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Upscaling debt swaps for greater impact

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Our poly-crisis world has led to rising debts, threatening the sustainable recovery and development of many countries in the Global South. Debt swaps, a financial transaction where creditors forgive a portion of a country's sovereign debt in exchange for investment in sustainable development, are praised as one of the innovative solutions to provide additional resources in support of developing countries. While there may be some enthusiasm to further the implementation of debt swaps, it should be done in a way that addresses some of its main limitations, and in particular, the lack of scale.

This paper puts forward three main avenues that European governments, financial institutions, civil society organisations and private financiers should explore if they want to upscale debt swaps involving both commercial and bilateral public creditors: (1) adopt a multi/plurilateral approach to debt swaps; (2) leverage and pool guarantees for debt swaps; and (3) attract co-financing.

The paper provides an overview of the underlying main challenges and opportunities and highlights some key reflections to consider to maximise sustainable development impact.

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Acronyms

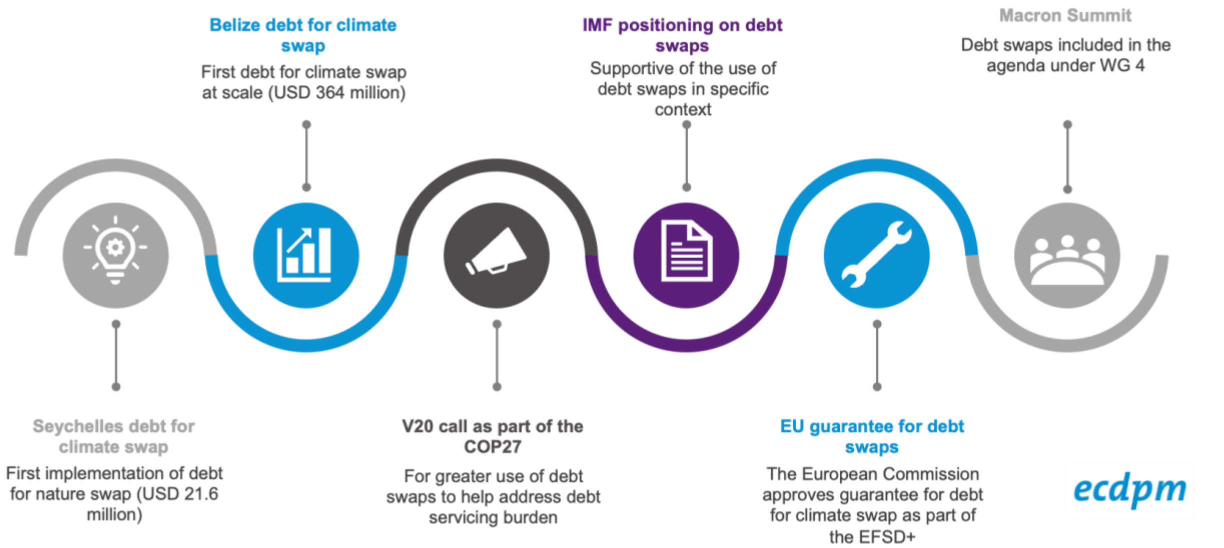
AFD	*Agence Française de Développement*
BMZ	Ministry of Economic Cooperation and Development
C2D	*Programme de contrat de désendettement*
CSOs	Civil Society Organisations
DAC	OECD Development Assistance Committee (DAC)
DFIs	Development Finance Institutions
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EFSD+	European Fund for Sustainable Development plus
ESG	Environmental, Social and Governance
EU	European Union
GSS	Green, Social and Sustainability
HPIC	Heavily Indebted Poor Countries
KPI	Key Performance Indicator
ICMA	International Capital Market Association
IMF	International Monetary Fund
LICs	Low-Income Countries
MICs	Middle-Income Countries
MDB	Multilateral Development Bank
MS	Member States
NWFE-EP	Nexus of Water, Food and Energy"
ODA	Official Development Assistance (ODA)
PDBs	Public Development Banks (PDBs)
PPF	Partnership Platform for Funds (PPF)
RST	Resilience and Sustainability Trust (RST)
SDGs	Sustainable Development Goals
SDRs	Special Drawing Rights (SDRs)
SASB	Sustainability Accounting Standards Board
SLBs	Sustainability-Linked Bonds

1. Introduction

Our poly-crisis world has led to rising debts, threatening the sustainable recovery and development of many countries in the South. Whereas the looming debt crisis requires the adoption of systemic approaches, promoting sustainable, just and resilient transitions and development while preventing debt vulnerability and distress calls for the mobilisation at scale of a range of innovative mechanisms. Debt swaps, combined with other instruments, is one of these approaches which deserves greater attention (Karaki and Medinilla 2022).

Multilateral institutions, governments, financial institutions for development and civil society organisations from the North and South have developed interesting initiatives related to debt swaps involving both commercial and bilateral public creditors, as illustrated in Figure 1. This instrument is seen as a means to invest not only in climate and nature (as in the case of the Seychelles and Belize), but also more generally in sustainable development, without adding to the debt burden of developing countries. In this context, debt swaps are a political and economic tool that is part of two broader agendas: the first one focusing on debt sustainability issues and the second on boosting climate (including adaptation) and sustainable development finance in developing countries (Paul et al. 2023).

Figure 1: Key initiatives focusing on debt swaps in the past five years



Source: From the authors.

Debt swaps are explicitly referred to in the Sustainable Debt Coalition Initiative launched at the COP27, and will feature at the Summit for a New Global Financial Pact in Paris on 22-23 June 2023 among the innovative solutions to provide additional resources in support of developing countries, including those vulnerable to climate change. While there may be some enthusiasm to further the implementation of debt swaps, it should be done in a way that addresses some of its main limitations, and in particular the lack of scale. This undermines its potential to address debt sustainability and achieve significant climate action and resilience and more broadly development-related impacts. This issue needs to be tackled if we are to address the enormous development needs of developing countries and mitigate the growing gap and disparities between the North and South, which also contributes to the geopolitical fragmentation currently observed. Recent estimates suggest that, in the short-run, climate and nature-linked debt instruments alone could provide up to $105 billion of debt relief and help mobilise $329 billion in new borrowing (Patel 2022).

