Commonwealth Secretariat
Discussion Paper 19
Number 19 • March 2015

The Commonwealth

Debt Swaps for Climate Change Adaptation and Mitigation: A Commonwealth Proposal

Join the Discussion
Email us your comments via publications@commonwealth.int

This discussion paper was written by Travis Mitchell, Economic Adviser, Finance and Development Policy in the Economic Policy Division of the Commonwealth Secretariat.

Published by the Commonwealth Secretariat
Editor: Joan Ross Frankson
Designer: Rob Norridge

ISSN: 2071-2022

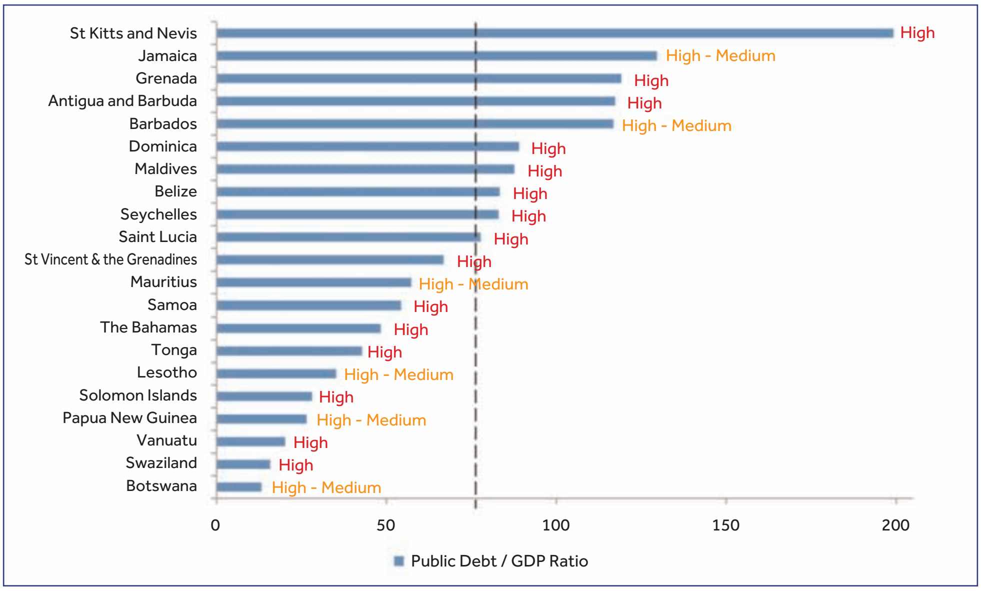
Publications Section
Commonwealth Secretariat
Marlborough House, Pall Mall
London SW1Y 5HX
United Kingdom

Introduction

Small states possess unique structural characteristics that pose a special development challenge and combine to place them amongst the countries most vulnerable to external shocks. Their efforts to integrate with the global economy have not gone to plan but have instead brought greater instability. At the same time climate change has been a real threat in these countries; natural disasters have become more likely, frequent and deep, thus negatively affecting growth and reversing hard-earned development gains.

Continuing high debt burdens compound small states' vulnerability and hamper domestic and international attempts to build resilience. The majority of Commonwealth small states have total public debt burdens that indicate solvency challenges, and the rest show signs that solvency challenges are emerging. As at the end of 2012, small states owed approximately 46 per cent of all their debt to multilateral institutions. Most of the total public debt burden was concentrated in the Caribbean, where five small states held total public debt stocks exceeding 100 per cent of gross income (Figure 1).

Figure 1. Indebtedness and environmental vulnerability of Commonwealth small states



*Notes: *Figures for SVE total public debt/GDP ratio as at December 2012.*
*** The dashed line is the IMF's 60 per cent threshold above which solvency challenges arise.*
Source: Commonwealth Environmental Vulnerability Index, 2000.

The debt challenge and the need to reduce vulnerability and build resilience in small states have been widely recognised within the international community, as reflected in more flexibility in some lending policies and donor's increased commitment to provide climate change financing. However, this flexibility and commitment has not yet been extended to debt relief.

