

# Debt for Climate Swaps in the Pacific SIDS



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# Summary

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The Pacific Small Island Developing States (PSIDS) are among the most vulnerable countries in the world to the effects of climate change and related disasters, but they can afford the least to invest in climate action. In addition to the adverse fiscal impacts of the COVID-19 pandemic, these countries have a high degree of economic vulnerability due to their small size and dependence on a few key export industries such as tourism or fisheries. As such, debt sustainability analyses

conducted by the IMF and the World Bank regularly assess most PSIDS to be at high risk of debt distress. This report discusses the potential of debt for climate swaps to leverage additional finance for climate actions in the PSIDS while also reducing their debt burdens. The report examines the concept of debt for climate swaps, outlines the potential of debt for climate swaps in the PSIDS, and provides recommendations for the scheme design based on best practices.

# Abbreviations

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ADB	Asian Development Bank
CIF	Climate Investment Funds
ECLAC	Economic Commission for Latin America and the Caribbean
ESCAP	Economic and Social Commission for Asia and the Pacific
FDI	Forest Direct Investment
GCF	Green Climate Fund
GDP	Gross domestic product
GEF	Global Environment Facility
GHG	greenhouse gas
IFC	International Finance Corporation
ITAP	Independent Technical Advisory Panel
MDBs	Multilateral development banks
NDC	Nationally Determined Contribution
NGO	Non-governmental organization
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PPG	public and publicly guaranteed
PRF	Pacific Resilience Facility
SDGs	Sustainable Development Goals
SeyCCAT	Seychelles Conservation and Climate Adaptation Trust
SIDS	Small Island Developing States
TNC	The Nature Conservancy
UN	United Nations
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
UNFCCC	United Nations Framework Convention on Climate Change
USD	United Statesdollar
USAID	United States Agency of International Development
WB	World Bank
WWF	World Wide Fund for Nature

# I. Introduction

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Addressing the challenge of global climate change requires a substantial mobilization of investments to limit global warming, adapt to its effects, and address associated costs of loss and damage. To support these efforts, developed countries have committed to provide 100 USD billion per year to finance climate action in developing countries, but this commitment has not been met yet. In addition, many bilateral and multilateral donors report challenges in disbursing funds due to a failure to identify fundable projects, especially for adaptation (UNFCCC Standing Committee on Finance, 2018), while many developing countries report difficulties in accessing available resources due to lack of capacities and the inability to fulfil specific requirements established by donors or financing institutions that many consider burdensome (UNFCCC Standing Committee on Finance, 2018). In this context, high external debt burdens, which increased substantially as a result of the COVID-19 pandemic, are creating further difficulties for many developing countries to access additional finance to set their economies on a low-emission and climate-resilient path.

The Pacific Small Island Developing States (PSIDS)<sup>1</sup> are some of the most vulnerable countries in the world to the effects of climate change and related disasters. The World Risk Index 2021 ranks several Pacific Island countries among the most at-risk countries, with Vanuatu, Solomon Islands and Tonga

ranking first, second and third, respectively, and Papua New Guinea, Fiji and Kiribati ranking among the top-20 (Aleksandrova and others, 2022). Although each country is affected by climate change differently, common risks include rising sea levels, stronger and more frequent tropical storms, soil erosion, food and water security, and damage to infrastructure.

At the same time, the PSIDS can afford to invest in climate actions the least. They are characterized by a high degree of economic vulnerability due to their relatively small size and dependence on just a few key industries – such as tourism, agriculture, or fisheries – that are highly exposed to climate risks. These countries have also been hard hit by the COVID-19 pandemic and its economic consequences, such as the collapse of the tourism and travel industry, which resulted in a GDP contraction of 5.4 per cent in 2020 and 0.3 per cent in 2021 compared to a growth rate of 3.5 per cent in 2019 (ESCAP, 2022, table 2.1.). The COVID-19 pandemic worsened the debt vulnerabilities of many low- and medium-income countries because government revenues declined as a result of limited economic activity.

This report discusses the potential of debt for climate swaps to leverage additional finance for climate actions in the PSIDS while also reducing debt burdens. The report examines the concept of debt for climate swaps, outlines the potential of debt for climate swaps in the PSIDS, and provides recommendations for the scheme design based on best practices.

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1 Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Nauru, Niue, Palau, Papua New Guinea,

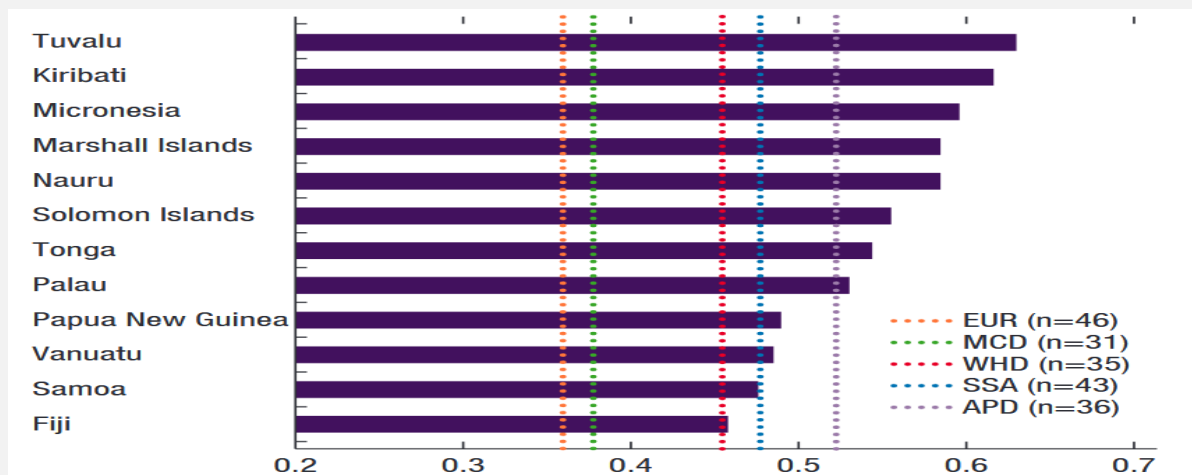
Republic of Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.

# II. Need for innovative financing options in the PSIDS, including debt for climate swaps

Nearly all countries in the world have signed the Paris Agreement.<sup>2</sup> Under this agreement and as reiterated at COP26 in Glasgow, developed and developing countries committed to ensuring that global warming is capped at between 1.5 and 2 degrees Celsius compared to pre-industrial levels and to take measures to adapt to climate change and mitigate its risks. Under the Paris Agreement, countries agreed to share binding commitments to prepare, communicate and

maintain Nationally Determined Contributions (NDC) for climate action, and to pursue measures to achieve them. The Paris Agreement commitments are critical for the PSIDS because of their high degree of exposure to climate change (figure 1), but the implementation of such commitments relies heavily on the availability of external financial resources.