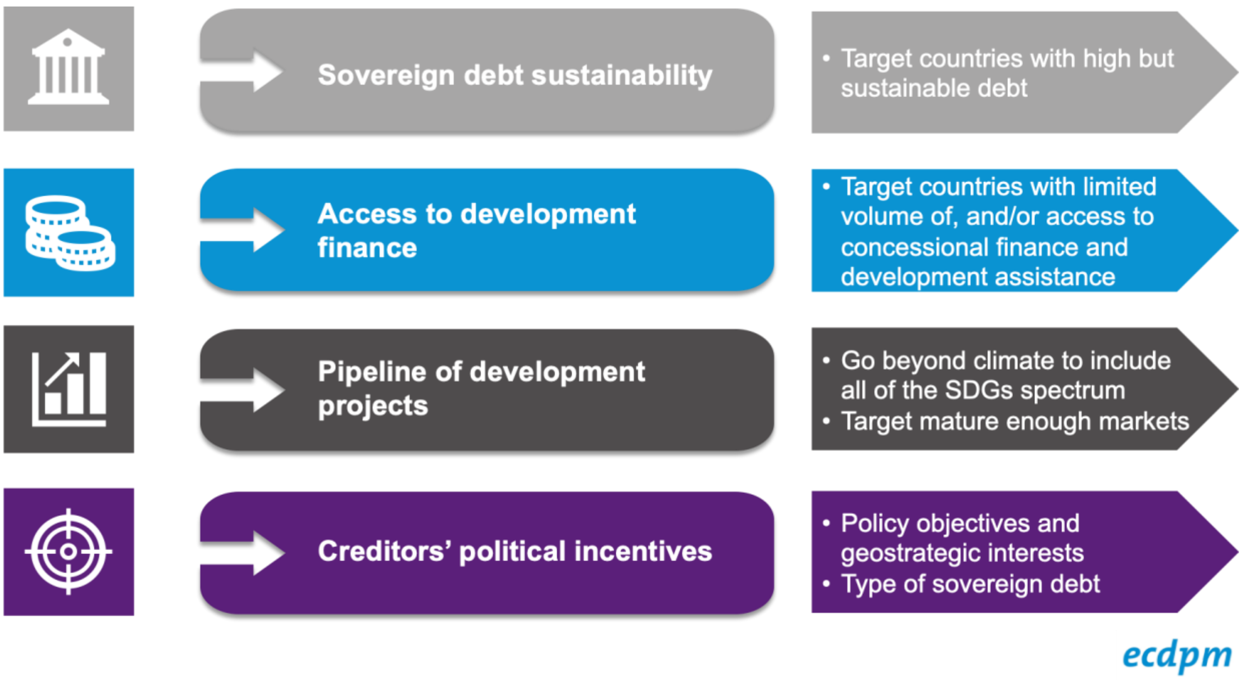
This paper puts forward three main avenues that governments, financial institutions, civil society organisations and private financiers should explore to upscale debt swaps involving both commercial and bilateral public creditors. In doing so, it provides an overview of the underlying main challenges and opportunities and highlights some key considerations that should be taken into account to maximise sustainable development impact. This note draws on the literature in addition to bilateral interviews and informal roundtable discussions.

2. Where do debt swaps fit best?

Debt swaps are no substitutes for debt restructuring, nor for grants and concessional loans financing the sustainable development goals (SDGs): they should be understood, designed and implemented as part of a "debt and development toolbox" (Karaki 2022). In other words, debt swaps are no silver bullets to debt sustainability issues or to development finance.

The scale, relevance and effectiveness of debt swaps vary depending on the macroeconomic, political and social context in which they take place. Hence, before exploring the avenues to upscale debt swaps, it is important to provide a better understanding of the factors shaping their potential to deliver at scale, for greater and more transformative impacts. These factors, presented in Figure 2, are further explained in the remaining part of this section.

Figure 2: Factors influencing the scale, relevance and effectiveness of debt swaps



Source: From the authors.

2.1. Sovereign debt sustainability

Debt swaps have a more limited value in countries characterised by limited sustainable debt, and those in debt distress where debt restructuring should be a priority. Instead, debt swaps are most relevant where fiscal risks are high, and debt level significant but not unsustainable. In that sense, they tend to be more effective in preventing rather than remediating debt sustainability issues (Chamon et al. 2022). When it comes specifically to debt for climate swaps, it is worth highlighting that the more a country (including its sovereign debt) is subject to climate change, the more debt (for climate) swaps become relevant.

2.2. Access to development finance

But the debt element is only one facet of debt swaps. They are also a means to invest in sustainable development. In this context, debt swaps make the most sense where alternative financing instruments, including concessional finance and grants, are too limited, and/or where governments are interested in creating fiscal space in addition to investing in sustainable development. While often overlooked, debt swaps are relevant in the context of middle-income countries (MICs), as these largely rely on loans from multilateral/bilateral institutions, and have limited access to concessional finance and grants, which largely focus on low-income countries (LICs). For poorer countries, debt swaps can act as a complementary tool to investing in sustainable development. Targeting MICs can also be a strategic developmental choice given that 62% of the world's poor live in MICs (World Bank 2022a). When it comes specifically to debt for climate swaps, research shows that a focus on climate adaptation is a better fit when applied in the context of targeting LICs, while debt swaps geared towards addressing climate mitigation may be better adapted to MICs (Essers et al. 2021).

2.3. Pipeline of development projects

For debt swaps to be effective, they need to be underlined by a sufficiently reliable stream of bankable sustainable projects to invest in. To achieve transformative and systemic impacts, debt swaps must therefore rely on the development of a pipeline of interrelated projects (rather than one-off projects/transactions). This is also where debt swaps can have an efficiency advantage over the "unbundled" alternatives (Chamon et al. 2022). Two key aspects can facilitate this approach (and help understand where debt swaps would be most efficient and achieve scale):

1. Though recent debt swaps focused on nature and climate, enlarging the scope to include social and sustainable development aspects can go a long way in facilitating the development of a pipeline of projects, which provides for more flexibility, scale and ultimately greater impacts. This also better reflects the interests of many developing countries, in particular in Africa, for which sustainable and inclusive development is a key priority.