Flexibility in lending and commitment to climate change financing is not reflected in debt relief

The reluctance to commit to debt relief is reinforced by limited international financial resources and the policy of safeguarding those scarce resources for low-income countries. The World Bank estimates[1] that there is a sizeable gap in funds to help countries achieve the Millennium Development Goals (MDGs) by 2015. Debt sustainability targets are included in the MDGs (Goal 8). Donor pledges to finance climate change adaptation and mitigation are also short of the international commitments articulated.

The Commonwealth proposal for a multilateral debt relief-for-climate swap mechanism illustrates there is ample scope for innovative solutions to address the debt challenges of small states, in spite of the recognised resource constraints. The sections that follow define the proposal and its rationale, explains how the debt swap instrument will work in practice and looks at the costs to donors.

The proposal and rationale

The Commonwealth proposal is for an innovative financing mechanism to assist small states, which comes in the form of a multilateral relief-for-climate change adaptation and mitigation initiative. This mechanism has the potential to provide significant debt relief while helping small states to unlock pledged climate finance to fund climate change adaptation and mitigation projects. Basically it requires donors to write off small states' multilateral debt using their climate finance pledges, in exchange for donor investment in climate change adaptation and mitigation projects.

The rationale underpinning the proposal is simple. On the one hand there is a huge pot of climate finance resources available against a similarly huge implementation gap, while at the same time there is a persistent and unsustainable debt overhang in climate vulnerable countries. This ground-breaking way of using climate funds could assist in alleviating both of these important challenges.

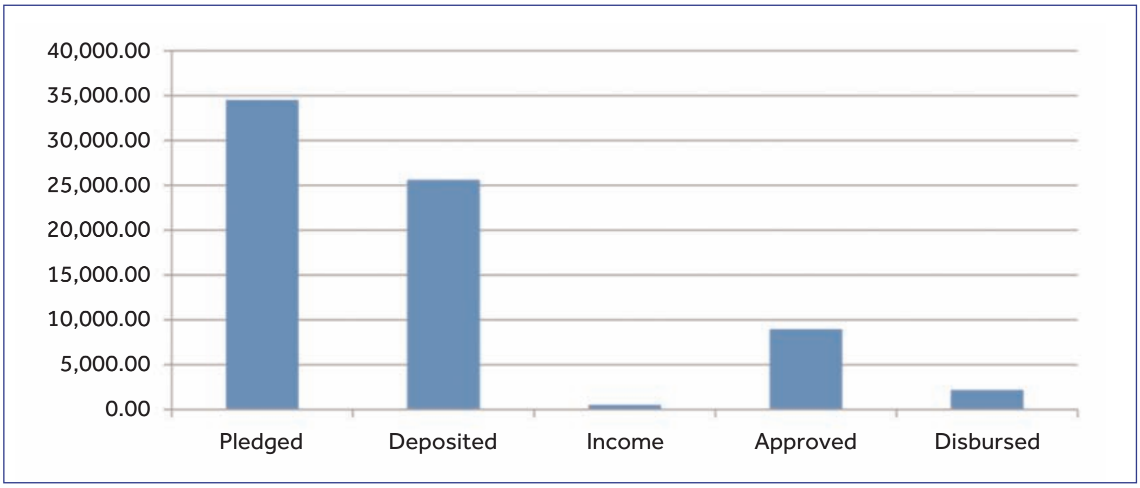
As is illustrated in Figure 2, developing countries have had extreme difficulty in accessing donors' climate change financial commitments. Such difficulty has stemmed from certain conditionalities linked to climate finance, which developing countries have been unable to satisfy, and in some cases to issues of absorption capacity and fragmentation with respect to sources of funding. Evidently, there is a significant climate finance implementation issue that needs to be resolved.

Debt relief provided by donor countries of the Organisation for Economic Co-operation and Development (OECD) and OECD-Development Assistance Committee (OECD-DAC) is eligible to be counted as official development assistance (ODA),[2] as is climate finance. This initiative could therefore

1 *'The Costs of Attaining the Millennium Development Goals' (2004), Summary of the World Bank Policy Research Working Paper, 'Development Goals: History, Prospects and Costs' (2003) by Shantayanan Devarajan, Margaret J Miller and Eric V Swanson.*

2 *Official development assistance (ODA) is a statistic compiled by the OECD Development Assistance Committee (DAC) to measure what does and doesn't count as aid. Debt relief is ODA-eligible, meaning that donor countries can count it as aid in their national accounts.*