FIGURE 1: INDEX OF EXPOSURE TO CLIMATE CHANGE



Source: International Monetary Fund, *Unlocking Access to Climate Finance for Pacific Island Countries* (2021). Available at [www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2021/09/23/Unlocking-Access-to-Climate-Finance-for-Pacific-Islands-Countries-464709](http://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2021/09/23/Unlocking-Access-to-Climate-Finance-for-Pacific-Islands-Countries-464709).

Notes: Notre Dame Global Adaptation Index (2018). Dotted lines show averages by IMF area departments, and the number of countries is shown in parentheses. APD = Asia Pacific; EUR = Europe; MCD = Middle East and Central Asia; SSA = Sub-Saharan Africa; and WHD = Western Hemisphere.

2 191 parties out of 197 parties to the UNFCCC are

also parties to the Paris Agreement.



Although not all NDCs include estimates of financial requirements (Regional Pacific NDC Hub, 2020), some are available: Fiji USD 500 million, Kiribati USD 120 million, Nauru USD 50 million, Palau USD 500,000 for assessment and preparation of plans, Solomon Islands USD 170 million, and Vanuatu USD 180 million. These numbers, however, seem to underestimate the needed investments. The IMF estimated the annual financing needs of the PSIDS for climate adaptation at close to USD 1 billion (IMF, 2021), and the Regional Pacific NDC Hub estimated that a total of USD 5.2 billion will be needed by 2030 only to implement renewable energy targets in the PSIDS's NDC, of which 93 per cent will be conditional on external investment (Regional Pacific NDC Hub, 2021).

Addressing these large financial needs will require considerable mobilization of external financial resources. To this end, a more expedient implementation of the climate finance commitments by the developed countries, which are listed in Annex II of the United Nations Framework Convention on Climate Change (UNFCCC), is needed. In addition to external finance from developed countries and other sources such as the Green Climate Fund (GCF), developing countries are also exploring innovative financing pathways including debt for climate swaps.



# III. Debt Profiles of the Pacific SIDS

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As will be discussed in more detail below, debt swaps offer a viable solution to environmental and financial challenges in indebted countries and have been utilized multiple times since the 1980s. To determine the suitability of debt swaps in the PSIDS, it is useful to take a closer look at their debt profiles.

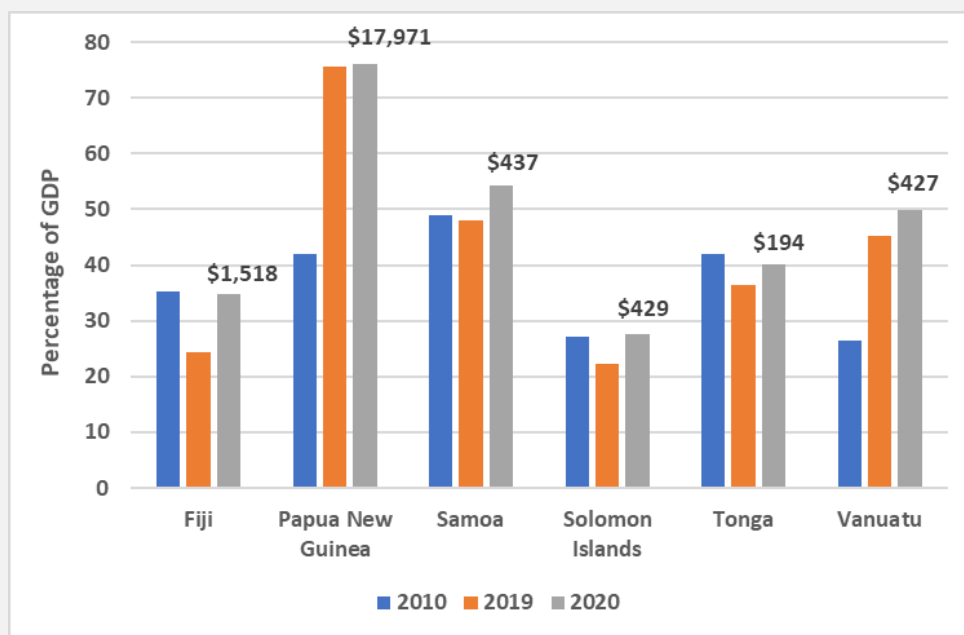
As a share of the GDP, the total external debt in the PSIDS in 2020 is highest in Papua New Guinea (76 per cent), Samoa (54 per cent) and Vanuatu (50 per cent), followed by Tonga (40 per cent), Fiji (35 per cent) and the Solomon Islands (28 per cent) (figure 2). Between 2010 and 2020, the annual average rate of increase in debt levels was highest in Papua New Guinea (12 per cent), followed by Vanuatu (9 per cent) and Solomon Islands (6 per cent). Between 2019 and 2020, it grew fastest in Solomon Islands (22 per cent) and Fiji (13 per cent). Between 2010 and 2019, the debt-to-GDP ratio increased only in Papua New Guinea (35 percentage points) and Vanuatu (19 percentage points), but between 2019 and 2020 it increased in the six countries.

The composition of the total external debt of the PSIDS differs across countries. Figure 3 shows data for 2020. In Papua New Guinea and Solomon Islands, most of the debt is private and non-guaranteed, representing 66 per cent and 60 per cent respectively. In Tonga, Samoa, Vanuatu and Fiji, the main component of the

external debt is public and publicly guaranteed debt, which represents respectively 95 per cent, 90 per cent, 83 per cent and 60 per cent of the total. The other two components, use of the IMF credit and short-term debt, are relatively small, representing on average 6 per cent and 3 per cent of the total external debt respectively.

The composition of the external public and publicly guaranteed (PPG) debt also varies across countries. Of the six PSIDS included in the World Bank's International Debt Statistics database, only Papua New Guinea had PPG debt with private creditors in 2020, representing 18 per cent of the total (figure 4). The main holders of PPG debt in Fiji, Papua New Guinea, Samoa, and the Solomon Islands were multilateral creditors, which represented, respectively, 71 per cent, 50 per cent, 52 per cent and 95 per cent of the total. In Tonga and Vanuatu bilateral creditors were the main holders of PPG debt, representing 58 and 59 per cent of the total respectively. Among the bilateral creditors, China is the most important country, representing 74 per cent of the total for the median PSID. Other bilateral creditors include Japan, Australia, India, and Republic of Korea (figure 5). The importance of China as a bilateral creditor of the PSIDS may be even higher. According to the OECD, the official statistics underrepresent the external debt because Chinese official creditors often lend to special-purpose vehicles that are not fully reflected in the IMF/WB data (Piemonte, 2021).

