Linking sovereign debt to climate and nature outcomes

A guide for debt managers and environmental decision makers

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Summary

As countries grapple with the triple crisis of debt, climate change and nature loss, compounded by the impacts of the COVID-19 pandemic, multiple innovative solutions in sustainable finance are beginning to gain traction. These innovations towards an inclusive green recovery offer substantial benefits for developing countries looking to increase their fiscal space, adapt to climate change, reduce their emissions and protect their natural environment.

This guide presents these innovations in an actionable plan that links sovereign debt to climate and nature outcomes. Seven practical steps outline ways for governments to complete a debt transaction linked to their sustainability goals for climate and nature.

Aimed primarily at debt managers and environmental decision makers, the guide also serves as an operational pathway for creditors, international institutions and nongovernmental organisations to work together, using these emerging financing innovations to improve debt sustainability and increase climate and nature investment in the most climate-vulnerable and biodiversity-rich countries.

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The Shaping Sustainable Markets group works to make sure that local and global markets are fair and can help poor people and nature to thrive. Our research focuses on the mechanisms, structures and policies that lead to sustainable and inclusive economies. Our strength is in finding locally appropriate solutions to complex global and national problems.

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Summary

This guide is part of a concerted effort by the international community to address the triple crisis of high and rising debt levels in developing countries, the climate change emergency, and the accelerated degradation of the natural world. Solutions to tackling this triple crisis holistically and inclusively can be found in the context of the international financial architecture. Multiple innovations in sovereign debt financing are offering numerous benefits to indebted countries. This guide outlines some of these innovations and provides useful information for governments seeking to achieve climate and nature outcomes while simultaneously strengthening their sovereign balance sheets.

Although this document has been compiled in the wake of the COVID-19 pandemic, the practical guidance it provides is intended to remain applicable long after the world recovers from the current health crisis. Development finance has always presented a conundrum, as the countries that need it the most are often the riskiest, which translates into a higher cost of capital and subdued investor interest. Developing countries have historically relied therefore on concessional financing. As those sources diminish, low- and middle-income countries have increasingly turned to non-traditional lenders and to the international capital markets to finance their development needs with consequent higher interest rates and costs of capital. Debt vulnerabilities have risen, and the frameworks that were used in the past to coordinate global debt relief efforts are less effective as creditors have become increasingly diverse.

In response to the COVID-19 pandemic, members of the Group of Twenty (G20) provided debt relief to low-income countries by delaying amortisation and interest payments, but, paradoxically, these measures are also creating **higher** debt service costs in future years. Recognising that some sovereigns would be facing solvency issues, rather than just immediate liquidity needs, the G20 introduced the Common Framework for Debt Treatments beyond the Debt Service Suspension Initiative (DSSI) in 2020. Unfortunately, middle-income countries facing high debt burdens remain ineligible to benefit from these initiatives, and the participation rate among eligible low-income countries has been very low.

At the same time, the international community urgently needs to mobilise unprecedented amounts of public and private sector funds into these overleveraged economies for critical investment in climate change resilience and mitigation, and in the protection and restoration of natural ecosystems. As climate pollution and the degradation of the biosphere are pressing global issues, it is imperative that we take immediate global action to address them inclusively.

The debt financing innovations that have been emerging are now central to the effort to holistically address these three interlinked threats to human development. IIED, Potomac Group, and their United Nations partners have published this 'how-to' guide for linking sovereign debt to climate and nature outcomes. The goal of this guide is to provide governments and their partners with an actionable plan for taking advantage of these innovations to improve debt sustainability and also increase climate and nature investment.

The guide breaks down the process of executing debt transactions for climate and nature into seven straightforward steps. These are:

1. Create an inter-ministerial taskforce and agree on national objectives
2. Access capacity building and advice
3. Choose type of sovereign debt transaction: debt conversion and/or new instrument
4. Structure climate and nature key performance indicators (KPIs) or other relevant performance criteria
5. Design the financing aspects of the transaction
6. Engage with market participants, including creditors, credit rating agencies and investors
7. Execute debt transaction.