Figure 2. Status of climate funding (US$ million)



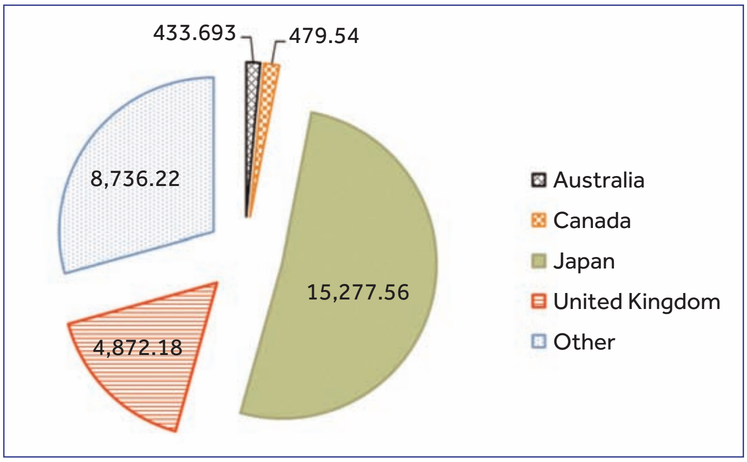
Source: www.climatefundsupdate.org/data, as at September 2014.

stimulate a more rapid increase in climate finance disbursements, thus reducing the implementation gap and helping donors to meet the internationally agreed aid target of at least 0.7 per cent of GNI annually as ODA to developing countries.

No need for additional resources

At the United Nations Conference on Climate Change, held in Copenhagen in 2009 and Cancun in 2010, rich countries committed to provide new and additional resources approaching US$30 billion in the period 2010 to 2012 and to mobilise long-term finance of a further US$100 billion per year to 2020, to help meet the climate change adaptation and mitigation needs of developing countries. In many cases, these pledges have already been factored into annual budgets. For instance, the UK government set a budget of £2.9 billion, known as the international climate fund, for climate finance over the period to 2014-2015. Of the total climate finance pledges made, as at September 2014, the UK accounts for 16.4 per cent, while Canada and Australia account for 1.6 per cent and 1.5 per cent, respectively.

Figure 3. Climate finance pledges by donor country (US$ million)



Note: Figures are cumulative since 2003. Source: www.climatefundsupdate.org/data

Donor Benefits in Brief

No additional resources
Increased disbursement of pledged funds
Reduce climate finance implementation gap
Help in meeting internationally agreed aid targets
Flexibility in design/amount provided

The mechanism: debt-for-climate swap

The initiative is essentially a variant of a debt-for-nature swap in which a donor writes off a portion of a country's foreign debt when the country agrees to finance a specific conservation project using local funds. In the case of a debt-for-climate swap, as currently being proposed by the Commonwealth, the project specified would be implementation of climate change adaptation and mitigation measures.

A variant of a debt-for-nature swap, with a climate change adaptation and mitigation focus

Most debt-for-nature swaps have been implemented by bringing in a conservation organisation to purchase the borrowing country's debt at a deep discount in the secondary debt market. Hence, there are two main actors. The debt relief is provided by the donor via the repurchase of the original debt by the debtor at a redemption price, which is lower than the original face value. However, the redemption price is normally higher than the buy-back price afforded to the conservation organisation, so that the difference between the redemption price and the buy-back price is used by the conservation organisation to finance the environmental projects. A trust fund is normally set up to manage the environment financing.

In the Commonwealth multilateral debt-for-climate swap initiative, there would be three actors – multilateral institutions, donor countries and small state debtor countries – but no interaction with the secondary debt market. This is the main element distinguishing the Commonwealth debt swap proposal from traditional debt-for-nature swaps in which the conservation organisation has to raise enough funds to buy back the debt of the debtor country at a particular secondary market price.

The secondary market price, however, is not fixed in stone. It will fluctuate depending on the market's perception of the debtor country's ability to repay and the debtor country's general macroeconomic performance. This complicates traditional debt swaps and has been one of the main reasons why they have not led to significant relief for developing countries. For example, in many cases the indebted countries will be at the same time undertaking reforms to tackle their debt situation, thereby increasing the secondary market price on debt and lowering the realised debt relief.