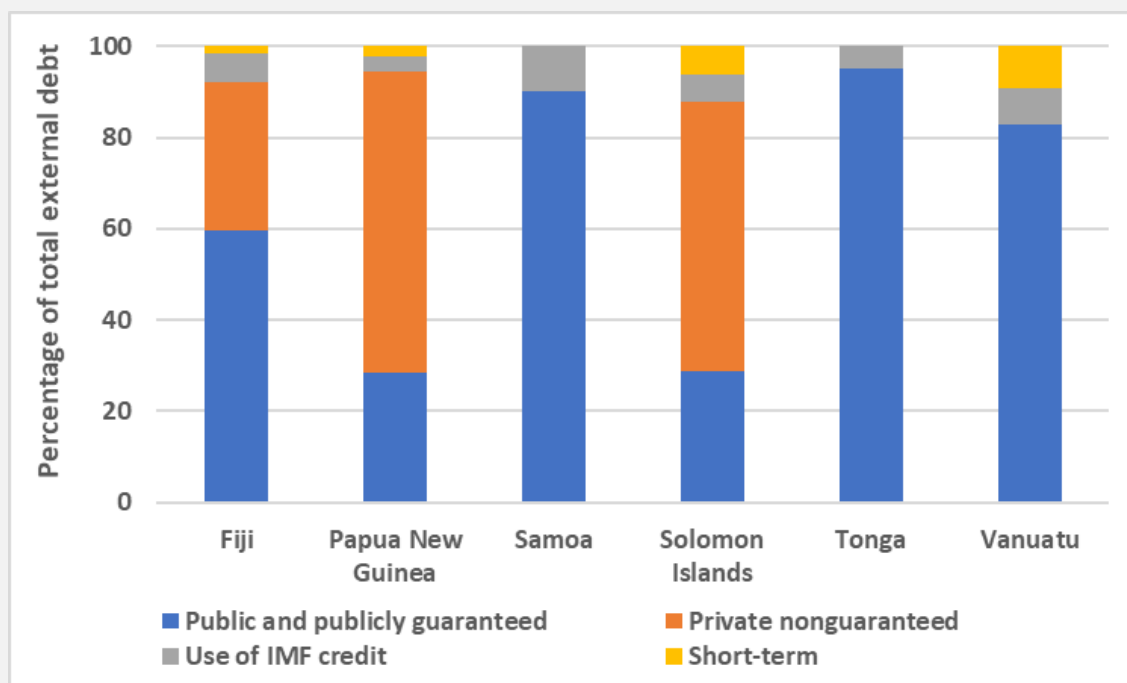
**FIGURE 2: TOTAL EXTERNAL DEBT OF SELECTED PSIDS IN 2010, 2019 AND 2020**



Source: World Bank, International Debt Statistics database.

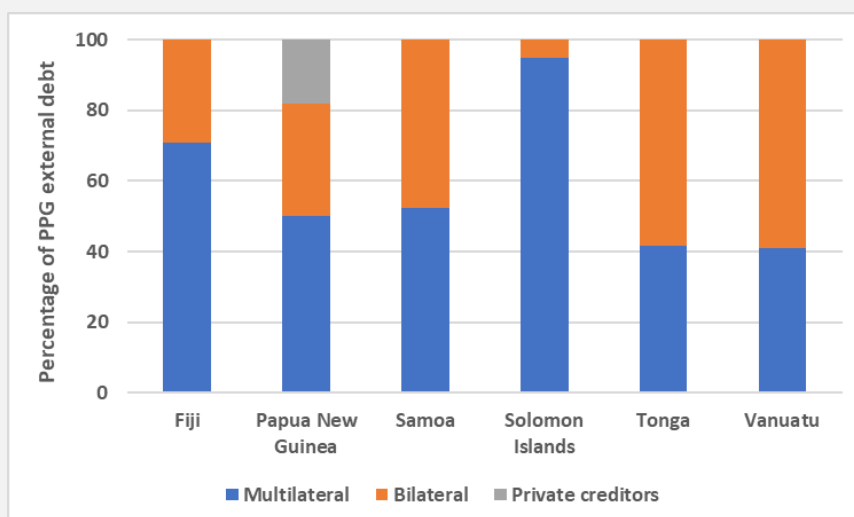
Notes: The values in the figure are the total external debts in 2020, in millions of current USD.

**FIGURE 3: COMPOSITION OF THE TOTAL EXTERNAL DEBT STOCKS OF SELECTED PSIDS IN 2020**



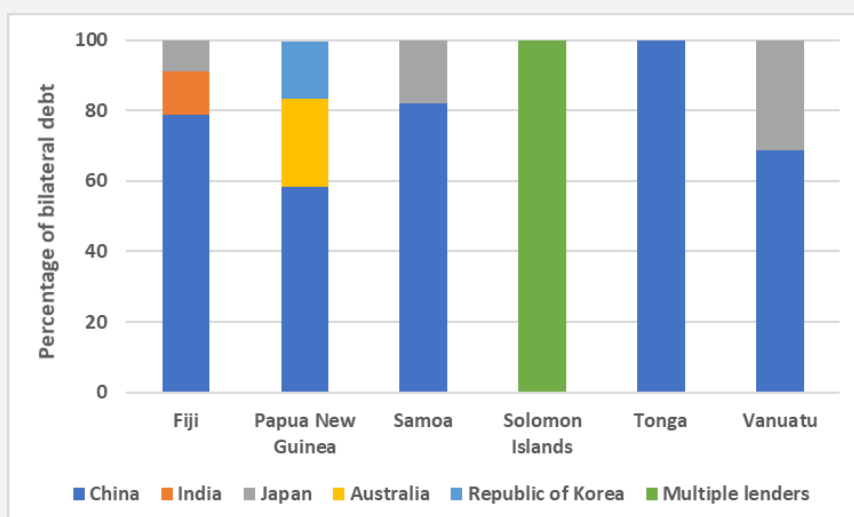
Source: World Bank, International Debt Statistics database.

**FIGURE 4: COMPOSITION OF THE EXTERNAL PUBLIC AND PUBLICLY GUARANTEED DEBT OF SELECTED PSIDS IN 2020**



Source: World Bank, International Debt Statistics database.

**FIGURE 5: COMPOSITION OF THE EXTERNAL BILATERAL DEBT OF SELECTED PSIDS IN 2020**



Source: World Bank, International Debt Statistics database.

To conclude the presentation of the Pacific SIDS debt profile, table 1 shows the latest IMF/WB assessments on the risk of external debt distress from debt sustainability analyses and the levels of general government gross debt in 2019 and 2020. For comparison, the table also includes data on PPG external debts for 2019 and 2020. Of eleven PSIDS, seven are at high risk of external debt distress, one at very high risk of debt distress, and only three at moderate risk of debt distress.

The table shows that Fiji and Papua New Guinea have significantly higher general government gross debts compared to their PPG external debts, implying that domestic creditors play an important role in financing the government's debt. In these two countries, the general government gross debt increased the most between 2019 and 2021: 30 per cent and 9 per cent of the GDP. All the other PSIDS, except for Solomon Islands, experienced minimum change and mostly decreases in their general government gross debt to GDP ratios. This could be due to the availability of additional support by donor countries through grants.