This guide is primarily directed at national debt management offices and ministries of finance, though it should also be useful for other government entities, such as ministries of environment, agriculture, energy, fisheries or forestry. It could also be useful for providing procedural context to other involved parties, including creditors and investors, international institutions, and nongovernmental organisations that would provide external advice and support.

One caveat is that, as of now, there is limited precedent for some of these instruments, but we expect their rapid proliferation in the near future. This guide is intended to drive forward and support that proliferation amongst sovereigns, and so we anticipate a revision of this document after twelve months to incorporate further real-world examples from country experiences.

List of abbreviations

COP26	26th Conference of the Parties under the United Nations Framework Convention on Climate Change
DFN	Debt-for-nature
DMO	Debt management office
DSA	Debt sustainability analysis
DSSI	Debt Service Suspension Initiative
EMBI	Emerging Market Bond Index
ESCWA	United Nations Economic and Social Commission for Western Asia
ESG	Environmental, social and governance
GCF	Green Climate Fund
GEF	Global Environment Facility
HIPC	Heavily indebted poor country
ICMA	International Capital Markets Association
IMF	International Monetary Fund
JSEG	JP Morgan ESG Index
KPI	Key performance indicator
LDC	Least developed country
MEL	Monitoring, evaluation and learning
MRV	Monitoring, reporting and verification
NBSAP	National Biodiversity Strategies and Action Plan
NDC	Nationally determined contributions
NGO	Nongovernmental organisation
OECD	Organisation for Economic Co-operation and Development
PEFA	Public Expenditure and Financial Accountability
RDB	Regional development bank
SIDS	Small island developing states
SLB	Sustainability-linked bond
SPO	Second-party opinion
SPT	Sustainability performance target
UN	United Nations
UNDP	United Nations Development Programme
UoP	Use of proceeds
WB	World Bank

Benin, Ganvie lake village. Photo credit: Agbeko Masseme via Pixabay, CC BY-NC-ND 2.0

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Introduction: the triple crisis, the green recovery and intended audience

The triple crisis of debt, climate change and environmental degradation

As countries around the world continue to grapple with the overwhelming humanitarian impact of the COVID-19 pandemic, additional crises are looming as serious impediments to a sustainable recovery:

1. **Debt:** the sharp rise in government expenditure needs required to address the public health crisis has put an unanticipated strain on sovereign balance sheets. With the urgent necessity to prioritise public health expenditure, the international community has mobilised to provide financing and temporary debt relief to many of the countries that require it most. While these emergency measures may have helped prevent a debt crisis in the immediate term, the deferral of debt service payments has resulted in an increase in debt stocks for many countries. Taken alongside other side effects of the pandemic, such as fiscal deficits, low interest rates, and a prolonged period of low economic growth, or even recessions, it leads to a precarious outlook for borrowers that are worried about their long-term debt sustainability. External pressures resulting from an asymmetric global recovery can also mean currency depreciation, which would lead to a rise in interest rates and further exacerbate the situation. Furthermore, fears of diminished credit ratings or the potential loss of market access have inhibited some from renegotiating the terms of their debt. Although a mid-pandemic debt crisis has been averted, the rise in debt-to-GDP ratios is likely to have a prolonged impact on market access and fiscal space, thereby limiting capacity for financing a post-COVID recovery. This growing debt burden urgently requires a comprehensive and forward-reaching solution.
2. **Climate:** worldwide, the effects of climate change have been felt with increasing intensity year by year. Many regions have recorded rising temperatures at an unprecedented level, and climate-related disasters, such as floods, storms, droughts, and wildfires, have been striking with increased frequency all around the world. Countries are struggling to meet their obligations under the Paris Agreement to reduce emissions within the necessary timeframe, and COP26 in Glasgow is aimed at streamlining these efforts by coordinating strategies to accelerate the transition to renewable energy sources. Phasing out fossil fuels when they are so firmly established in all economies will be no easy task, and some countries will find the process more difficult than others, both practically and politically. It is therefore imperative that the international community share the burden by helping to ensure that this transition is feasible for every country. Climate change is a global issue and requires a global solution.
3. **Nature:** the natural world is often critically important in a developing country's economy as a source of livelihood through agriculture, fishing, tourism and other nature-based industries, as well as a provider of cultural and aesthetic value. Nature is also fundamentally and inseparably linked to climate stability. As human activity emits greenhouse gases that heat the world, natural ecosystems, such as forests and oceans, act as natural buffers to regulate the biosphere, absorbing carbon and even mitigating the damage from climate-related disasters. Biodiversity loss and the destruction of natural ecosystems have dramatically reduced the planet's capacity to do this, accelerating the negative effects of climate change. Despite this relationship, nature conservation remains a distinct issue from emissions reduction, therefore requiring specific attention.

