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The EU and debt-for-climate swaps: Geopolitical ambitions and development impacts

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Summary

Debt swaps, a financial transaction where creditors forgive a portion of a country's foreign debt in exchange for investment in sustainable development, are praised as one of the innovative solutions to provide additional resources to support developing countries.

So far, the implementation of commercial debt-for-nature swaps has been largely led by the US and the Inter-American Development Bank, with transactions taking place in the Latin America and Caribbean (LAC) region. With the expansion of debt swaps to Africa (see the example of Gabon), there is merit in understanding and analysing why and how Europe could position itself in this field based on its current institutions, assets and instruments. The paper provides concrete options on a possible European approach to engage in commercial debt-for-climate swaps, as a means to achieve development and environmental impact and strengthen the geostrategic positioning of the European Union.

1. A current landscape dominated by the US

Debt-for-climate (and development) swaps are increasingly recognised by multilateral institutions (International Monetary Fund - IMF, Multilateral Development Banks - MDBs), donors and partner countries as one of the innovative tools that can help channel investments in climate action and the Sustainable Development Goals (SDGs), without adding to the debt burden of developing countries. In fact, S&P Global recently declared that "*debt-for-nature swaps have gained traction among sovereigns in Latin America, and their appeal will increase in coming years among lower-rated issuers*."

The use of debt-for-climate swaps has been growing (Figure 1), particularly commercial debt-for-climate swaps (as opposed to bilateral debt-for-climate swaps), especially since its introduction in Belize in 2021, which can be considered as a pilot type of approach. Given its success, and building on the lessons learnt, commercial debt-for-climate swaps have been replicated in new geographies (Gabon) and have reached scale (see the case of Ecuador) allowing for greater impacts. While some, including in the EU, consider the instrument not efficient enough - part of which is explained by the novelty and pilot approach - the experience of Belize and other partner countries seem to suggest that debt swaps can deliver impact, provide highly concessional finance which sources are increasingly scarce and limited, and pushes partners countries to commit to investing in SDGs in the long-term.

Figure 1: Ten debt-for-climate swaps between 2018 and 2023

Source: ECDPM guide 2023.

They are not anymore a pilot instrument but an increasingly mature instrument, which raised the attention not only of policy-makers but also multilateral development banks (MDBs), as seen in the recent COP28 and the creation of the Task Force on Credit Enhancement for Sustainability-Linked Sovereign Financing, led by the Inter-American Development Bank (IDB) and the United States International Development Finance Corporation (DFC). Even private investors such as Climate Fund Managers have been involved in, and plan to facilitate more, debt-for-climate swaps operations.

In this context, the US and its institutions have positioned themselves strongly on commercial debt-for-climate swaps and have shown clear leadership in this endeavour. US DFC and IDB have been the main MDBs offering the critical guarantees needed to support the instrument. Given the initial focus of commercial debt-for-climate swaps on the Latin America and Caribbean (LAC) region, it can seem logical to see the US taking the leadership and in doing so, advancing its own development agenda, interests and geopolitical objectives.

However, now that the instrument is implemented in Africa, that there is increasing demand from African countries (and beyond), and that it is part of the current G7 and G20 agendas[1], one of the questions is whether the European Union (EU) could and should proactively engage in commercial debt-for-climate swaps or whether it should leave the leadership and space to the US and potentially other late-comers such as China, missing the opportunity to respond to partner countries' needs and demands and strengthen its influence in the continent.

The paper aims to provide a better understanding of why and how Europe could position itself in commercial debt-for-climate swaps, given i) the importance of Africa in European development cooperation, ii) its broader involvement in debt swaps, and iii) the range of assets it can leverage to engage in commercial debt-for-climate and development swaps.

2. EU involvement in debt-for-climate swaps

Thus far, European experience with debt-for-climate swaps (and more generally debt-for-development swaps) has focused on the bilateral level, with different EU Member States conducting specific transactions in silos, following their own institutional and operational processes and programmes in place.

For instance, in 2023, a few bilateral debt-for-climate or development swaps were concluded between Germany and Kenya, Egypt; Belgium and Mozambique; while Italy and France extended and signed respectively bilateral debt-for-development swap agreements with Egypt and Côte d'Ivoire. In a rare instance, a few European countries (UK, France, Belgium and Italy) came together under the umbrella of the Paris Club to sign a debt-for-climate swap agreement, which was done back in 2018 with Seychelles.

Though these are positive endeavours supporting climate action and sustainable development investments, the European approach to debt-for-climate swaps is i) highly fragmented, by political choice (national visibility) or by default (see the challenges of adopting a multilateral approach to debt swaps) - resulting in the multiplication of debt swaps management structure, which impacts the efficiency of such intervention, including from a partner country perspective; and ii) small-scale, with the most recent bilateral debt-for-climate swaps ranging from approximately EUR 2 million to EUR 60 million, limiting the number and scope of projects that can be undertaken and hence their transformative impacts - which can be considered as an issue given the scale of finance required for climate action. Last, the negotiations leading to an agreement on a swap often take over a year to be finalised, showing that even a bilateral approach to swaps is relatively lengthy.