**TABLE 1: DEBT SUSTAINABILITY ASSESSMENTS  
AND GENERAL GOVERNMENT DEBT LEVELS FOR SELECTED PSIDS**

	Risk of external debt distress	General government gross debt (Percentage of GDP)			Memo item: PPG external debt (Percentage of GDP)	
		2019	2020	2021	2019	2020
Fiji	Moderate	48.7	62.0	79.2	13.0	20.6
Federated States of Micronesia	High	18.6	15.9	15.0		
Kiribati	High	20.1	19.0	17.6		
Marshall Islands	High	24.8	19.0	14.8		
Nauru	Very high	62.8	61.4	27.1		
Papua New Guinea	High	40.2	46.4	49.3	17.4	21.7
Samoa	High	47.5	46.5	49.6	45.5	48.8
Solomon Islands	Moderate	8.2	13.1	16.5	6.2	8.0
Tonga	High	41.3	43.3	44.7	34.6	38.3
Tuvalu	High	11.5	7.3	6.0		
Vanuatu	Moderate	46.2	49.4	47.3	36.7	41.4

Source: DSA ratings from World Bank, COVID 19: Debt Service Suspension Initiative, 24 September 2021. Available at [www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative](http://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative); general government gross debt to GDP ratios from IMF, World Economic Outlook Database, April 2022; PPG external debt from World Bank, International Debt Statistics.

Notes: The DSAs of Nauru and Fiji were part of Article IV reports issued in January 2020 and March 2020, respectively.

# IV. Access to climate finance from multilateral and bilateral donors

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Despite several multilateral and bilateral donors being active in the PSIDS, these countries have difficulties accessing sufficient financing for climate action. The IMF estimates that between 2014 and 2019 only about 20 per cent of the approved adaptation funds were recorded as disbursed (IMF, 2021). Thus far, the international community has failed to make adequate progress in mobilizing climate finance. The financing needs outlined in the available NDCs are much higher than the financing volumes received from major available sources such as the Green Climate Fund (GCF), the main climate fund in the Pacific region. The GCF cumulative approvals for both adaptation and mitigation projects in the PSIDS have been less than half of the PSIDS's estimated annual needs, and the cumulative GCF disbursements represent approximately a quarter of their annual needs (IMF, 2021).

Between 2010 and 2014, the Pacific island countries received a total of USD 748 million in climate finance, of which USD 210 million were contributed by multilateral climate funds (Atteridge and Canales, 2017). Since the establishment of the GCF in 2015, USD 603 million have been approved for grants in the Pacific from multilateral climate funds, including USD 362 million from GCF, USD 210 million from the Global Environment Facility (GEF), and USD 21 million from the Adaptation Fund.<sup>3</sup> For

the period 2010-2020 PIFS estimated that the Pacific accessed a total of USD 2.2 billion in climate finance, of which more than 59 per cent was sourced from bilateral sources and 41 per cent from multilateral sources.<sup>4</sup>

The GCF project approval time for LDCs is often long, with a median time of 619 days or 21 months between November 2015 and July 2021. Because submissions are made quarterly in accordance with the GCF project submission schedule, this could represent 6 to 7 rounds of reviews of the funding proposal at the GCF Secretariat and/or from an Independent Technical Advisory Panel (ITAP). The shortest approval time for LDC projects was 113 days (about 4 months) and the longest was 1727 days or 58 months. Adaptation projects had the longest average time of 22 months compared to 20 months for mitigation and cross-cutting projects (Climate Analytics, 2021).

As pointed out in the introduction, a failure to identify fundable projects is among the main reasons given by donors for their inability to disburse funds faster, especially for adaptation projects and activities, while recipient countries highlight difficulties in accessing available resources due to insufficient capacities to fulfil specific requirements established by donors and climate funds.

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3 [www.sprep.org/sites/default/files/30-SPREP-Meeting/Officials/Eng/WP\\_7.2-Securing\\_climate\\_financing%20.pdf](http://www.sprep.org/sites/default/files/30-SPREP-Meeting/Officials/Eng/WP_7.2-Securing_climate_financing%20.pdf).

4 [www.forumsec.org/wp-content/uploads/2021/07/Leveraging-Climate-Finance-Opportunities\\_Final.pdf](http://www.forumsec.org/wp-content/uploads/2021/07/Leveraging-Climate-Finance-Opportunities_Final.pdf).

# V. Debt for nature swaps

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A debt for nature swap is an agreement between a creditor and a debtor by which the former forgives a portion of the latter's foreign debt in exchange for a commitment to invest in a specific environmental project. Debt for nature swaps first appeared in the context of the debt crisis of the 1980s, which affected mainly Latin America. They aimed both at reducing unsustainable external debts and at addressing worsening environmental conditions in developing countries caused by the exploitation of natural resources, including deforestation. Debt swaps can also be used to finance climate mitigation and adaptation projects, in which case they can be called debt for climate swaps. Two main types of debt for nature swaps, illustrated in **Error! Reference source not found.6**, have been popular: bilateral or direct swaps and third-party swaps.

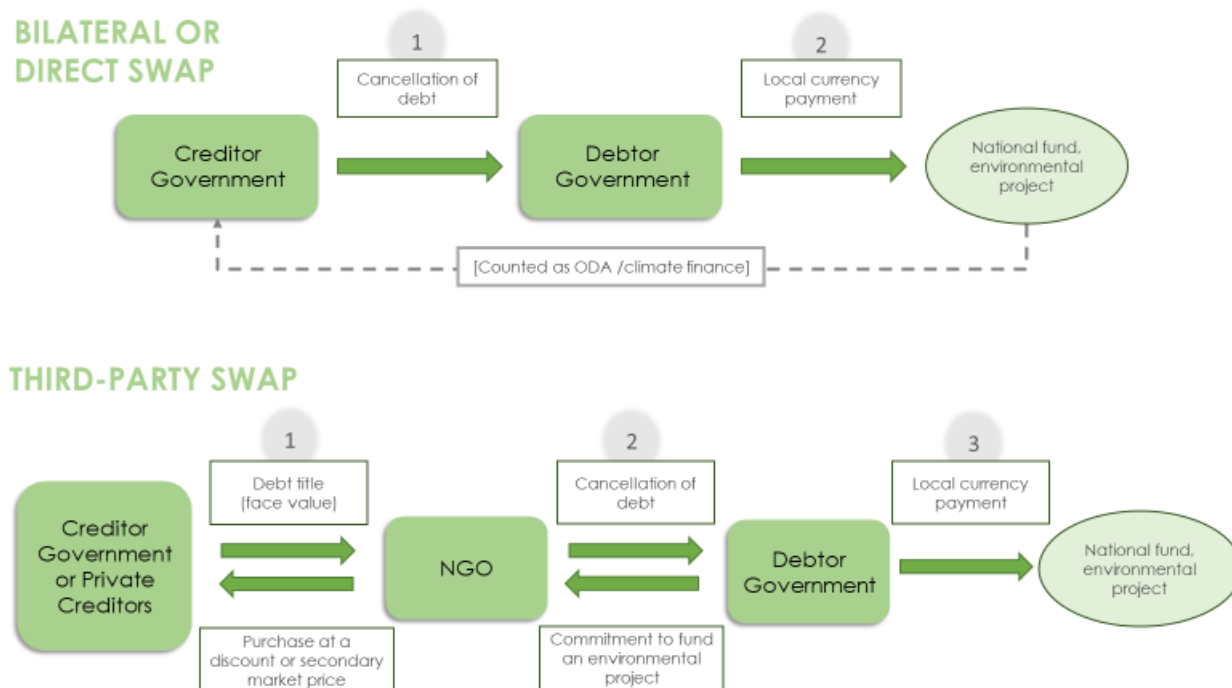
**Bilateral or direct swaps:** When the swap is bilateral, the creditor government directly cancels debt owed by the debtor government in exchange for the debtor setting aside an agreed amount of counterpart funds in local currency for an agreed purpose, such as a nature conservation project. This model has been used principally in official (government to government) debt swaps. Bilateral swaps can also be multilateral when they involve multiple creditor countries (Bove, 2021).

