for a small state once a climate event has passed. Further, creditors recognise the need for additional investment to build resilience.

Finally, The Nature Conservancy (TNC) has been working with private creditors like Credit Suisse to advance climate resilience for small states. Economic, Social and Governance Guidelines (ESG) (Drei et al., 2019) have influenced how companies invest and build sustainability. The financial sector has responded by 'greening' its portfolio.

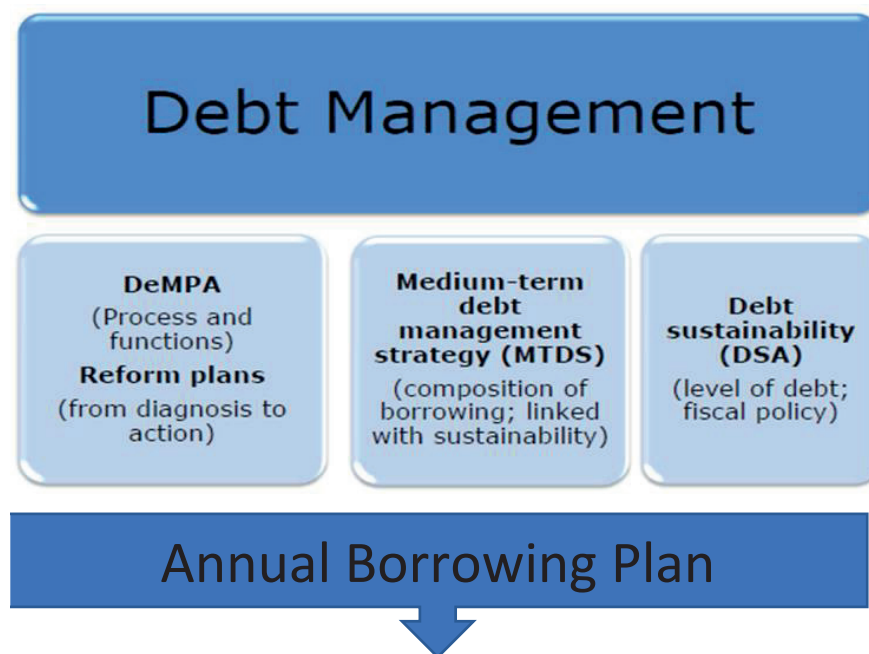
Debt sustainability

Debt sustainability is generally measured by using the debt-to-GDP (gross domestic product) ratio and the ability to generate primary surpluses to cover interest. The IMF's more recent debt sustainability assessment (DSA) tool also measures the effects of debt sustainability based on an extreme event. Steele and Patel (2020) note that a good debt swap could improve debt sustainability in the long run by contributing to economic growth and helping to generate fiscal surpluses. The debt dynamic equation is as follows:

$$\frac{(D/Y)_t}{D/Y - \text{Debt-to-GDP ratio}} = (1 + (r-g))(D/Y)_{t-1} + d$$

* For the purposes of this paper, the creditors are not named as negotiations are still ongoing.

Figure 1. Tools for sound debt management



r - interest rate on government debt
 g - growth rate of the economy

The borrower can control primary surpluses, but it can't control long-term interest rates.

International financial institutions like the IMF and World Bank, when involved in the transaction, ensure that the countries' initiatives are fiscally prudent and support debt sustainability.

The debt-for-climate swap provides the following advantages that can help borrowing countries improve their debt sustainability.

- The commitment of the government to pay its debt obligations at a reduced level increases primary surpluses, especially when the debt swap is done on a larger scale.
- Policy co-ordination helps the government to target investments towards reducing climate risks, while at the same time boosting economic growth.
- Budget support mechanisms have the potential to attract other sources of financing and provide buffers in times of climate events. The borrower would not be forced to borrow unsustainably in the time of crisis.

Ensuring prolonged debt sustainability requires adherence to the fundamentals of sound fiscal and debt management.

The best option

The debt swap mechanism is not for all small states. Countries that may want to consider this as an option should be prepared to commit to both debt reduction and investment in climate resilience, so that they can have impactful returns. The options presented in this paper may not all result in debt reduction and adequate financing, however, and it is important that countries have discussions with creditors who share their ambition and understand the goal.

I propose that the best option should be one where the creditor provides savings that allow the borrower to build short-term and long-term debt sustainability. Alternative Option 2, discussed above, presents the most viable option in this respect. The new instrument should be structured as a state-contingent instrument to ensure short-term as well as long-term debt sustainability for the small state. The debt identified should be of a large-enough scale to have significant impact.

It will not be an easy task for borrowers to convince creditors to accept some element of debt relief and help the borrower establish a sustainable debt service profile. From inception, the borrower should adopt a consultative approach aimed at engaging creditors proactively throughout the design and implementation of the new debt instrument. A consultative approach is likely to be viewed as a collaborative effort by creditors and may well facilitate what could become a complicated and protracted process. The main goal of such an approach is to open dialogue with creditors and create a channel through which the borrower encourages creditors to voice their concerns and the borrower provides adequate responses to those concerns.

Conclusion

This paper contributes to the discussion on debt-for-climate swaps and the considerations that could be made for small island borrowing nations. Financing climate resilience and the SDGs requires countries to generate fiscal savings and improve their public investments. However, high debt continues to plague many SIDS and the COVID-19 pandemic has placed many of these countries into debt distress. Debt-for-climate swaps are a viable option for SIDS and can serve to generate fiscal savings and improve debt management capability.

The multilateral community can advance these debt instruments by advocating for their support with creditors and by helping the borrower to undertake good debt management practices and supporting dynamic climate resilience planning. Further study is also required on how countries can scale up their investments while maintaining debt sustainability.

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