2. Though debt swaps tended to focus thus far on small island states characterised by relatively small economies, going beyond these geographies will also facilitate the development of a pipeline of projects and impact the scale of debt swaps that can be reached. In addition, given the level of maturity and risks of MICs' markets in comparison to LICs', the transaction costs involved in building a pipeline of projects in MICs may be lower than in LICs.

This suggests that debt swaps should not be pursued on their own, but must be accompanied by complementary approaches and tools to generate a credible pipeline of transformative projects, which meet a set of transparent and objective criteria related to the sustainability, social, climate or nature-based dimension of the swap.

2.4. Creditors' political interests

Beyond these technical considerations, it is also important to highlight that the choices of countries often correlate with creditors' political interests - which affect, first and foremost, the relevance and scale of debt swaps beyond their effectiveness. Creditors may target the use of debt swaps towards their own priority countries as defined by their development policy objectives - e.g. Germany and Italy identified 24 and 15 eligible countries, respectively, while France focuses on heavily indebted poor countries (HPIC) (Swanson et al. 2022, Zupi et al. 2013). Beyond these objectives, creditors may also pursue debt swaps as a means to further their influence in partner countries, in a way that contributes to their geostrategic interests - whether these relate to showing leadership in climate and development finance or demonstrating solidarity with the South. Last, creditors also have their own processes in place, including in terms of the eligibility criteria applying to the type of sovereign debt that can be swapped. For instance, France and Germany can only swap official development assistance (ODA) debt.

Key insights

While debt swaps can be implemented in any country, the highlighted factors above help better understand the strategic value of debt swaps, and the key considerations to bear in mind when investigating their scale, relevance and potential effectiveness in addressing debt sustainability and more especially boosting investment in sustainable development. While debt swaps are a technical tool, their relevance and scale are also shaped by political factors and considerations, which may not necessarily go in the same direction.

3. Concrete avenues to upscale debt swaps and reach greater impacts

This paper puts forward three avenues for upscaling debt swaps, highlighting their potential opportunities and challenges, with a view to better understand their desirability and feasibility. These are not necessarily mutually exclusive, and importantly they involve both commercial and bilateral public creditors.

Avenue 1: A multilateral or plurilateral (EU) approach to debt swaps?

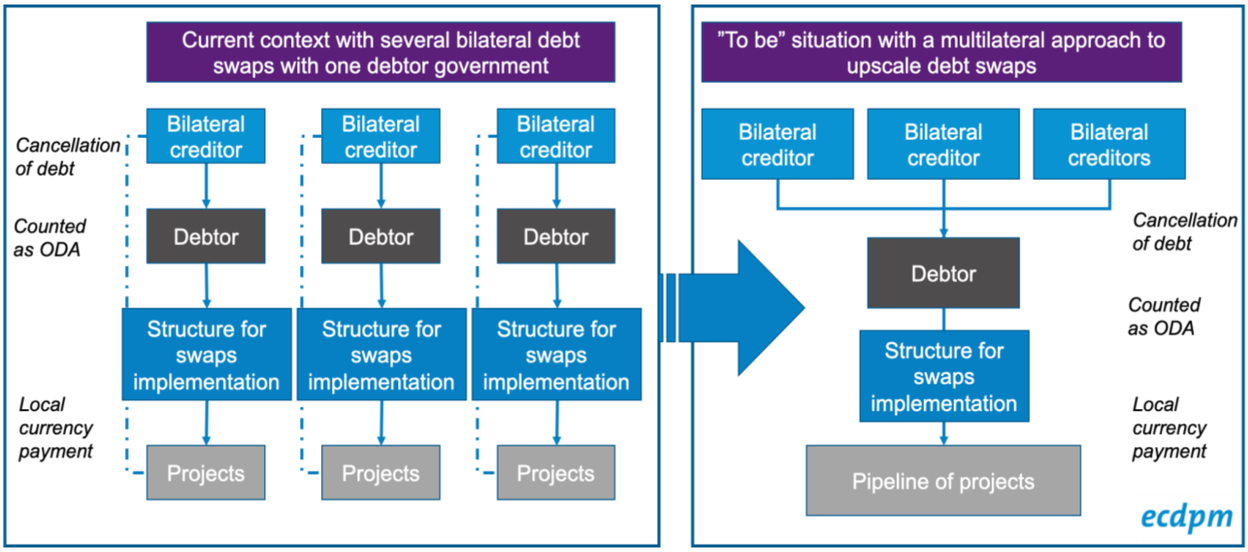
Currently, most debt swaps take place in their simplest form, i.e. through a two-party debt swap involving only official bilateral debt (African Natural Resources Management and Investment Centre 2022). In this context, the creditor country cancels part of the original debt agreement or creates new debt at more favourable terms, in return for a commitment from the debtor country to fund development projects in local currency. The value of the fund is generally based on the value of the savings in payments from the former debt to the new debt (Swanson et al. 2022).

On the one hand, this type of debt swap is often used to serve creditors' development policy objectives and generate additional ODA funding, which helps maintain diplomatic ties (Lazard 2021). On the other hand, it is essentially small in scale, and hence focused on a few specific projects and resulting in limited impacts on debt sustainability and sustainable development.

Moving from the bilateral to the multilateral level or the plurilateral level, from one to several creditors, would allow the pooling sovereign debt of several creditors to reach a greater scale and impact (Figure 3).

At the strategic level, multi/plurilateral debt swaps raise the scale and thus also the political profile of debt swaps. Doing so also increases the political leverage of the creditors to promote systemic impact, potentially helping to shift the focus from one-off projects towards the development of a pipeline of projects aiming for transformative and sustainable impacts. In addition, it would strengthen the visibility of the swap, and the reputation and influence of actors involved, creditors and debtors. While there might be economies of scale, the coordination costs among creditors of negotiating multi/plurilateral debt swaps would arguably be higher than bilateral debt swaps.

