Debt-for-Nature Swaps (DFNS): A Primer

This primer was made possible through support provided by the U.S. Agency for International Development, under the terms of Contract No. 7200AA22C00044. The opinions expressed herein are those of Chemonics International and do not necessarily reflect the views of the U.S. Agency for International Development.

Debt-for-Nature Swaps (DFNS) provide debt reduction in exchange for agreements to invest financial savings to protect nature and mitigate climate impacts.

Given the growing linkages between climate vulnerability and sovereign debt, and the growing scarcity of concessional financing for vulnerable countries, DFNS can offer governments a financing option for mitigating fiscal vulnerabilities while meeting climate and nature conservation commitments.

Some countries face limitations in their budgetary capacity to finance necessary climate investments, even with concessional financing. This issue is particularly evident in countries whose debt levels may become unsustainable due to climate change. Climate change and loss of biodiversity can increase debt vulnerabilities by reducing a country’s productive capacity and its tax base, burdening a country with the financial costs associated with natural disasters, and making external borrowing more expensive. At the same time, growing debt reduces available funding for nature conservation and climate mitigation and adaptation investments. These two problems act in concert to make both environmental and financial challenges more demanding.

A DFNS, generally referred to as a “debt conversion,” is a financial instrument that can help countries tackle issues linked to climate and biodiversity loss while simultaneously resolving debt burdens. This enables a country to respond to both challenges through one mechanism, rather than enacting a complicated mix of debt relief and fiscal adjustment in combination with climate finance programs.

Contexts when a debt swap would (or would not) be a suitable instrument can include the following:

<table>
<thead>
<tr>
<th>DFNS can work well when...</th>
<th>But not when...</th>
</tr>
</thead>
<tbody>
<tr>
<td>The debtor country has existing or potentially significant natural reserves at risk (i.e., protected natural areas of importance for flora and/or fauna), but insufficient resources to develop and maintain programs to ensure the long-term conservation of these areas.</td>
<td>The debtor country is not able to provide the policy and management resources needed for climate and nature projects due to ongoing conflict, or an elevated risk of corruption or mismanagement, raising concerns about the effective use of the funds from the transaction.</td>
</tr>
<tr>
<td>The debtor country is unlikely to receive concessional or grant funding due to it being a middle-income country.</td>
<td>The debtor is on a severely unsustainable debt trajectory and the proposed climate and nature initiatives do not materially affect the government’s overall risk profile.</td>
</tr>
<tr>
<td>The debtor country has sovereign debt that is trading at a significant discount.</td>
<td>The debtor country is looking for a quick restructuring process (i.e., less than 6 months).</td>
</tr>
</tbody>
</table>

There are commonly two types of DFNS:

1. **Bilateral debt conversion**, in which a creditor forgives a portion of the public bilateral debt of a debtor nation in exchange for environmental commitments from that country. One example of a bilateral conversion is the recent €54 million Germany-Egypt debt conversion agreement that finances investments in renewable energy and supports the Government of Egypt’s goal of reaching 42% renewables of its energy production by 2030.
Multi-party commercial or private debt conversion, in which an independent entity purchases debt titles from commercial banks on the secondary market and transfers the debt title to the debtor country. In exchange, the debtor country agrees to either enact certain environmental policies or fund a government bond and use its revenue for conservation programs. Multi-party conversions usually engage at least three entities: (a) the debtor government; (b) the organization sponsoring and facilitating the conversion (frequently a development bank, private financial institution, or international NGO); and (c) the private holders of sovereign debt. A typical structure for a multi-party conversion could proceed as follows:

1. The sponsor uses internal funds or those pooled from other investors to buy back debt in the secondary market, which it acquires at a significantly discounted market price because of the risk of default due to over-indebtedness.

2. The government repays the purchase price of the debt to the sponsor. This results in a significant reduction in the debt interest rate.

3. The reduced debt burden and lowered interest rate allow the government to generate significant savings in its debt repayments. The debtor government pledges to use all or part of the annual savings (usually in local currency) for nature conservation projects agreed upon with the sponsor.