**Third-Party Swaps:** Third-party swaps involve the debtor, the creditor(s), and an environmental NGO such as Conservation International, The Nature Conservancy, or World Wildlife Fund. In

this scheme, an NGO typically purchases outstanding debt of the debtor country to private creditors in the secondary market at a discount. The NGO can also acquire outstanding debt of the debtor country from an official bilateral creditor at a discount. The NGO then passes the savings to the debtor by refinancing the debt at a lower face value under the condition that the debtor allocates an agreed part of the savings in debt service payments, in local currency, to pre-agreed conservation investments. In this second leg of the transaction, the NGO can also lower the interest rate on the discounted debt, change its currency of denomination, or even cancel it (Bove, 2021). In addition to its role as intermediary, the NGO also plays an important role by contributing expertise and services to facilitate the country's investments towards conservation measures (Bove, 2021).

Under both models, after an agreement is reached between the debtor government and its creditor(s) the former commits to periodically transfer a pre-agreed amount to a dedicated trust fund, usually based on the original debt repayment schedule. The trust fund often provides grants to local NGOs for the implementation of agreed environmental projects or programmes, for which any interest earned on the trust fund adds funding. To facilitate earmarking to pre-agreed projects and increase accountability, the governance structure of the trust fund is important. A useful governance structure is a committee comprised of representatives from both governments and independent observers such as national or international NGOs.

**FIGURE 6: BILATERAL AND THIRD-PARTY SWAPS**



Source: Adapted from M. Olshanskaya and others, “Evaluating the fiscal and environmental efficacy of debt-for-climate swaps: using global case studies to derive recommendations for countries of Central Asia and the Caucasus”, Working Paper (Berlin, Institute for Climate Protection, Energy and Mobility (IKEM), 2020).

Commercial debt can be purchased in the secondary market both by an NGO, as it has been typical in third party swaps, or by a donor country. In that latter case, the portion of the debt forgiven to the debtor could count as ODA or as climate finance under the UNFCCC (DFI, 2009).

In the case of commercial debt acquired in the secondary market, the price is determined by the credit rating, debt situation, and overall economic performance of the indebted country. However, when debt titles are bought back through a bilateral agreement between the debtor government and the creditor government, the discount rate is determined through a negotiation between the parties (Ruiz, 2007).

Generally, debt swaps are more feasible when creditor governments are willing to sell titles at a price lower than face value, because only then there is some fiscal space created for the debtor government. However, as bilateral debt is predominantly held in US dollars and investments in local environmental projects are generally made in local currency, a debt swap agreement could still be beneficial to the debtor country even if the discount rate is zero because it allows scarce hard currency to be saved.

In the past, most debt swaps have involved bilateral public debt or commercial debt, but debt swaps can also be conducted with multilateral public creditors. Although multilateral creditors such as the World Bank cannot provide debt relief due to operating procedures agreed by their shareholders (Mitchell, 2016), donor countries could use their resources to pay off developing countries’ debt to such creditors.

A successful example of a debt for nature swap undertaken by the Seychelles took close to four years to negotiate and lifted this mechanism to a new level of complexity. A total debt volume of USD 21.6 million with several Paris Club creditors – Belgium, France, and the United Kingdom – was cancelled in exchange for projects in marine conservation and climate adaptation (Silver and Campbell, 2018). The Seychelles government started designing the scheme in 2011 and negotiations with NatureVest, the impact investment unit of The Nature Conservancy (TNC), were completed in 2015 (Convergence, 2017). Initially, the deal was supposed to entail a USD 80 million debt swap, but following initial discussions Germany opted out of the deal and France reduced part of its debt claims.



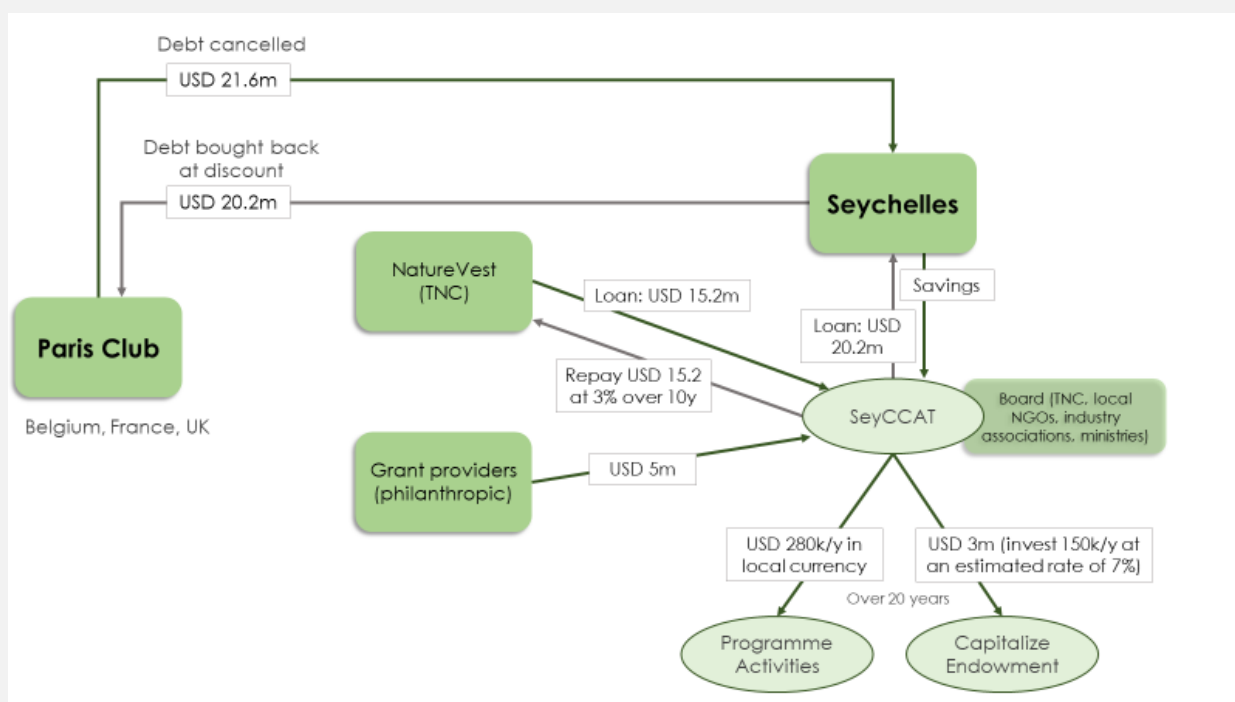
Figure 7 contains details of the Seychelles debt for nature swap. The discount provided by the Paris Club participating governments was small, 6.5 per cent. The main attractiveness of this deal for the Seychelles government was a concessional 10-year loan for USD 15.2 million at an annual interest rate of 3 per cent provided by NatureVest plus a grant for USD 5 million provided by philanthropists such as the Leonardo DiCaprio Foundation, the Oak Foundation, or the China Global Conservation Fund. This constituted an innovation in debt swaps as grants from charities had not been previously used as a source of finance.