In contrast, the Commonwealth proposal calls for donors to use pledged climate funds to finance a gradual write down of 100 per cent of the small states' multilateral debt stock held at various multilateral institutions. This would be contingent on debtors' agreeing to make an annual payment to a trust fund in an amount equal to their existing multilateral concessional debt service, and in local currency. The payments would be made over a period of 10–15 years (or a period prior to maturity of the existing debt), and used to finance climate change adaptation and mitigation projects.

For this to happen, the Commonwealth proposes that multilateral institutions set up a system to ensure donor participation is in proportion to respective climate finance pledges to the indebted countries and the total debt to be written off. They should then ensure that transfer of donor contributions be included as part of the annual subscriptions of participating donor countries to multilaterals, or as a single transfer from their climate finance budgets, the latter of which would cause an immediate jump in climate finance disbursements and individual donor contributions to ODA. In any case, these transfers should be in addition to pledged ODA[3].

3 Despite debt relief qualifying as ODA, the ODA generated from the debt relief operation should not be used to reduce the planned disbursement of ODA to small states. Rather the ODA from debt relief should be additional to ODA already planned.

Table 1. Public debt-to-GDP pre- and post-debt exchange in Commonwealth small states

Step	Considerations
1. Donors decide on a cut-off date for multilateral concessional loans eligible to be included in the initiative.	Will existing disbursing loans be eligible?
2. Calculation of total multilateral concessional debt owed by small states, and to which particular multilateral institution (e.g., IMF, World Bank and/or regional development banks).	Data on aggregate multilateral debt stock by country are available from the World Bank Global Finance Database. With co-operation from governments of small states and relevant multilateral institutions, it would be relatively easy to calculate the composition of small states' multilateral concessional debt stock by stock of debt owed to the various multilateral institutions
3. Donors decide on the extent of debt relief.	This will have implications for the cost of the initiative to donors and whether it will be 100 per cent as proposed by the Commonwealth or less.
4. Multilateral institutions and small states jointly verify whether the amount of debt relief is sufficient for the envisioned projects based on the climate change adaptation and mitigation plans submitted by the borrowing country.	This is assuming that the country has already prepared a costed climate adaptation and mitigation plan. If not, this could be done in collaboration with a relevant agency (e.g., World Bank).
5. Multilaterals in collaboration with participating donors set up a system to calculate individual donor contributions to the initiative.	This system would be based on the debt to be written off and existing donor pledges to the indebted countries. The cost of the adaptation and mitigation measures to be implemented would also be a major determinant.
6. Donors transfer earmarked climate funds, in an amount equal to the agreed write-off of small states' multilateral concessional debt stock, to the multilateral institution(s).	Donors and multilaterals have to decide whether transfers of contributions will be annual as part of donor subscriptions to multilaterals or through one lump sum payment. Contributions should be additional to existing ODA donations.
7. The debt-for-climate swap process is carried out through the central bank of the indebted country. Over a period of approximately 10–15 years (or another period as determined), the host country places the converted local currency equivalent of annual multilateral concessional debt service obligations into a climate change trust fund established at the central bank, where interest can be earned until such time as it is spent on climate finance projects.	The central bank converts the external debt to local currency and governs the trust fund.
8. The climate change adaptation and mitigation projects are implemented.	Examples include adaption/disaster risk management projects, agriculture and natural resources management projects and mitigation/bioenergy projects

Small states, in collaboration with relevant agencies (e.g., World Bank) should prepare beforehand a climate change adaptation and mitigation plan outlining key projects and the necessary financing. Costing of the climate change adaptation and mitigation needs will be important to determine the adequacy of the relief. This costing would in essence determine the length of the debt service payments in local currency and the ultimate debt relief received.