Need for sustainable finance for an inclusive green recovery

The triple crisis of debt, climate and nature has been recognised as an immovable obstacle in the way of development for many of the world's most vulnerable countries (Steele and Patel, 2020). Simultaneously, there is growing global consensus that the climate and nature crises are reaching a tipping point, and that channelling funds to protect these public goods which sit in emerging markets is vital to reversing the situation worldwide. The international community has therefore been emphasising the urgent need for global coordination towards an inclusive 'green recovery' from the pandemic.

Many countries aspire to dedicate resources to climate change, with adaptation being the priority for climate-vulnerable countries with very low emissions. The 46 least developed countries (LDCs) and small island developing states (SIDS) are collectively responsible for a very small percentage of global emissions, but agricultural dependence and the need for stronger infrastructure make them very vulnerable to climate-related disasters. Large middle-income countries, however, are major sources of greenhouse gas emissions. Likewise, heavily forested large countries contribute to global emissions through agricultural expansion and logging, reducing the natural environment's ability to sequester carbon.

Despite these varying climate and nature concerns, all of these countries face budget constraints and competing needs, many of which have a more immediate impact or stronger political demand. As seen during the pandemic, health and other social needs, such as economic stimulus, can take precedence over environmental concerns, which are perceived as longer-term challenges and therefore crowd out necessary spending on climate and nature policies. For countries with market access, such behaviour has generally been rewarded by investors. International capital markets tend to focus more on governance and social issues than environmental risks when pricing sovereign debt instruments.

In a concerted effort to address the climate and nature crises, as well as the growing debt burden, multiple innovations in the field of sustainable finance have begun to gain traction. The goal of these innovations is to offer substantial financial benefits for countries seeking to reduce their emissions, adapt to climate change and protect their natural environment, beyond simply making these efforts more affordable. In this way, sovereign debt managers, depending on their country's situation, may be able to improve debt sustainability while mobilising new sources of capital with attractive terms and conditions.

Intended audience for this guide

This how-to guide provides governments with an actionable plan for doing this, explaining how to take advantage of transactions that link sovereign debt to climate and nature outcomes. While primarily directed at debt management offices (DMOs) and ministries of finance in developing and emerging market countries, it should also be useful for ministries of environment, agriculture and energy, and other agencies that have a stake in budget finance and environmental outcomes. Likewise, the guide may serve as an operational roadmap for other involved parties, such as creditors, international institutions and nongovernmental organisations (NGOs) that provide external advice and support.

Bangladesh, preparing to build a road. Photo credit: Scott Wallace/World Bank via Flickr, CC BY-NC-ND 2.0

How to complete a debt transaction for climate and nature in seven steps

This guide sets out seven clear steps to complete a debt transaction for climate and nature outcomes:

1. Create an inter-ministerial taskforce and agree on national objectives
2. Access capacity building and advice