The sum of the concessional loan and the grant provided the Government of Seychelles USD 20.2 million USD to cancel USD 21.6 million debt at a 6.5 per cent discount. In exchange, the government committed to use its savings to contribute funding for conservation activities in local currency for the equivalent of USD 280,000 per year for 20 years and an additional USD 150,000 per year to an endowment fund for

future conservation activities (Convergence, 2017). All the relevant financial transactions, as well as the selection of projects and their monitoring, review and verification, are conducted by Seychelles Conservation and Climate Adaptation Trust (SeyCCAT), the board of directors of which includes representatives from TNC, local NGOs, industry associations, and relevant ministries.

Another interesting example of a debt swap design is a proposal jointly developed by the Commonwealth Secretariat, the World Bank, and the Economic Commission for Latin America and the Caribbean (ECLAC), in which donors write off small states' multilateral debt using their climate finance pledges in exchange for investments in mitigation or adaptation projects (Mitchell, 2015a; 2015b; 2016; see also ECLAC, 2016; 2017). This scheme is particularly suitable for small states that have difficulties accessing donors' climate finance commitments as they fail to comply with specific conditionalities or lack absorption capacity.

**FIGURE 7: OVERVIEW OF THE DEBT SWAP BETWEEN THE PARIS CLUB AND THE SEYCHELLES**



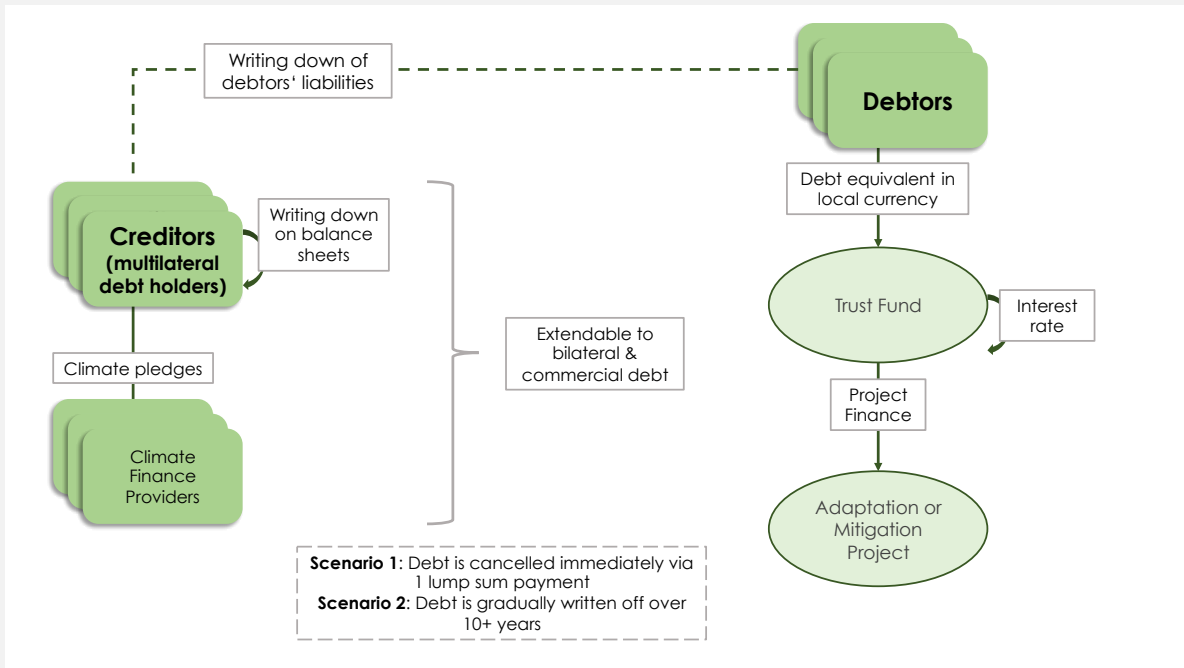
Source: Adapted from M. Olshanskaya and others, "Evaluating the fiscal and environmental efficacy of debt-for-climate swaps: using global case studies to derive recommendations for countries of Central Asia and the Caucasus", Working Paper (Berlin, Institute for Climate Protection, Energy and Mobility (IKEM), 2020).

Notes: SeyCCAT: Seychelles Conservation and Climate Adaptation Trust; TNC: The Nature Conservancy.

The funds transferred from donors to multilateral institutions can be scheduled annually, as subscriptions, or as one upfront lumpsum payment. Small states then make annual payments into a trust fund in an amount close to the initial debt service but in local currency over

10-15 years. As noted above, interest earned by the trust fund can be used to provide additional finance to environmental projects. **Error! Reference source not found.**<sup>8</sup> illustrates the key elements of the Commonwealth proposal.

**FIGURE 8: OVERVIEW OF THE DEBT SWAP SUGGESTED BY THE COMMONWEALTH**



Source: Adapted from M. Olshanskaya and others, "Evaluating the fiscal and environmental efficacy of debt-for-climate swaps: using global case studies to derive recommendations for countries of Central Asia and the Caucasus", Working Paper (Berlin, Institute for Climate Protection, Energy and Mobility (IKEM), 2020).

# VI. Opportunities and challenges in light of the post-COVID recovery

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In 2020, total global debt reached a record USD 281 trillion, equivalent to 355 per cent of global GDP (Maki, 2021). The debt burden of the world's low-income countries rose by 12 per cent to a record USD 860 billion in 2020, and the external debt stocks of low- and middle-income countries combined rose by 5.3 per cent to USD 8.7 trillion in 2020 (World Bank, 2021). Despite the growing levels of debt, there remains an urgent need to scale up investment in development and climate resilience.

The Pacific SIDS are suffering a triple crisis of climate change, COVID-19, and debt.<sup>5</sup> The SIDS' vulnerabilities to climate change have been internationally recognized since the Rio Earth Summit in 1992, and the Paris Agreement and Glasgow Climate Pact also explicitly recognizes the priorities and needs of SIDS for public and grant-based financial resources.