Table 2. Estimated costs of multilateral debt-for-climate finance initiative

	Most environmentally vulnerable: ranking extremely vulnerable to vulnerable		Less environmentally vulnerable: ranking at risk to resilient		All SVEs	
Cancellation of multilateral concessional debt stock (US$ million)						
	2008	2010	2008	2010	2008	2010
Commonwealth SVEs						
IDA-eligible and blend	1,701.1	1,970.2	432.3	423.9	2,133.5	2,394.1
Middle/Higher Income	465.5	495.3	337.5	353.9	803.0	849.2
Total	2,166.7	2,465.5	769.8	777.8	2,936.5	3,243.3
Non-Commonwealth SVEs						
IDA-eligible and blend	0.0	527.3	598.5	706.0	598.5	1,233.3
Middle/Higher Income	481.5	4.5	87.9	64.1	569.4	68.6
Total	481.5	531.7	686.4	770.2	1,167.9	1,301.9
All SVEs						
IDA-eligible and blend	1,701.1	2,497.5	1,030.8	1,129.9	2,731.9	3,627.4
Middle/Higher Income	947.0	499.7	425.4	418.0	1,372.4	917.8
Total	2,648.2	2,997.2	1,456.2	1,548.0	4,104.3	4,545.2
Cancellation of annual multilateral concessional debt stock (US$ million)						
Commonwealth SVEs						
IDA-eligible and blend	67.5	88.8	21.7	25.1	89.2	113.9
Middle/Higher Income	46.6	42.7	19.1	43.0	65.7	85.7
Total	114.1	131.5	40.8	68.1	154.9	199.6
Non-Commonwealth SVEs						
IDA-eligible and blend	0.0	18.5	16.8	25.1	16.8	43.6
Middle/Higher Income	12.8	0.4	7.3	33.5	20.1	33.9
Total	12.8	18.9	24.1	58.6	36.9	77.6
All SVEs						
IDA-eligible and blend	67.5	107.3	38.6	50.3	106.0	157.5
Middle/Higher Income	59.4	43.1	26.4	76.5	85.8	119.6
Total	126.9	150.4	64.9	126.8	191.8	277.2

Source: World Bank, Global Financial Development Database, 2013.
Note: 'Blend' refers to access to both concessional and non-concessional resources. The World Bank's concessional resources are managed by the International Development Association (IDA) and its non-concessional resources by the International Bank for Reconstruction and Development (IBRD).

Table 1 provides a brief step-by-step outline of how the Commonwealth multilateral debt-for-climate finance initiative is expected to work in practice.

Amount of climate finance to be allocated

The climate finance funds that would have to be allocated for implementation of a multilateral debt-for-climate finance initiative are relatively small. Table 2 provides some crude estimates underpinned by a number of different permutations that stem from the donor's choice of suggested eligibility criteria. These can include income classification, degree of environmental vulnerability and whether or not the small state is a member of the Commonwealth.

Assuming 100 per cent write down of small states' multilateral concessional debt stock, and based on data for 2012, the total cost of the initiative could range from an estimated US$4.5 million to US$4.5 billion depending on donors' preferred eligibility criteria. This is within the US$5.78 billion of total climate funds pledged by the UK, Canada and Australia since 2003. In line with this range of options, the multilateral debt relief initiative could translate into US$0.4 million to a maximum of US$277.2 million worth of debt service ring-fenced annually for climate change projects in beneficiary countries, respectively. Over the life of the debt swap (assuming a write down over 10–15 years), that would generate US$6 million to US$4.2 billion of climate financing.

In addition to the eligibility criteria suggested above, there is wide scope for adapting this initiative to match donors' preferences with respect to the scale of debt relief. For example, donors can decide to:

- Arbitrarily cap the level of debt relief per country;
- Cap total debt relief at a percentage of individual climate finance pledges; or
- Provide debt relief at a discount rather than at 100 per cent as suggested above.

Other key points to consider

- This mechanism for funding climate change adaptation and mitigation builds on a history of debt relief as an efficient modality for poverty reduction spending.
- For small states the real value of this approach is the allocation of current multilateral debt service to agreed climate change adaptation and mitigation priorities, providing an immediate development spin off proportionate to a 10–15 year investment of these debt servicing resources.
- The actual debt relief received is dependent on the length of the agreed repayment in local currency and the cost of the projects to be financed. If the cost of the climate change programme is high, it is unlikely that the debt relief received will be large given the need to fully utilise donor pledges for the purposes intended. In essence, the write down period would be longer.
- The initiative can be adapted to relieve commercial as well as bilateral debts, and expanded to utilise funds pledged for renewable energy.

The Commonwealth