(Re)orienting Sovereign Debt to Support Nature and the SDGs:

Instruments and their Application in Asia-Pacific Developing Economies

July 2023

Executive Summary

Brief Description of the Publication

Many Asia-Pacific low- and middle-income countries are facing the dual challenges of sovereign debt distress and climate and biodiversity breakdowns, while also lagging on Sustainable Development Goal (SDG) achievement. Competing financing priorities, along with sharp increases in the share of public debt held by bondholders and emerging bilateral creditors, complicate urgently needed agreements to restructure sovereign debt and reorient resources toward the SDGs, particularly climate and nature-positive actions. We propose additional means to manage sovereign debt and environmental distress, showing how debt-for-nature swaps have been successfully deployed in debt-reorganization packages. For illustrative purposes, we present rationales and possible roadmaps to deploy debt-for-nature swaps for a selection of Asia-Pacific economies: Lao PDR, Pakistan, the Maldives, and a group of Pacific Small Island Developing States. While the scale of such swaps has risen significantly in recent years, their contribution to debt reduction remains modest so far, hence stakeholders need to be realistic about the extent of the instrument's impact on debt sustainability. However, successful and relatively large-scale debt-for-nature swaps in Belize and Ecuador have given sovereign debtors a new impetus to explore them. We also show how sovereign borrowers have used – or could use – thematic bonds, sustainability-linked bonds, and other SDG-aligned instruments to raise new financing. We focus on the role China could play in the Asia-Pacific region, adding to knowledge about this comparatively less-understood emerging creditor. We conclude with four recommendations for how policymakers in creditor and debtor countries and other stakeholders can effectively engage in debt relief and reorientation arrangements to support the SDGs and global environmental commitments.

Authors and Acknowledgements

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Executive Summary

Looming crises: Debt and environmental sustainability at risk in the Asia-Pacific region

Many developing low- and middle-income countries (LMICs) in the Asia-Pacific region are confronted with the dual challenges of greater sovereign debt distress – exacerbated by global shocks including COVID-19 – and environmental risk through climate change and biodiversity loss. Without an effective solution to the debt crisis and significant additional financing and investment in Asia-Pacific LMICs, regional and global ambitions to meet the Sustainable Development Goals (SDGs) will become impossible to achieve.

Out of the world's 52 most debt-vulnerable economies, 12 are in the Asia-Pacific region (UNDP, 2023). Due to unaddressed debt distress and insufficient or non-existent access to external finance, these economies are at risk of being severely underinvested in social, economic and environmental development. At the same time, Asia-Pacific economies count among the most vulnerable to climate change, land and marine degradation, and subsequent biodiversity loss, all of which severely impact lives and livelihoods, the countries' debt-carrying capacity, and their short-, medium- and long-term development goals.

For these reasons, finance ministers from Asia-Pacific countries – members of the Vulnerable 20 (V20) coalition – have called for debt reorganizations and sustainable finance instruments, including swaps, grants, loans, or bonds linked to the climate and other SDGs, for enhanced resilience and green and inclusive recoveries (V20 Presidency 2021). This requires not only updating and expanding upon traditional debt treatments and instruments, but also managing an increasingly complex creditor composition.

New challenges and opportunities for debt reorganization in Asia-Pacific LMICs

Traditionally, to address sovereign debt issues, official multilateral and bilateral creditors (often coordinated by Paris Club members) have provided debt relief to low-income countries through concessional restructurings, including debt-for-development swaps. However, few standardized single- or multi-creditor interventions exist to address debt issues in middle-income countries, while even fewer interventions combine debt relief and SDGs related to the climate and nature.

An analysis of the 24 Asia-Pacific economies covered by the World Bank International Debt Statistics (IDS) (2022) database shows that:

- **Bondholders** greatly expanded their total and relative exposure, and now hold 45.4 percent of total public and publicly guaranteed (PPG) external debt in the region.
- The **World Bank** (16.9 percent) and the **Asian Development Bank** (11.2 percent) are the second and third largest creditors, respectively.
- **Emerging bilateral creditors** are playing a greater role. China, for example, has significantly increased its total and relative external debt exposure to 7.1 percent of the total PPG debt exposure of Asia-Pacific countries analysed in this report, becoming the fifth largest creditor in the region.