As discussed above, the COVID-19 pandemic shrank fiscal spaces and increased external debts in the Pacific SIDS. With lower fiscal revenues and additional fiscal expenditures to recover from the pandemic and to service additional public debts, these countries have less resources to finance crucial investments to climate-proof their economies and achieve a green, resilient, and equitable recovery.

In this context and due to the potential of debt for climate swaps to tackle this triple crisis simultaneously, it is likely that China and the members of the Paris Club may be interested in supporting debt for climate swaps in the Pacific SIDS.

While specific designs can vary, all debt for climate swaps share the same underlying mechanism: the public debt of a debtor country is partially cancelled in exchange for domestic investments in climate-related actions, and the reduction in debt counts towards the creditor's climate finance commitments (ESCAP, 2021). Debt for climate swaps can thus enable the financing of climate action in the Pacific SIDS targeted to both mitigation and adaptation. As such, they can contribute to the implementation of national disaster risk financing strategies and reduce the adverse financial implications of climate-related disasters.

In addition to allowing developed countries to fulfil their commitment to mobilize climate finance under the Paris Agreement and reiterated in the recent Glasgow Climate Pact, debt for climate swap in the Pacific SIDS have the potential to leverage additional finance towards the fulfilment of commitments in the debtor countries' NDCs. By providing debt relief while mobilizing new finance for climate change mitigation and adaptation, debt for climate swaps can simultaneously address both the climate crisis and the debt crisis.

While the need for action is clear, it is useful to review the opportunities and challenges of debt for climate swaps for both debtors and creditors (table 2).

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5 As a result of the war in Ukraine, global increases in food and energy prices since March 2022 are contributing additional stress to governments' finance

and are likely to result in further increases in public debts.

**TABLE 2: OPPORTUNITIES AND CHALLENGES FOR THE INVOLVED PARTIES**

Advantages and positive outcomes for the debtor country	Advantages and positive outcomes for the creditor country	Shortfalls and challenges
<ul style="list-style-type: none"> <li>- Through debt relief and conversion, the overall debt burden on the debtor country is lowered and the strain on the national budget is reduced.</li> <li>- Since counterpart payments into environmental projects are generally made in local currency, debtor governments save scarce hard currency which they can then use to build foreign exchange reserves.</li> <li>- Debt swaps have the potential to improve the overall macroeconomic situation of an indebted and developing country through alleviating its public debt burden in the medium term and creating fiscal space in the short term.</li> <li>- Debt relief can strengthen economic stability, improve the credit rating of a debtor, and attract new investments.</li> <li>- Environmental projects benefit from freed finance that would have otherwise gone towards the creditor's budget, often bringing economic and social benefits at a local level.</li> <li>- Grants to environmental projects or local NGOs are typically distributed via a trust fund which is set up according to the original repayment schedule. This long-term regular funding facilitates investments in climate finance.</li> </ul>	<ul style="list-style-type: none"> <li>- From a financial perspective, creditor countries' remaining debt claims increase in value through such swaps, and creditors can recover either full or at least a larger part of their debt. Debt swaps are particularly beneficial if parts of the debt have been already written off but full repayment remains unlikely.</li> <li>- Creditors have to mobilise less additional finance to meet their international climate commitments and, at the same time, can register the instrument as the provision of ODA. Since the nominal value of non-concessional debt can be registered as ODA, many creditor countries have used this instrument to boost their ODA numbers.</li> <li>- Further, creditor countries can raise their environmental credentials by mobilising co-financing through international funding institutions. A debt swap that is carefully designed can guarantee an adequate use of funds and carry a greater weight than a single donation.</li> <li>- Debt for climate swaps can help developed countries reach their COP 26 target of mobilizing at least USD 100 billion annually by 2023 while providing developing countries with additional resources for mitigating and adapting to climate change.</li> </ul>	<ul style="list-style-type: none"> <li>- If the write-off rate is low or even zero, no extra-budgetary room is provided, which leaves the overall macroeconomic situation unaffected.</li> <li>- If the debt swap volume is small, the positive impact on the debtor's economic situation is negligible or might even be outweighed by the costs incurred when negotiating a swap and setting up a trust fund.</li> <li>- Debtor countries must have sufficient funds to put into trust funds, and there exists a risk of inflation if debtor governments print money to pay the agreed amount in local currency. This risk does not apply to countries that do not have a national currency.</li> <li>- Debt swaps carry the threat of crowding out other forms of finance that are potentially more effective. Debt swaps should be additional to the already delivered ODA and not substitute other channels of new aid.</li> <li>- Climate-relevant debt swaps have to compete with other sectors (health, education, infrastructure) for a limited amount of eligible debt.</li> <li>- Countries will need to negotiate with creditors specifying the conditions of the swap, reduced debt, selection of projects, implementation and monitoring, additional financial sources, connections with the SDG's and the Paris Agreement.</li> </ul>

# VII. Recommendations for a financial structure of a debt for climate swap arrangement

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Based on the description of debt swaps and the opportunities and challenges discussed above, the debtor country designing and negotiating a financial structure of a swap mechanism to maximize the financial values of such schemes should consider the following essential features:

- Seek to achieve a positive difference between the original **face value of the debt** and the redemption price so that fiscal space is created. This can be done either by purchasing debt titles in the secondary market in the case of commercial debt or by bilaterally agreeing with an official creditor on applying a write-off rate greater than zero.
- Negotiate a full or partial cancellation of the outstanding **debt service payments** before making counterpart payments to a trust fund to provide extra-budgetary room. This could be achieved either by bilateral negotiation with the creditors or, more likely, through a third party that can raise finance to pay back the debt to the creditors and refinance it at more favourable terms, including a grant element and concessionality in the interest rate.
- Ensure that savings in debt service payments are channelled in **local currency** into a trust fund that will invest in climate adaptation and mitigation projects, so that hard currency reserves can be preserved.
- Schedule payments according to the **original repayment schedule** so that a constant and predictable stream of finance is provided to invest in climate adaptation and mitigation.
- Allocate part of the funding in the trust fund to financial assets and **re-invest the return** on those assets to provide additional capitalization for the trust fund.
- Only conduct debt swaps if the savings in debt services payments are **large enough** to justify the lengthy negotiation process and high transaction costs associated with debt restructuring and implementation.

The additionality of the funding should be ensured in three ways. First, debt swaps and their corresponding debt relief should be **additional to existing ODA commitments** and not crowd out other ongoing investments in climate mitigation and adaptation. Second, climate-related projects funded by debt swaps should be **additional to climate and non-climate projects** already funded in debtor countries, and payments originating from swap deals should not be used to legitimise cutting back governmental spending in other areas. Finally, it is essential to ensure **financial additionality for the debtor country through debt relief**.

The design of the climate swap mechanism should also be **aligned with national climate commitments**. In particular, the activities funded by the swap should be fully anchored in and aligned with national climate change priorities and the objectives communicated in the NDCs.