Figure 3: From a bilateral to a multi/plurilateral approach to debt swaps



Source: From the authors

At the operational level, a multi/plurilateral approach to debt swaps would help reduce transaction costs for debtors and creditors by streamlining the implementation and monitoring process (one instead of several structures/funds administrating the debt swap); and enhancing coordination between creditors' interventions - instead of several debt swaps focused on specific issues, a bigger debt swap coordinating different policy areas.

At the European level, EU member states (MS) could leverage the Team Europe approach and initiatives to upscale debt swaps and strengthen the EU leadership in development and climate finance, while potentially also including/joining other non-EU creditors.[1] This is even more relevant in a context where several EU member states are already engaged in debt swaps in the same countries. For instance, Germany and Italy are implementing debt swaps in Egypt of €240 million and $149 million respectively. Likewise, Spain, Italy and Germany all engaged in debt swaps in Ecuador.

However, such an approach to upscaling debt swaps also faces several challenges.

1. Debt swaps eligibility criteria (e.g. geographical scope and type of sovereign debt), regulations, as well as EU MS' policy objectives and geostrategic interests vary from one country to another, as discussed in the previous section.

[1] It's important to note that this multilateral approach has been implemented in the context of the Paris Club (which included several EU member states: UK, France, Belgium and Italy), as done in the case of the debt for climate swaps in Seychelles in 2017 (Gerretsen 2020).

2. The processes (and the actors) by which debt swaps are agreed upon also differ. For instance, in Germany, the Ministry of Economic Cooperation and Development (BMZ) is responsible for designing the debt swap, which is then submitted to the Ministry of Finance and to the Parliament Budget Committee for review and approval, and implemented by KfW. All in all, this process can take two or more years. In France, the process seems more straightforward, with the Ministry of Finance and Ministry of Foreign Affairs defining the objectives of the debt swaps ("*programme de contrat de désendettement - C2D*") and the French Central Bank and the Agence *Française de Développement (AFD)* manage the implementation.

3. As illustrated above, debt swaps require a certain degree of alignment between various actors with different mandates, interests and objectives (what is sometimes referred to as political economy dynamics), making the coordination at the national level potentially challenging and lengthy. For instance, the debt swap in Seychelles was negotiated four years before being concluded - even though it was done under the Paris Club. Involving creditors such as China or the private sector would certainly complicate further the process, and make it potentially lengthier and more costly. If these additional coordination and transaction costs are not kept in check, it could ultimately undermine the relevance of debt swaps in comparison to other debt sustainability and development finance instruments.

4. A multi/plurilateral approach to debt swaps requires in consequence effective coordination mechanisms, which a Team Europe approach could help provide, to avoid unnecessary additional time and coordination efforts and transaction costs from each participating country, in comparison to a bilateral debt swap. It might therefore be worthwhile to carefully set up a framework to address this, coordinating efforts from different EU member states and in other relevant international fora (G7, Paris Club, G20, International Monetary Fund - IMF, etc.).

5. The multi/plurilateral approach focuses only on debt involving European bilateral creditors, leaving aside non-Paris Club creditors including the private sector and countries such as China. Hence, while upscaling debt swaps by adopting a Team Europe approach would be beneficial, it will remain limited in a context where a large part of African sovereign debt is owned by China and commercial creditors (Karaki & Medinilla, 2022).

Key insights

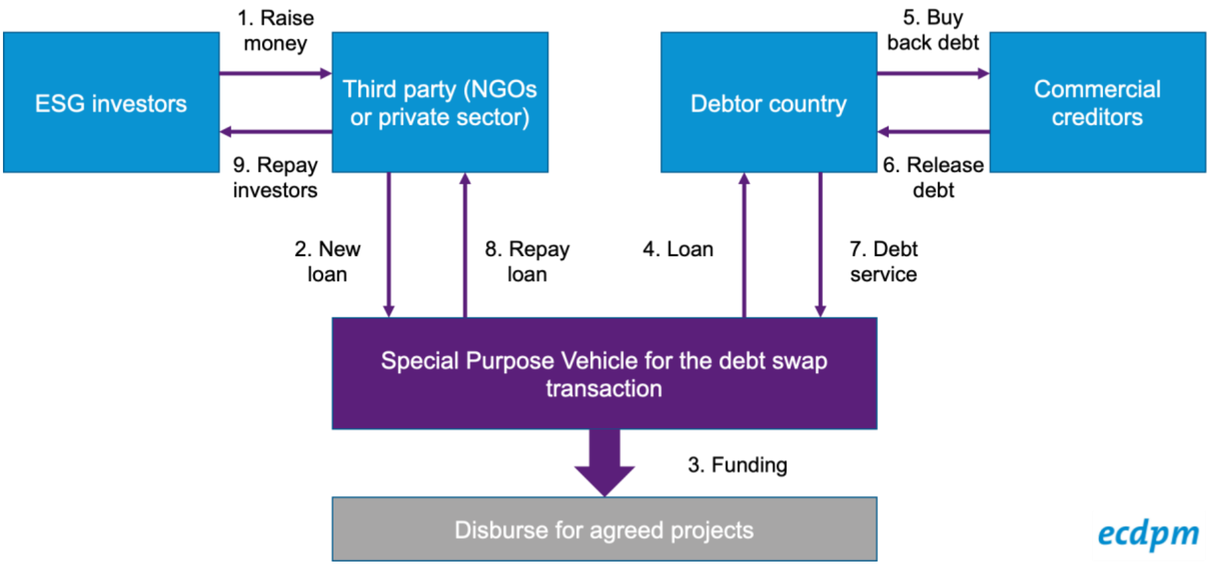
Progress towards achieving a multilateral or plurilateral approach to debt swaps should be encouraged to achieve swaps at scale with transformative and sustainable impacts. However, in the short-term, significant challenges remain, ranging from the lack of common eligibility criteria and processes, to potentially diverging incentives, and political and geostrategic objectives.