Importantly, more innovative approaches are being piloted, including the case of a bilateral debt-for-climate swap between Germany and Egypt, which aims to support the implementation of the energy pillar of the Egyptian country platform "Nexus of Water, Food and Energy" (NWFE-EP), the most important pipeline for Egypt's energy transition. There, the debt-for-climate swaps would aim to attract additional public and private financing, allowing to scale up potential impact.

When it comes to commercial debt-for-climate (or development) swaps, Europe has been shy in its engagement, leaving the space and leadership to the US. In terms of operational support, the EU i) supported the debt-for-climate swap in Ecuador though to a lesser extent than US institutions; ii) approved in principle, under the European Fund for Sustainable Development Plus (EFSD+), a guarantee in 2022 on debt-for-climate swap - though its implementation is not likely to take place before 2025; and iii) backed, through the European Investment Bank (EIB), an innovative (in that it leverages sustainability-linked debt instrument) debt-for-climate swap in Barbados.

Box 1 - Debt-for-climate swap in Barbados

The announced partnership will allow the Government of Barbados to issue approximately EUR 276 million (USD 295 million) equivalent to debt, structured as a Sustainability Linked Bond (SLB) or a Sustainability Linked Loan (SLL). This issuance would be backed by a EUR 280 million (USD 300 million) guarantee. The European Union would provide, through the EIB, a EUR 140 million (USD 150 million) guarantee while the Inter-American Development Bank (IDB) will make available another guarantee of the same amount, subject to the approval of the banks' governing bodies.

These freed-up proceeds from the debt swap would be used to pay for the upgrade of the South Coast Sewage Treatment Plant, a multi-faceted project that aims to increase existing water supplies, mitigate the impacts of climate change, combat seawater intrusion and rising sea levels, diversify potable water sources, as well as reduce the environmental impact of treated effluent on marine life and the local ecosystem. In addition to helping address many challenges linked to water in Barbados, it will also contribute to generating much-needed employment opportunities for the local population. The total estimated cost for the upgrade is EUR 100 million, which requires upfront financing.

Source: Based on European Commission press release November 2023.

A few observations can be made regarding the debt-for-climate swaps in Barbados. First, such an operation involving both IDB and EIB is a smart way to support EIB's capacities by allowing it to learn from IDB on this specific instrument, thereby helping to build the EIB's experience and credibility in this domain. It could well be the case that such an IDB-EIB collaboration could be replicated and strengthened on the way forward. Second, the operation also integrates new innovative features - the Sustainability Linked Bond (SLB) or Sustainability Linked Loan (SLL) aspect, which provides more flexibility than green, social, sustainable, and sustainability-linked (GSSS) bonds, whose use of proceeds is more restricted. In doing so, partner countries also benefit from a stronger influence and ownership on how resources should be used. Third, engaging in commercial-debt-for-climate swaps in Barbados seems like a wise approach to build experience and expertise for the EU as it also meant lower risks in comparison to other countries where such an instrument has never been used, and/or where governments may not have the necessary capacities to manage it.