To ensure the achievement of climate and other environmental and social benefits through a climate swap scheme, it is important to establish a **baseline scenario** against which both progress and final outcomes are measured. This entails developing **key performance indicators** and defining specific **targets** for the various steps throughout the implementation

phase. **Monitoring plans and methodologies** also need to be developed to enable regular progress tracking, reporting and communication to all stakeholders and the wider community to ensure transparency.

The involvement of **independent actors, such as environmental NGOs**, has also proven helpful to facilitate trust between a debtor and creditor government and has been crucial for encouraging civil society participation. While international NGOs such as Conservation International and the World Wildlife Fund have gathered extensive experience in facilitating debt for nature swaps, the contribution of a local or regional organization like the new Pacific Resilience Facility is similarly important to provide insights about local conditions. Moreover, studying the effectiveness of implemented projects will help guide policymakers in designing future swaps according to best practices.

**Effective implementation and governance structures** are essential for the success of the swap mechanism. The priority is the establishment of an operator of the scheme, which can be selected among existing organizations. This should be a financial institution with solid funds management expertise and technical capacities to implement climate projects. The combination of financial and climate expertise rarely exists in developing countries and often has to be built from scratch with additional technical assistance from international organizations such as the Global

Environmental Facility or the Green Climate Fund (GCF), as was the case in Seychelles. As mentioned above, a good practice is to establish a **supervisory committee** that is comprised of representatives of both the debtor government and the creditors, as well as international and national NGOs, to provide oversight and strategic guidance.

The **debtor government's leading role and close involvement** in designing and implementing a swap deal is crucial to ensure national ownership and the longevity of the program. At the negotiation stage, political support of the climate swap proposal at the highest level has proven decisive to make the deal happen. Crucially, the climate-related projects funded must be anchored in national climate policies and the debt swap must be **embedded in a broader debt reduction strategy**.

Countries that participate in swaps can also take advantage of their experience to improve their organizational capacity and enhance the skills of their personnel. In fact, single swap arrangements can be steppingstones for future debt swaps. While it has been widely criticized that debt volumes in past swaps were too small to have any substantial impact on the overall debt burden and economic situation, **establishing an infrastructure and institutional capacity** allows for the continuation of support and can promote the use of this mechanism in the future.



# VIII. Possible architecture for a debt for climate swap in the Pacific

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As discussed above, debt for climate swaps can either be arranged directly between a debtor and one or more creditor governments (bilateral or multilateral swaps) or facilitated by a third party (third-party swaps). In both kinds of debt for climate swaps, two potential concerns for creditors and third parties, in the case of a third-party debt swap, are the use of the funds saved and the effectiveness of the climate mitigation or adaptation projects to be implemented. As suggested above, a solution to both concerns is to set up an independent entity such as a trust fund or facility with responsibility for managing the saved funds, allocating them to appropriate projects, and monitoring, reporting and verifying the execution of these projects. The use of an independent facility or trust fund will involve additional costs such as management fees.

In the case of the Pacific SIDS, a suitable independent facility for the implementation of debt for climate swaps could be the Pacific Resilience Facility (PRF). The PRF is a multi-donor funded facility that aims to provide predictable, sustainable, accessible, and accountable grant funding, with technical assistance if required, for community-level projects across the Pacific SIDS (Pacific Islands Forum, 2021). The projects to be funded by the PRF will aim to increase community resilience to climate-induced disasters. The PRF will have capacities to both manage funds and to provide technical support in areas such as monitoring, reporting and verification. Because both functions are critical for the success of a debt for climate swap, the PRF could play a similar role to SeyCCAT in the Seychelles swap (figure 7) or the trust fund in the Commonwealth proposal (figure 8).

Using the PRF could be advantageous to both Pacific debtors interested in a debt for climate swap deal and to the PRF itself. For the debtor, the PRF will remove the need to set up a

specialized national entity to manage the funds and oversee the implementation of projects. This possibility is appealing to small economies with limited human resources to undertake specialized financial and technical functions. For the PRF, supporting debt for climate swaps will provide it with additional experience and expertise in both fund management and in the technical management of climate projects that will be transferable to projects funded by the fund itself. In addition, having a single entity managing debt for climate swaps in several countries will allow it to reach an economically efficient scale and reduce overhead costs.

To be sure, the PRF is not funded yet and it will take some time until it is fully staffed and ready to support the implementation of climate projects in the Pacific SIDS. In the interim, debtors seeking a debt for climate swap deal could make alternative institutional arrangements with a development partner, international NGO or private entity with the appropriate capacity and technical and financial expertise.

The Commonwealth proposal described in figure 8 is a suitable architecture for debt for climate swaps in the Pacific SIDS because it is applicable to debt with MDBs as well as bilateral creditors, which hold the great majority of the Pacific SIDS's debt. According to this proposal, Annex II countries of the UNFCCC could partially pay back debt of the Pacific SIDS with MDBs or bilateral creditors and register such payment as a contribution towards their climate finance commitments. For the scheme to work, Pacific SIDS interested in accessing this novel form of financing should have a suitable pipeline of climate projects that contribute to the implementation of their NDCs and could be started as soon as financing becomes available. Building such project pipelines may require technical assistance, but this is a worthy



undertaking, as the projects in the pipeline could be financed through other available sources. Furthermore, if debt for climate swaps become a more standard modality of climate finance, thus expanding the potential pool of funds for climate projects, countries will be motivated to increase the level of ambition and degree of detail in their NDCs.

To acquire appropriate technical and financial capacities to negotiate debt for climate swaps, a useful source of funding is the Readiness and Preparatory Support Program of the GCF. This program supports country-driven initiatives by developing countries to strengthen their institutional capacities, governance mechanisms, and planning and programming frameworks towards a transformational long-term climate action agenda (Green Climate Fund, 2022). The annual funding for each eligible country is up to USD 1 million, of which up to USD 300,000 may be used for strengthening the National Designated Authority (NDA) and up to USD 700,000 may be allocated

to a potential partner, which could include the PRF.

Additional factors that need to be considered include the extent to which the outstanding debt service payments have been already written down by the creditor government and the overall economic situation and growth projections of the debtor country. Countries may negotiate with creditors bilaterally, or if they do not have the necessary capacity, they may delegate this to another entity such as PIFS or the UN. Alternatively, they could negotiate bilaterally with assistance from PIFS or the United Nations.

Finally, it is important to note that countries that have higher transparency in debt reporting and monitoring and pledge increased climate commitments in their NDCs under the Paris Agreement may receive more favourable consideration by creditors and development partners for the implementation of a debt for climate swap.

# IX. Conclusion

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The PSIDS are among the most vulnerable countries to climate change, their debt situation worsened over the last decade but most importantly after the COVID-19 pandemic, a large number of them are at high risk of debt distress, and the conventional sources of climate finance are notoriously insufficient. This justifies the search for financing options for

climate action, specifically for adaptation investments. Based on the analysis of the experience and policy recommendations, with support from key partners, debt for climate swaps are a feasible option to address the insufficient availability of climate finance in the PSIDS in conjunction with ongoing development support.

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