This avenue should be best approached following a mid-to-long-term process, starting by promoting the exchange of knowledge and practices on debt swaps at the EU level, including where EU MS are already active on debt swaps, and what financial features and operational processes they have developed (Lazard 2021). Based on this, EU MS could identify potential opportunities for collaboration, and develop through a Team Europe approach a light framework facilitating their cooperation and engagement in multi/plurilateral debt swaps, to limit coordination costs and time.

Avenue 2: Using guarantee for multi-party debt swap involving commercial creditors

In comparison to bilateral debt swaps, multi-party commercial debt swaps involve a third-party organisation, which purchases discounted commercial debt in secondary markets and reduces or replaces it with new and more affordable debt - including through the capital market, by issuing SDG or blue bonds for instance. The difference in payment amounts between the former debt and the new debt is then paid by the debtor country in local currency for development projects (Figure 4). This type of debt swap has attracted attention following its implementation in Seychelles in 2017 and especially Belize in 2021, as they are particularly relevant in economies with significant commercial debt such as the MICs (World Bank 2022b). Naturally, this type of swap is only accessible to countries that already have access to capital markets, and that are exposed to commercial creditors (which is often the case of MICs and to a lesser extent LICs).[2]

Figure 4: Indicative illustration of multi-party debt swaps



Source: Adapted from Chamon et al. 2022.

It is worth noting that multi-party commercial debt swaps also involve the creation of parallel structures often managed by a third party (in collaboration with the local government). This is not the case for bilateral debt swaps, whose funds are often managed by the local governments, contributing more effectively to local ownership and capacities.

a) Using (and pooling) guarantees at the EU level

One way to upscale multi-party debt swaps is by using guarantees for credit enhancement by covering, at least partially, interest payments for the bond and hence acting as a de-risking mechanism for potential investors. This allows issuing SDG or blue bonds (as in the case of the Seychelles and Belize) that are highly rated (Aa2 in the case of Belize) and have low risks. In doing so, a larger investor base can be reached, including major ESG and institutional investors such as pension funds and insurance companies (GreenFinance Institute 2023). In turn, the interest rates are lower than otherwise, providing a cheaper cost of funding to Belize (which means less debt servicing).

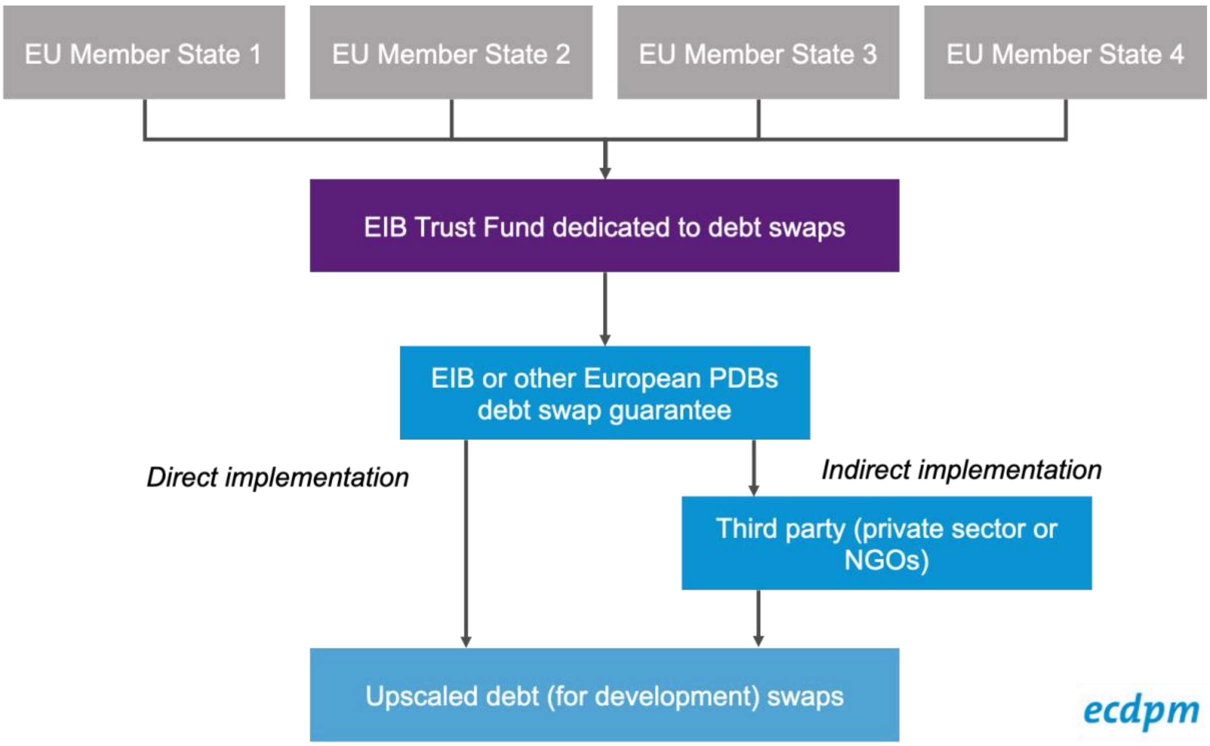
2 Commercial debt is often more expensive than public debt - strengthening the relevance of focusing on commercial debt in the context of multi-party commercial debt swaps.

The volume of these guarantees has been growing significantly from $5 million in Seychelle to political insurance worth $ 610 million in Belize (US Embassy in Belize 2021). Recently, the same logic has been applied in the case of Barbados in October 2022, with a combined guarantee of $150 million allowing debt swaps to reach scale and impact. In the case of Belize, the debt for nature swap had arguably a major impact on the debt sustainability of the country, as well as on future investments and commitments in the blue economy (Uxolo 2022).

The EU, its member states and their institutions are well placed to innovate, fostering a Team Europe approach for commercial debt swaps. While no European Public Development Banks (PDBs) or donors have been involved in providing guarantees to third-party organisations in the context of debt swaps,[3] this is likely to change if the Project Investment Proposal under the European Fund for Sustainable Development plus (EFSD+) on commercial debt for climate swaps, led by Climate Fund Managers, is approved.