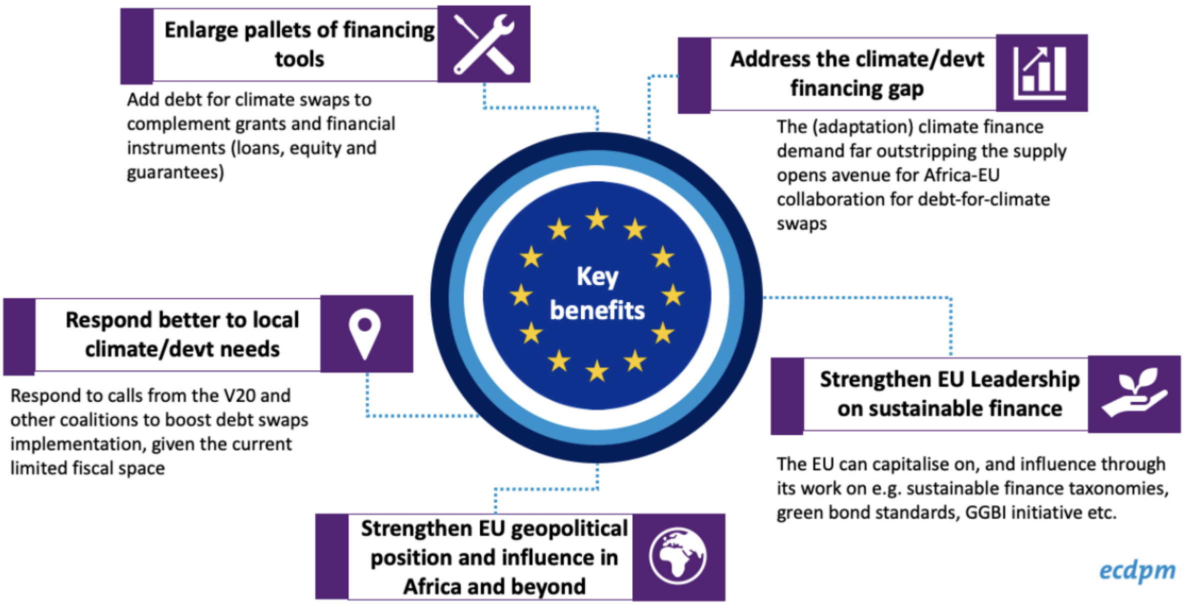
In line with the increasing European efforts to jump on the commercial debt-for-climate swaps bandwagon, the European Union and its Member States have been active in policy dialogues and events, cautiously pushing forward some considerations on the debt-for-climate swap agenda. During the Paris Summit organised by France in 2023, debt-for-climate swaps were discussed as part of the conclusions and roadmap of actions. This was also the case of the Finance in Common Summit in September 2023 and more recently of the COP28, where i) France, together with Kenya and Colombia announced an expert review on debt, climate and nature; and ii) a Task Force on Credit Enhancement for Sustainability-Linked Sovereign Financing was created and initiated by US DFC and IDB and includes the EIB, with a view to supporting the further implementation of debt swaps.

Overall, Europe has started positioning itself on the commercial debt-for-climate swaps agenda, though quite late in the process and in a cautious manner. As a result, it is not yet clear what role the EU and its Member States want to play - rather passive, or on the contrary active and showing some leadership in this field. Would the EU and its Member States not engage further in this field, we could expect other actors such as the US, and China who recently showed interest in debt-for-climate swaps, to gain further weight and visibility on not only the climate finance but also sovereign debt agenda, translating into concrete geopolitical influence on countries where such operations take place. If Europe opts for an (pro)active approach, it will need to be more audacious and strategic in its engagement.

3. What is next?

This Section looks at the strategic benefits of Europe in engaging more actively and strongly in commercial debt-for-climate swaps (Figure 1), and highlights a few options the EU and its member States could pursue to do more.

Figure 2: Why should Europe proactively engage in debt-for-climate swaps (and development)?



Source: From the authors.

First, the current sovereign debt crisis and more especially limited fiscal space, together with limited access to official development assistance (ODA) in the form of grants (or its absence for middle-income countries - MICs) means that developing economies have limited means to invest, and when they do, investments rarely go towards climate adaptation (given other competing priorities such as food security). Having debt-for-climate swaps as yet an additional financial instrument that does not increase sovereign debt vulnerability offers additional possibilities to engage in contexts where equity, loans and guarantees are not possible given the debt issue, and where grants may not be available.

Second, groupings such as the V20 or the current G20, through the current Brazilian G20 Presidency, have openly shared their interest in exploring and implementing debt-for-climate and development swaps. By partnering on debt swaps with African countries and institutions like the African Development Bank (AfDB), the EU, its Member States and the EIB would respond better to developing economies' needs, in a way that meets their expectations and helps scale up climate finance in a way that could not be achieved otherwise.

Third, European financial institutions for development investments focus on climate mitigation, with too little done on adaptation when this issue is of prime importance for those countries most vulnerable to climate change. In this context, and given the focus of debt-for-climate swaps on adaptation activities (which can have a positive impact on gender equality) through, for instance, marine conservation in the case of the recent Ecuadorian or Gabonese swaps. In addition, the issuance of green/blue bonds, through the use of proceeds, commits countries to invest in areas that would traditionally be easily cut in case of a change of political leadership or declining fiscal space.

Fourth, engaging in debt-for-climate swaps would assert European leadership in sustainable finance, and be a means to promote EU innovative work around climate finance. This includes the development of sustainable finance taxonomies, green bond standards, and the Global Green Bond Initiative, which will help avoid greenwashing and boost the development of green capital markets. Likewise, all of these initiatives can be leveraged by the EU to get a head-start in implementing debt-for-climate/development swaps.

All in all, engaging in debt-for-climate (and development) swaps more boldly could translate into a stronger partnership between Africa and the EU. Realising this opportunity demands more effort, but the EU and its member states can leverage i) their public development banks and development finance institutions used to work with guarantees, notably but not only the EIB; ii) experience in implementing swaps; and iii) the credibility and legitimacy, given their leadership in sustainable finance. The risks of missing such an opportunity should not be overlooked either (Table 1).