Compared with past debt-crises negotiations, this significantly different creditor composition and the urgency of climate and biodiversity breakdowns require a more tailored application of treatments and instruments. For this reason, new and some less-frequently used instruments, such as SDG-aligned debt-for-development swaps, have attracted growing interest in recent years. In particular, two approaches to sovereign debt can improve both debt and environmental sustainability:

- **Debt reorganization treatments** that convert and possibly forgive debt contracts for SDG and nature-positive development through debt-for-nature swaps and other SDG-conditional instruments.
- **New SDG-aligned debt issuance** through thematic bonds, i.e., green or blue bonds, and sustainability-linked bonds and loans.

Nature-positive debt reorganizations would benefit sovereign debtors by freeing up resources used to pay debt service to instead invest in climate-resilient infrastructure, green productive capacity, and nature-based solutions that could stimulate employment and citizen wellbeing. Creditors, too, would benefit from positive effects, such as lower default risk, higher shareholder and stakeholder value, less litigation exposure, and greater portfolio diversification.

Debt-reorganization packages can involve more than one type of treatment and instrument to improve outcomes. Importantly, each treatment and instrument for reorganizing debt or issuing new debt can be applied to specific situations that have different underlying requirements and circumstances.

Possible applications in support of nature and the SDGs in Asia-Pacific LMICs

To illustrate how debt-for-nature swaps might be applied, this report provides rationales and possible roadmaps for a selection of Asia-Pacific economies: Lao People's Democratic Republic (PDR), Pakistan, and a group of Small Island Developing States (SIDS). These economies have different creditor compositions, but share three important characteristics that apply to other Asia-Pacific LMICs:

- High vulnerability to the effects of climate and biodiversity breakdowns, with knock-on implications for macroeconomic conditions and debt sustainability.
- National priorities that include nature conservation, protection, and restoration for which securing financing at the required scale is extremely challenging.
- A readiness to move forward with pertinent debt reorganization treatments, including exploring the potential for debt-for-nature swaps.

Lao People's Democratic Republic (PDR) appears to have potential to engage with its bilateral creditors on a debt reorganization package. There has been some interest in understanding the operational aspects of debt-for-nature swap-type instruments. Lao PDR has prepared sustainable development plans that include additional forest protection projects, and it has the support of implementing agencies, including UNDP. In addition to the need for creditors' willingness to participate in such an arrangement, Lao PDR would need to further strengthen its governance mechanisms through monitoring, reporting, and verification (MRV) systems to help ensure that projects funded from debt-for-nature swap proceeds deliver the desired outcomes.

Pakistan faces significant levels of debt and challenges for refinancing it, such as declining bond-market access. It is also facing an imperative to ensure climate-resilience and conservation. Against this background, Pakistan could explore new opportunities to use debt-for-development swaps, including -nature swaps, with major bilateral creditors, such as China. The debt-service savings or grant funding from such conversions could be used to support the SDGs, the 2022 flood reconstruction efforts, and climate-resilience and nature-conservation programmes. Governance, transparency, and accountability concerns could be addressed using an intermediary entity and multilateral technical advisory partners.

Asia-Pacific Small Island Developing States (SIDS) could benefit from debt reorganizations in single or multi-creditor arrangements that include debt-for-climate or -nature swaps or, if the strength of their economy allows, new financing through thematic and sustainability-linked bonds. The IMF believes that some debt reorganization instruments that consider nature outcomes "could be superior to grants when structured in a way to make the climate commitment senior to debt service" or in specific circumstances of debt restructuring (Chamon et al 2022).