However, given the limited amount of the guarantee available under the EFSD+, reaching a higher scale (over €500 million) is likely to require additional top-up (climate) guarantees which could come from EU Member States and/or their PDBs. Whilst there are several avenues that can help pool MS guarantees, it is worth highlighting the European Investment Bank (EIB) Partnership Platform for Funds (PPF), which gives the opportunity for EU MS to jointly provide guarantees through dedicated trust funds, tackling specific regions, sectors and issues, following a streamlined process (Figure 6). These guarantees could be channelled through a trust fund dedicated to debt swaps to the EIB and other European PDBs and potentially additional EU private financiers and civil society organisations (CSOs), provided they can be eligible and able to manage such financial instruments.

Figure 5: Leveraging EIB Partnership Platform for Funds to pool guarantees to support debt swaps operations



Source: From the authors

[3] Thus far, the examples of the debt for nature swap in the Seychelles, Belize or Barbados involved guarantees from the U.S. International Development Finance Corporation and the World Bank Group.

Beyond donors' guarantees, countries which will have access to the International Monetary Fund (IMF) Resilience and Sustainability Trust (RST) can use the Special Drawing Rights (SDRs) to finance already agreed programmes with IMF staff.[4] Instead of using the SDRs as balance of payment support, they could use them as long-term 'collaterals' (preserving their reserve asset and liquidity nature), with a view to optimise the use of limited public resources. In this context, SDRs could potentially serve as a form of guarantees, enabling to leverage additional financing through the debt swap. To be effective, such a guarantee should be accompanied by e.g. a counter-guarantee from a Multilateral Development Bank (MDB), in order to achieve credit enhancement.[5] More broadly, SDRs can boost confidence of investors by strengthening the reliability of the debt swap from the debtor country.

While guarantees have a great potential in helping scale debt swaps, they also come with a few challenges, including:

1. As of today, guarantees do not count as ODA according to the OECD Development Assistance Committee (DAC). This will make creditors' participation difficult, especially since ODA eligibility is often one of the conditions for them to engage in debt swaps (e.g. Germany). Discussions are, however, underway to come to an agreement on ODA recognition of the use of guarantees.

2. Guarantees require different types of mindsets, capacities and management requirements. In this context, governments with limited experience with guarantees and combining SDRs with guarantees may need to build up their capacities. In addition, a question arises as to whether a guarantee from a developing country's government will be as effective for credit enhancement as one from a triple-A rated MDB, even if the developing country benefits from a reallocation of SDRs through the RST.

3. Last, the financial engineering and involvement of several actors can be costly. In Belize, the cost for the debt for climate swap disclosed was $10 million, whilst some estimated it up to $85 million, which is a sizable amount for such a deal and economy (Padin-Dujon 2023).

b) Future-proof new debt by using disaster clauses

In addition to the guarantee, a few debt for nature swaps, including the ones issued in Belize and Barbados, also included climate and/or pandemic disaster clauses. The principle is the following: in case of a climate disaster (which impacts are defined and assessed independently), the natural disaster clause can kick in, allowing e.g. Barbados to defer payments to bondholders up to two years (but not after 2027 - in order not to affect the bond's maturity which ends in 2029), and up to three times in the course of the bond's term. This allows the country to protect its economy from potential future climate risks, making the economy more resilient and able to respond to crises while improving the debt sustainability of the country. This type of clause is extremely relevant for all countries, but particularly those subject to a high probability/high impact of social (pandemic) or climate disasters (such as Barbados, where 1 in 10 climate disasters in small countries can cause damage equal to >30% GDP).

Contrary to common wisdom, creditors are not opposed to this type of clause. First, it is not like a natural catastrophe bond where bondholders are not repaid if a qualified catastrophe event occurs - the risk remains on the country and not with the bondholders. In addition, the deferred amounts are capitalised to prevent losses for bondholders. Second, in the case of Barbados, bondholders have a veto right (in case there is doubt about the

[4] To date, Rwanda, Costa-Rica and Barbados are the three countries with IMF approved programmes that can benefit from the funds under the RST.

[5] In other words, a guarantee by a developing country to back up e.g. its own issuance of GSSS bonds will not generate credit enhancement benefits. This is why a counter guarantee from a triple A rated MDB can be useful.

assessment of impacts). Third, debt restructuring is often more painful than deferring payments, so there is also a financial interest (Ho 2021).

In this regard, it is interesting to note that the International Capital Market Association (ICMA) has published new Climate Resilient Debt Clauses, thus facilitating sovereign debt relief and financial stability by helping standardise such a type of clause (ICMA 2022).

c) Innovate by exploring the potential of sustainability-linked bonds

So far, multi-party commercial debt swaps have led to the issuance of green or blue bonds credit enhanced by a guarantee. Whilst this type of debt allows tapping into a larger and more diversified type of investors, they restrict the use of proceeds which must contribute to the set of eligible projects identified by the governments.

Another relevant avenue would be to leverage the potential of sustainability-linked bonds (SLBs). Contrary to green, social and sustainability (GSS) bonds, SLBs can be assimilated to performance-based financing where "*the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability or environmental, social and governance (ESG) objectives*" (OECD 2021). An increasing number of governments, including in developing countries, have shown interest in this type of instrument, as demonstrated by the recent issuances of SLBs by Chile and Uruguay (Financial Times 2023, Uxolo 2023).