Table 1: Risks of not engaging in debt-for-climate/development swaps

	Inaction because of the lack of appropriate tools, or limited investments in climate adaptation will lead to a greater negative **impact on developing economies** in case of climate disasters. This will also have regional and global economic and social repercussions, resulting in an even greater global divide between the Global North and South.
	Inaction also has a **political cost**: i) the EU risks not being perceived as a key and innovative partner, able to offer financial instruments in line with developing economies' expectations, and ii) other powers such as the US (as currently done) and China and their engagement in debt-for-climate and development swaps could come in to mitigate some of this gaps, showing their relevance and leaving the EU behind.
	Given the interest at the global level - ranging from the G7 to the G20 and the Paris Summit process, it is likely that specific approaches, tools and processes will be developed at the multilateral level for debt-for-climate/development swaps. The EU, if not actively engaged, will be more on the receiving part of the progress and action around swaps, not only missing the opportunity to shape and influence these discussions in a way that aligns with its own development and policy objectives and values but limiting its influence at the global level.

Source: From the authors.

To engage in debt-for-climate/development swaps, the EU could:

1	**The EU should capitalise on existing debt-for-climate / development swaps to further streamline processes and address systemic issues.**	

- **Develop principles to foster efficiency of debt-for-climate swaps:** this was one of the commitments enacted following the Macron Summit in June 2023, aiming to standardise, to the extent possible, procedures and processes to cut swaps' transaction costs. The participation of the EIB in the Task Force on Credit Enhancement for Sustainability-Linked Sovereign Financing could be an opportunity for the EU to shape this process at the multilateral level.

- **Facilitate discussions around, and the development of, methodologies regarding the assessment of the market values co-benefits**. This would not only facilitate the engagement of financial institutions for development in supporting debt-for-climate swaps but also help mobilise private climate finance. This systemic issue could help unlock especially climate adaptation finance.

2	**The EU should capitalise on its knowledge and experience of innovative finance instruments to contribute to more efficient, effective and impact-driven guarantees.**

- **Given its knowledge and experience with guarantees, further explore ways to optimise the use of guarantees in the context of debt-for-climate swaps**, including related to the following dimensions: i) coverage: does it need to cover 100% of the transaction to be effective? ii) risks perception vs actual risks: when provided by MDBs, which benefit from a AAA rating with strong governance and hence low risks of loss, could guarantees backing swaps consume less capital requirement to deliver more investment volume? iii) monitoring and reporting of guarantees to avoid greenwashing: what Key Performance Indicators (KPIs) should be used? What are some of the good practices in monitoring and evaluation (M&E) systems, and which actors should be involved?
- **Given the importance of working better together including on climate and development finance to promote EU leadership, visibility and influence, develop an EU guarantee pooling mechanism**, leveraging not only EU guarantees (through the EFSD+) but also EU Member States guarantees. This could be done, for instance, through the EIB Partnership Platform for Funds (PPF), which gives the opportunity for EU Member States to jointly provide guarantees through dedicated trust funds, tackling specific regions, sectors and issues, following a streamlined process. The trust fund could be open not only to the EIB but also to Joint European Financiers for International Cooperation (JEFIC) members.

3	**The EU should capitalise on its knowledge and experience of innovative finance instruments to contribute to more efficient, effective and impact-driven guarantees.**

- **Promote innovative features that can be plugged into debt-for-climate/ development swaps:** the EU could consider integrating schemes that can help strengthen the debt sustainability of developing economies, and/or maximise the impact of the instrument. This includes:
    a. **Climate (and pandemic)-resilient debt clauses**: these, based on the International Capital Market Association (ICMA) standard on Climate Resilient Debt Clauses, can provide borrowers with a fiscal "breathing space" at the time of a severe climate-induced disaster or health crisis, allowing them to redirect financial resources from debt servicing to immediate response and recovery needs.
    b. **SLBs**: Debt-for-climate swaps involve the issuance of green, social, sustainability (GSS) and sustainability-linked bonds. While swaps' implementation has relied largely on GSS bonds, SLBs could be leveraged given that they are less costly and lighter in terms of operational set-up, and more flexible (once key performance indicators - KPIs - are achieved, any remaining funds can be used at the discretion of governments). More generally, the EU could also consider supporting the issuance of GSS bonds and SLBs in local currency.
    c. Coordinate the implementation of debt-for-climate with the International Monetary Fund's (IMF) Resilience and Sustainability Trust, rechanneling **special drawing rights** (SDRs). Several financial institutions are looking into how to better coordinate these two instruments in a way that delivers impactful investments at scale.

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Endnotes

1. Though at the multilateral level, it is less debt-for-climate swaps rather than debt-for-development swaps (targeting food, health etc.) that are of prime interest.

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