Table: Overview of recent multi-party DFNS - Belize, Barbados, Ecuador, and Gabon

<table>
<thead>
<tr>
<th>Country</th>
<th>Belize</th>
<th>Barbados</th>
<th>Ecuador</th>
<th>Gabon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>2021</td>
<td>2022</td>
<td>2023</td>
<td>2023</td>
</tr>
<tr>
<td>Debt retired</td>
<td>USD180M over 20 years</td>
<td>USD50M over 15 years</td>
<td>USD450M over 20 years</td>
<td>USD163M over 15 years</td>
</tr>
<tr>
<td>Amounts to be invested in nature conservation</td>
<td>TNC, DFC</td>
<td>TNC, IDB</td>
<td>Ocean Finance Company, DFC</td>
<td>TNC, DFC</td>
</tr>
<tr>
<td>Sponsors</td>
<td>30% of its maritime area</td>
<td>30% of its maritime area</td>
<td>Additional 60,000km² of maritime area in Galapagos Islands</td>
<td>30% of its maritime area</td>
</tr>
</tbody>
</table>

Establishing independent planning and robust governance mechanisms ensures compliance with environmental objectives

DFNS are designed to facilitate sustainable, continuous, and reliable funding for nature conservation and climate mitigation and adaptation. The pillars on which a DFNS stands are the conservation agreements that lay out structural, operational, and financial commitments to achieve specific environmental results. These conservation commitments are set as time-specific objectives. For instance, conservation agreements coving marine protected areas for Belize, Barbados, Ecuador, and Gabon bind the governments to lay out a clearly defined Marine Spatial Plane (MSP) within a specified timeframe. Any delays in meeting milestones typically result in extra payments from the government. Rather than being distributed to debt holders, payments for missed milestones are placed into an escrow account. Once a milestone is successfully achieved, the funds held in escrow are returned to the government. If a milestone is never reached, the funds are transferred into the conservation fund.

1 Sources: Fitch Ratings, IMF, TNC, White & Case, OECD
The funds generated through debt conversion are typically managed by a private independent conservation trust fund (CTF). CTFs operate autonomously and are commonly registered as a national non-profit organization with well-defined independent governance structures and personnel. The CTF generally operates with an independent board of directors appointed from a mix of government and non-government sectors (e.g. academia, civil society organizations, and NGOs), with no one sector having majority representation. The CTF is guided by national policies and the criteria set in the conservation agreement to facilitate the disbursement of funds through grants and other financial mechanisms to support the financial needs of conservation initiatives.

Case Study: Barbados DFNS

The recent debt conversion in Barbados provides an example of a typical DFNS process. In September 2022, the Inter-American Development Bank (IDB), the Government of Barbados (GoB), and The Nature Conservancy (TNC) completed a $150 million debt conversion that created long-term sustainable financing for conservation across Barbados land and marine ecosystems.

The transaction enabled Barbados to replace relatively expensive pre-existing debt (at a 7.2% average interest rate) with significantly lower all-in financing costs of 4.9%. The debt repurchase was funded by a new “Blue Loan” arranged by Credit Suisse and CIBC First Caribbean, with 50% of payments in US dollars and the other half in Barbadian dollars. The new Blue Loan is co-guaranteed by IDB (67%) and TNC (33%). The GoB repurchased the titles, and the IDB guarantees the transaction and provides technical advice on the commitments.

The net savings will allow Barbados to direct an estimated $50 million into conservation funding over 15 years, with an estimated annual payment of $1.5 million delivered to a newly established private, independent conservation fund, the Barbados Environmental Sustainability Fund (BESF). An additional $17 million will be invested in a separate fund to build a long-term endowment for BESF, which is expected to generate an additional $10 million in returns over 15 years.

The conservation agreement incorporates ocean conservation commitments, including a transparent, participatory, and collaborative MSP guided by the best available science, data, and information. It aims to protect 30% of the country’s ocean by 2030 across more than 55,000 km² of the Barbados Exclusive Economic Zone (EEZ) and Territorial Sea. Additionally, the BESF leads a grants program aligned with national conservation, environmental, and sustainable development priorities. The IDB and TNC will provide technical assistance to support the planning and implementation of the initiative, with

---

2 Source: TNC, [https://www.nature.org/content/dam/tnc/nature/en/documents/TNC-Barbados-Debt-Conversion-Case-Study.pdf](https://www.nature.org/content/dam/tnc/nature/en/documents/TNC-Barbados-Debt-Conversion-Case-Study.pdf)
particular attention to ensuring the GoB has the technical and institutional capacity to monitor, report, and verify key performance indicators.