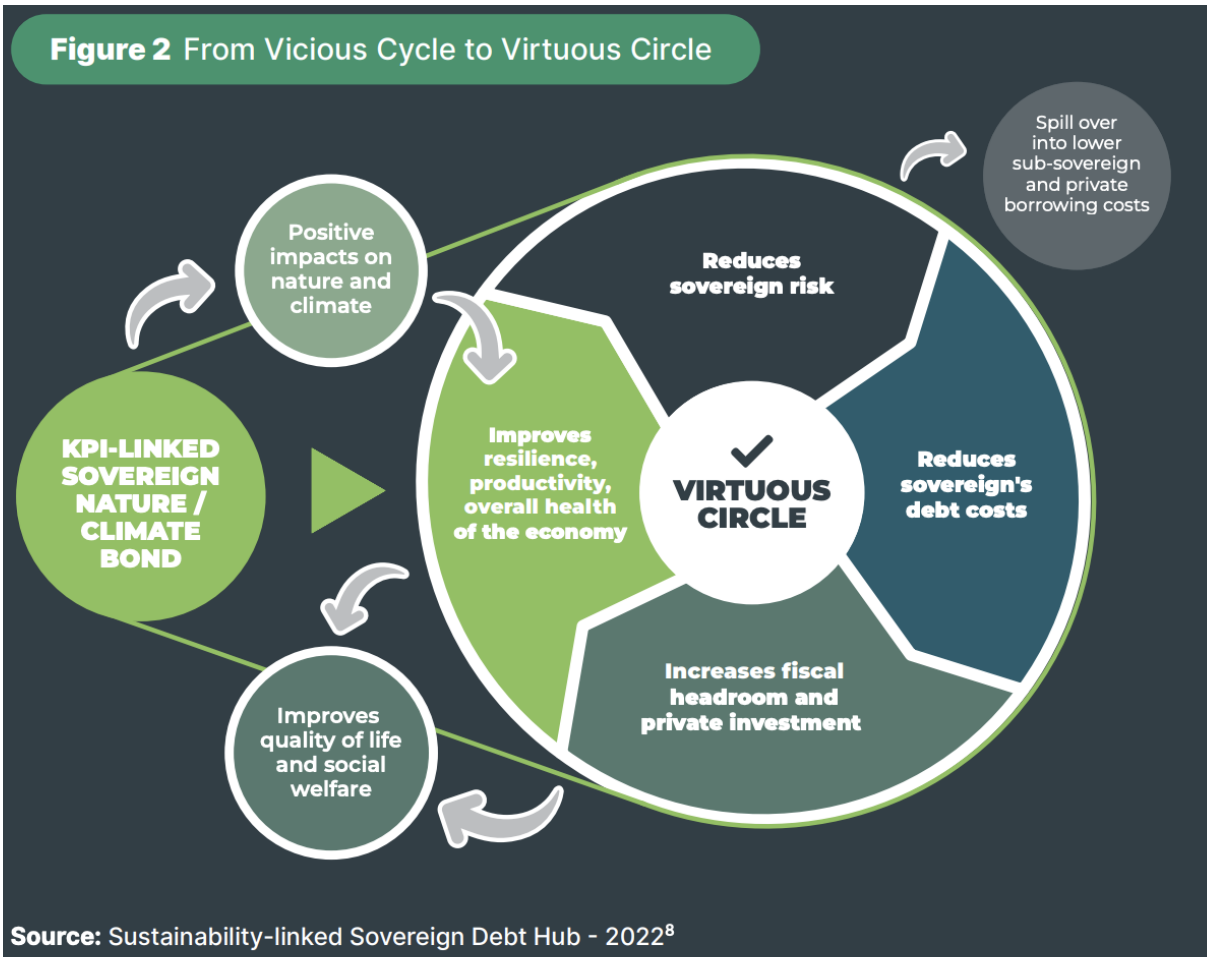
Box 1: Uruguay issuance of SLBs

Last year, Uruguay issued $1.5 billion in sustainability-linked bonds (SLBs), and could see its associated debt-servicing costs fall by up to 60 basis points (Zadek 2023). This issuance will serve the strategic priorities of the country in line with its Nationally Determined Contribution (NDC), and will notably focus on performance indicators related to the evolution of the intensity of CO_2 emissions, and on the protection of native forests (UNDP 2022). In case it exceeds its targets, Uruguay will benefit from a reduction in interest rates.

Source: From the authors.

The added value from a developing country perspective is that SLBs are less costly and lighter in terms of operational set-up, as they do not involve use-of-proceeds tracking (Murphy 2021). In addition, this also means that once a key performance indicator (KPI) is reached, any remaining funds can be used for other issues (whether related to fiscal relief and/or additional investments in other sectors).

Figure 6: Cascading benefits of SLBs



Source: From [Kulenkampff and Pipan (2023)](#).

However, this option of combining multi-party commercial debt swap with SLBs is not without challenges:

1. SLBs' impact reporting suffers from a lack of transparency and standardisation, though existing non-mandatory reporting frameworks exist, such as the Sustainability Accounting Standards Board (SASB) reporting framework which facilitates the disclosure and comparison of consistent and reliable ESG information (Murphy 2021).

2. It is hard to assess the extent to which the KPIs accompanying the issuance of SLBs are ambitious enough to deliver material impact. A Bloomberg study revealed that the KPIs relating to climate were weak, irrelevant, or even already achieved for over 50% of more than 100 SLBs analysed (Azevedo Rocha et al. 2022). More work is required on standardising instruments and metrics, which will ultimately help cut costs related to SLBs issuance and reduce the likelihood of greenwashing (Kulenkampff and Pipan 2023).

3. Whilst there is a growing appetite for SLBs, ESG and institutional investors may favour more mature products such as GSS bonds, which framework and functioning (use of proceeds) may allow for more predictability.

4. Last, sovereign SLBs have so far been issued in hard currency, which poses crucial risks for developing countries' economies and debt sustainability (whilst supporting the liquidity of the bonds). Addressing currency risks is, therefore, imperative when leveraging capital markets.

The EU has been a leader in the sphere of sustainable finance and green bonds, with the development of the EU taxonomy on sustainable finance, the green bond standard, but also through the EIB as the first MDB to issue green bonds. The EU could also build on its most recent Team Europe initiatives, e.g. the Global Green Bond Initiative and the Sustainable Finance Advisory Hub. Such initiatives could be extended to SLBs in order to contribute to the solid development of the market, by supporting its credibility (to avoid greenwashing) and growth.

Key insights

Multi-party commercial debt swaps offer a strong potential to upscale debt swaps in a way that can generate impactful investments in sustainable development in the short term.