Recommendations to accelerate debt reorganization and (re)orientation negotiations to benefit nature and the SDGs in the Asia-Pacific region

While debt-for-nature swaps could be feasible in Asia-Pacific LMICs and are potentially superior to some other instruments (Chamon et al 2022), they require creditors and sovereign debtors to undergo often complex negotiations to reorganize sovereign debt, ensuring both sufficient transparency and the confidentiality of market-sensitive information. Adding debt-reorientation ambitions to improve environmental or broader SDGs outcomes further complicates such negotiations, although, as previous deals show, there is some potential to meet both sets of objectives in tandem. Learnings from the island nation of the Maldives are relevant. The report highlights the challenges encountered during the exploration of a Maldives' debt-for-nature swap in 2020 and provides lessons for sovereign debtors and their advisors. It is critical to enhance the understanding of creditors' roles and challenges as they voluntarily participate in single- or multi-creditor sovereign debt-relief treatments, or cash out through third-party-organized debt conversions, in order to accelerate negotiations. Following an extensive analysis, this report makes four recommendations:

1. **Creditors and sovereign debtors should exercise caution when choosing between or combining debt-relief treatments and instruments** to ensure that they are suitable for the sovereign debtor's specific situation and the creditor's interests and *modus operandi*.

2. **Asia-Pacific sovereign debtors should be prepared to understand and negotiate the implicit and explicit conditions of each type of creditor** – traditional, emerging, private – as they pertain to debt relief, debt-for-development swaps, debt-for-nature conversions, or new sustainable finance. Asia-Pacific economies aiming to engage with traditional Paris Club creditors should familiarize themselves with relevant policy frameworks, including those related to debt-for-development swaps. Asia-Pacific economies aiming to engage with China should build a solid understanding of Chinese overseas loans and lending governance.

3. **Asia-Pacific sovereign debtors should prepare for negotiations to (re)orient debt by developing a clear plan for the implementation of a debt-for-nature swap or other nature-aligned instrument and related project** in line with their national priorities. This includes identifying and engaging with domestic government officials, citizens, and civil society organizations; international institutions and nature conservancy groups for the provision of expertise; and bankers and development finance institutions for the provision of credit enhancements and other financing services. It also includes putting into place nature-project plans, managers, and monitoring, reporting and verification systems.

4. **Creditors should play an active role in helping Asia-Pacific economies manage sovereign PPG external debt and environmental and climate risks** by significantly expanding the scope for debt reduction and reorientation arrangements, and by making more extensive use of state-contingent debt instruments in their lending. In exchange for climate or nature protection benefits, traditional multi- and bilateral creditors can accelerate the deployment of their debt-relief and reorientation frameworks and mechanisms, provide credit enhancements, and participate in the equity of overleveraged debtor-state-owned enterprises. They can also evaluate and deploy non-traditional instruments, incentivize sovereign debtors to design and negotiate nature-positive debt reduction plans, and coordinate with other creditors. China, as a key emerging creditor, has an important opportunity to make a significant contribution to debt-relief and reorientation arrangements in Asia-Pacific LMICs and support partner countries' development priorities, while also demonstrating strong commitment to international environmental agendas. Similarly, private creditors can step up their participation in Asia-Pacific LMIC debt reorganization and reorientation arrangements, including by purchasing and holding nature-aligned sovereign bonds.

By following through on these four recommendations, Asia-Pacific LMICs and their creditors can overcome some of the limitations of traditional debt-reduction arrangements and also address debtor countries' vulnerabilities to climate and biodiversity breakdowns. SDG- and nature-aligned debt instruments could thus have the power to resolve the increasingly urgent crises of debt and environmental distress. That said, while the scale of such swaps has risen significantly in recent years, their contribution to debt reduction remains modest so far, hence stakeholders need to be realistic about the extent of the instrument's impact on debt sustainability. However, successful and relatively large-scale debt-for-nature swaps in Belize and Ecuador have given sovereign debtors a new impetus to explore them. The timely and deft deployment of SDG- and nature-aligned instruments, particularly of debt-for-nature swaps, could provide new momentum and some of the finance needed to realise global and regional ambitions to advance the SDGs.