ESG Matters - Emerging Markets

Conf call takeaways: debt-for-nature swaps

Thematic Investing

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Another tool for sustainable debt markets

Debt-for-nature swaps (DNS) are a developing tool for sustainable debt markets, although their use is likely to remain highly specific. Our conference call on February 13 highlighted the views of three experts from Columbia University's Center on Global Energy Policy (part of the School of International and Public Affairs): Gautam Jain, Luisa Palacios and Harry Verhoeven. Our speakers highlighted that DNS deals will remain complex, but they will also bring direct investment flows into biodiversity for adaptation and conservation efforts. Not every country is an ideal issuance candidate, transparency is crucial, and investors need to do their homework on each transaction.

Debt-for-nature swaps – the 'other' blue bonds

Debt-for-nature swaps allow a country to buy back existing debt (often below par) using lower interest rate borrowings and often longer maturities. Lower coupons on replacement debt are achieved through third-party credit enhancement (guarantees / political risk insurance), and commitments are made for future conservation. These debt-for-nature swaps were originally dubbed 'blue bonds' by The Nature Conservancy, although we expect this term to be phased out. Conservation efforts to date have focused on ocean-related projects from the Galapagos Islands to Belize and Gabon.

Standardisation and 'stretch' – where can they grow?

At their core, DNS are likely to remain largely bespoke: a tailored response to a country's fiscal stress, with specific conservation projects attached. But our speakers did note areas where standardisation is possible: buying back bonds via voluntary auction, creating a standard governance structure (for conservation), more commonly recognized key performance indicators, and more streamlined monitoring standards. Credit enhancement providers are likely to drive this as they are involved in multiple / repeated DNS structures. The scope of 'conservation' may stretch: this could include land-based projects or completely new areas (health and human services or electrification?).

Challenges: a lot of stakeholders to satisfy

How much fiscal stabilisation can DNS achieve? Will conservation efforts be enough? Does government commitment to conservation conflict with local views? Do sovereigns sacrifice agency for interest cost savings? Our speakers highlighted key challenges in executing a debt-for-nature transaction – as well as some mitigants.

The public good? 'Guardrails' vs economic progress

There is a 'sweet spot' where conservation goals are also crucial to a sovereign's fiscal outlook. This is what issuers, insurers and investors should consider, in the view of our speakers. Conservation projects should provide economic benefits or preservation of an economic livelihood (tourism, etc.) – and they should serve a public good. Projects mustn't 'shut down' a country's economic progress. To justify the credit enhancement, the conservation goal should also be globally relevant (e.g. biodiversity hotspots).

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Debt-for-nature – and for transparency

Debt-for-nature swaps have a few key elements, including 1) the replacement of existing debt with lower cost new debt, 2) credit enhancements (to facilitate lower interest rates), and 3) a commitment to conservation (including governance requirements). The effect of a DNS is to facilitate a country's fiscal stabilisation alongside additive conservation. Our conference call on February 13 highlighted the views of three experts from Columbia University's Center on Global Energy Policy (part of the School of International and Public Affairs): Gautam Jain, Luisa Palacios and Harry Verhoeven.

In recent debt-for-nature swaps, all or part of a country's outstanding debt is repurchased, usually at a discount. In recent deals, his has been achieved through a voluntary bond auction. New debt is issued that includes some form of credit enhancement (a guarantee or political risk insurance). This allows for a much higher rating and leads to the lower cost of funding. In exchange, a sovereign agrees to use part of the interest cost savings for conservation efforts. Ecuador is expected to save $1.1bn over 17 years with its 2023 swap, for instance.

Credit enhancement is typically provided by a highly rated institution, such a multilateral development bank or a non-governmental organisation (The Nature Conservancy and the Development Finance Corporation are two recent providers).

DNS candidates and credit enhancements

Our speakers highlighted that DNS transactions are complex, and a lot is required of issuers in terms of pre-requisites, preparations, agreements, etc. There need to be appropriate projects that include detailed outlines, costings, and evidence that conservation efforts will be additional rather than already committed. Long-term governance of these projects needs to be agreed.

Not all countries will meet the governance and willingness required for a debt-for-nature transaction. Emerging market countries with stronger governance, nations with strong institutional structures and governments with the political will to engage are generally the best candidates. Our speakers highlighted that while DNS is a tool, it's not really a solution for a country in default. It could be part of a restructuring, but probably should not be the only solution. Restructuring needs to restore fiscal sustainability, and DNS transactions may not always go far enough.

Credit enhancements may take the form of third-party guarantees or political risk insurance. Investors need to understand exactly what will be covered in order to properly price a transaction – this is not an area that lends itself to standardisation.

Some areas of DNS could see more standardisation in the future, including the (voluntary) bond auction process (already standardizing), governance structures for conservation programmes, more commonly recognized key performance indicators, and more streamlined monitoring standards. Credit enhancement providers are likely to drive this as they are involved in multiple / repeated DNS structures.

The scope of 'conservation' may stretch over time: projects could include land-based projects or completely new areas (health and human services or electrification?). Our experts noted interest in more experimentation – debt for health, debt for electrification, etc. At the same time, sovereigns need to consider what they gain and whether they are willing to lose agency as projects are subjected to outside oversight. Investors should consider how projects will be monitored and evaluated.

What makes a good conservation project?

Our experts stressed the importance of the 'public good' and economic development in identifying appropriate conservation projects. There is a 'sweet spot' where conservation goals are also crucial to a sovereign's fiscal outlook. Projects should have a preservation benefit and a conservation benefit – they should present an opportunity for economic development and/or preservation (such as tourism, supporting regulated, sustainable fishing practices, etc).

One speaker noted that projects should address conservation goals that benefit a wider community – they need to justify the credit enhancement being received. For example, the Galapagos Islands are a World Heritage site – protecting them has a local advantage (facilitating sustainable tourism) and a broader public good. Similar biodiversity hotspots need to be protected. Projects also need to provide additionality – these are conservation goals that won't be met without assurance. Projects should aim to preserve a cash flow into the future.

Challenges and mitigants

How much fiscal stabilisation can DNS achieve? Will conservation efforts be enough? Does government commitment to conservation conflict with local views? Do sovereigns sacrifice agency for interest cost savings? All of these are challenges for debt-for-nature instruments, and they require a balance between issuers, insurance providers and investors. Fiscal relief could be mixed – this isn't a comprehensive debt restructuring. Government commitment may vary over time. Investors may have limited ability to enforce on the conservation side.

Our speakers noted that while debt-for-nature swaps are another important tool for sustainable debt markets, issuers should not try to oversell them. These are highly bespoke instruments. In most cases, a DNS will only somewhat reduce a country's debt burden, but they don't necessarily restore or improve market access. A DNS might act as an extra resource for a conservation area that is otherwise less prioritised or hard to fund in a country's existing circumstances. Expecting DNS to radically lower a country's indebtedness is very often a stretch.

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