This is especially the case when they integrate one of the three instruments highlighted in this section: i.e. guarantees, pandemic/climate disaster clauses and SLBs. According to some, it is likely to see in the near future multi-party commercial debt swaps combining all these instruments and innovations.

The EU and its member states could play a key role in supporting multi-party commercial debt swaps by providing and pooling (through a Team Europe approach) guarantees, combined with technical assistance and expertise. These could be implemented by private sector actors (as in the case of the Climate Fund Managers), possibly with CSOs, but also European national PDBs and European MDBs (the EIB and the European Bank for Reconstruction and Development (EBRD)), which often have more capacities to empower local governments in a way that fosters their ownership over the funds rising from the debt swap operation. Beyond providing guarantees, the EU could further explore the potential for performance-based instruments such as SLBs, by i) supporting SLBs market infrastructure (including efforts towards the harmonisation of standards and transparency and ii) piloting innovative approaches involving SLBs in multi-party commercial debt swaps.

Avenue 3: Boosting investments from debt swaps' operations

The third avenue highlighted here shifts the focus from the upstream level of swaps - to the downstream level, i.e. how the swap is implemented in practice. In this context, it is important to note that the funds generated by debt swaps' operations, especially those that are bilateral, are often disbursed using grants - as in the case of the French C2D. Two ways could help optimise the use of the funds, in a way that would upscale the impact of the debt swap:

1. switch from grants to financial instruments (loans, equity or guarantees) to generate a return that could be invested in additional development projects; and
2. leverage grants to attract additional investments from the public and private sector - in other words, use blended finance.

Such an approach is planned to be implemented by Germany in Egypt (Box 2). Importantly, it also allows shifting the focus from a few projects to a pipeline of projects able to generate systemic transformative changes and impact.

Box 2: Attracting co-financing: the case of Germany debt swap with Egypt

At COP27 in Sharm El-Sheikh, Germany, together with the United States, pledged to support the implementation of the energy pillar of the Egyptian country platform "Nexus of Water, Food and Energy" (NWFE-EP), as the most important pipeline for Egypt's energy transition. The NWFE-EP will lead to a significant acceleration of Egypt's energy transition through the leverage of private climate finance. Germany and the US committed $250 million to the NWFE-EP, including €100 million in the form of debt swaps.

Source: From Zawya (2022).

This approach may also offer a more pragmatic entry point for a European multilateral or plurilateral approach, and would largely be driven by implementing agencies and even more public development banks and development finance institutions (DFIs) for the co-financing part. In this context, the PDBs engaging in bilateral debt swaps should share information on the projects targeted by the debt swap operation, to facilitate additional co-investments and attract private finance, including through the DFIs. Beyond the European level, it may be strategic to also engage local and regional PDBs, given their knowledge, expertise and networks in partner countries.

This would require additional transaction costs and time, reflecting the more complex type of operation characterised by the involvement of additional actors. This also requires identifying common priorities and pipelines of projects where PDBs and DFIs interests converge. But in doing so, it could lead to higher mobilisation of sustainable finance for a more coherent pipeline of transformative projects, while reducing the debt burden through the swap.

Key insights

Co-financing and blended finance can boost investments generated by (bilateral) debt swaps, which too often rely on grants, and do not systematically seek strategic co-financing from other PDBs or even DFIs. This avenue offers pragmatic and concrete ways to achieve greater and more transformative impacts.

To realise this ambition, European debt swaps' implementers - whether implementing agencies or PDBs, should share information about the targeted operations involved in the debt swaps with other PDBs and whenever relevant with other DFIs as a means to further attract private finance. This could be done by supporting the implementation of a common European PDBs-DFIs debt swaps platform.[6]

[6] This could be done for instance through their respective groupings, the Joint European Financiers for International Cooperation (JEFIC) and the Association of European Development Finance Institutions (EDFI), together with the EIB and EBRD.

4. Key consideration - the local and regional anchor

Debt swaps operations should not aim to duplicate or replace local or regional structures, but rather build on them in a way that fosters local ownership and capacities - whether these relate to debt management or development finance. There are several ways in which creditors can follow this principle and ensure the sustainability of the interventions and impacts of debt swaps.

In bilateral and multilateral debt swaps, creditors should consider using existing governmental structures and building local government's capacities whenever relevant, by providing technical assistance. In addition, they should try to consolidate rather than create additional bilateral debt swap structures ad infinitum.

For multi-party commercial debt swaps, third parties tend to be in the driving seat possibly at the expense of local governments, who may play a more passive role than in a bilateral debt swap. In this case, it could be a missed opportunity for governments to upgrade their capacities to manage public debt and especially investments in sustainable developments that sometimes require specific expertise (e.g. climate adaptation). Specific engagement modalities and targeted accompanying measures may alleviate this risk by strengthening local authorities' ownership. Local governments play a key role in providing the necessary capital market infrastructure and favourable business environment crucial for the issuance of GSS and SLBs. Besides providing guarantees for the bonds' issuance, PDBs and MDBs can also provide technical assistance to strengthen the local GSS and SLBs' ecosystem. Last, governments can leverage their access to SDRs to issue guarantee or counter-guarantees to credit enhance GSS or SLBs issuance - playing in this context a central role.

Leveraging the knowledge, expertise and networks of local and regional actors, and PDBs in particular, is critical to help develop a pipeline of projects and support co-financing and blended finance types of approaches. European financial institutions for development should continue partnering with their local and regional counterparts and share information and good practices in a way that also supports their capacity development.

Last, involving local civil society organisations in debt swap operations can also be useful to ensure a certain level of monitoring, transparency and pressure on the local governments and/or third parties to deliver on their promises, helping ensure that debt swaps avoid green or development washing type of criticism (Financial Times 2023).

Stepping up collective (European) creditors' efforts to promote debt swaps should therefore be conceived not as a simple conditionality externally imposed on developing countries, but as a constructive way to engage local actors on their transformative development objectives, strengthening both their capacities, incentives and credibility in doing so in an effective and sustainable manner.

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