Debt swaps – lessons learnt and way forward

Debt swaps have been used by official creditors since 1990 for claims covered by a restructuring agreement, on a bilateral and voluntary basis for low-income countries. They were used in particular in debt cancellation and are still implemented by official creditors today. Debt Swaps are a bilateral financial mechanism that aims at transforming sovereign debt claims into ODA investments in a developing or emerging country.

Another type of debt swap has been emphasized in the discussions more recently, mostly "debt-for-nature swaps" as a financial deal to redirect portion of the debt service to a specific objective, conservation in general. Such transactions lay on blue bonds issuances by the debtor country, guaranteed by third parties, to buy back sovereign debt and rechannelling up to 100% of the savings to conservation. This was the scheme used for instance for Belize (553 M USD), Barbados (150 M USD) or Ecuador (1.6 bn USD). This paper aims at clarifying the issue of debt-swaps and cases where they are relevant, as well as situation where the recourse to this mechanism is appropriate.

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1/ Debt swap: one term but very different concrete financial instruments

– **Objectives of debt swap**:
  - Debt swap is a general term that encompasses different meanings and stakeholders. Debt swaps are a way to generate more SDG financing, as limited fiscal space is frequently identified as a major obstacle to increased ambition and implementation of SDGs.
  - They are trending back thanks to debt for climate/nature swaps but they can target many other development objectives (education, health, nature, humanitarian projects, SDGs at large etc.).
  - In the case of debt for climate and debt for nature swaps, these mechanisms are presented as a way to encourage and accelerate the implementation of climate Nationally Determined Contributions (NDCs), National Adaptation Plans (NAPs) and National Biodiversity Strategy and Action Plan (NBSAPs).
– **Two very different kinds of debt swaps**:
  - <u>Debt swaps granted by official creditors on official non-bonded debt</u>. They are basically a debt conversion targeted to development projects or directed towards budget appropriations on specific sectors. The sums owed to the creditor by the debtor country are redirected to finance development in the debtor country, often in local currency.
  - <u>Debt swaps on private debt</u> (sovereign debt towards the private market, mostly on bonded, but on few cases also on non-marketable debt), which are very different from the previous case, though also called debt swaps. Debt swaps of this kind are mostly based on the buyback of their debt at a discount by the debtor country; the difference in the reimbursement flows before and after the buyback is -totally or partially- then directed towards a development project.
– **Recent analytical papers on debt swaps**
  - The IMF published a study aimed at presenting, among other things, the cases and conditions in which a debt swap is more efficient than other existing tools.[1] It is, according to the IMF, when public finances are very constrained and climate challenges very high. Debt swaps, both bilateral conversions and private buybacks, have distinct features (e.g., reputational effects, magnitude) when compared with conventional debt treatments.
  - A Lazard Bank study commissioned by the European Commission published in September 2021, studied and presented European Member States debt swap mechanisms and the pros and cons of debt swap compared to grants[2]. They conclude that donors with debt swap instruments could

[1] Chamon, Marcos, et al. "Debt-For-Climate Swaps: Analysis, Design, and Implementation." IMF Working Papers, vol. 2022, no. 162, Aug. 2022, p. 1, https://doi.org/10.5089/9798400215872.001. Accessed 20 Dec. 2022.

[2] https://europa.eu/capacity4dev/paramos/file/120008/download?token=U1eoc0ac

standardise and scale their application by, e.g., pooling their claims and exchanging and standardising best practices.

2/ Debt swaps granted by bilateral official creditors[3] on official non-bonded debt (i).

- Such debt swaps are a **bilateral financial mechanism that aims at transforming sovereign debt claims into ODA investments in a developing or emerging country.** The debtor country either reimburse its debt in hard currency (interests and principal) or provides the equivalent in local currency (or a portion of it) to be rechanneled towards development projects or specific budget items. Even bearing a higher transaction cost than grants, such debt swaps could allow stronger ownership by the recipient country.
- **Various models can be implemented**: at an initial stage, creditors may provide for a suspension of debt service; once the development results are achieved, the creditor country cancels the owed amounts. In other words, the country "swaps" the benefit from the debt service relief, with its commitment to invest in SDGs. Another possibility is that the debtor country still reimburses its debt (interests and principal), but once the creditor receives the reimbursement, he reinvests directly the amount for financing development projects. Hence, the creditor country cancels the amounts it is owed to convert them into grants to finance development projects (interests and principal).
- **There are two different circumstances by which swaps are granted by official creditors**: a) in the context of a debt restructuring (e.g. Paris Club) often as a limited complement to an official debt treatment (this complement usually needs official creditor coordination); b) when the country is still current in its payments and is not considered in high risk of debt distress or already in debt distress, as a means to provide additional fiscal space. In the latter case, those creditors whose legislation enables such a mechanism, consider them a development tool - it is recommended that this kind of swap is implemented when they are more efficient than traditional financial ODA instruments (grants, or concessional finance). The final decision belongs to donors (and debtors) discretion to use swaps as a political instrument, showing good-will to partner countries, consistent with the transparency among Paris Club creditors.
- **Lessons Learned:** In most cases, debt swaps have little impact on debt sustainability, which remains better addressed by debt treatment or a restructuring as the right tool to do so. Their primary objective is therefore to free up additional and targeted financing for development projects. Regarding financing of SDG goals, they bear the same budgetary cost for creditors as grant from a public finance perspective, having a dollar-for-dollar impact on revenues for creditors over time. They may present higher costs of implementation given their ad hoc structure, whereas grants seem to be more efficient.

3/ Debt swaps on sovereign debt issued to private creditors

- **Debt for SDG swaps applied on sovereign debt issued to private creditors[4] cover for instance cases where an issuer buybacks debt through cheaper financing, targeting part of the saving to SDGs swaps.**
- **Quality of the debt swaps**: continuous engagement with the private sector and the relevant NGOs helps ensuring the quality of the debt swap in terms of content for the SDG project. In this regard, it could be interesting to define a threshold on the savings allowed by the swap to be redirected towards the financing of the SDG goal for a specific debt swap to be labelled as "debt for nature" or "debt for SDG" for example.
- **MDBs, regional or national development finance institutions or private organisations can intervene to enhance credit worthiness of the third party**, through, for example, providing a guarantee on the newly issued facility. This allows the third party (e.g. a NGO) to receive a better credit. The risk has to be carefully handled in the MDB risk management model. Besides, both the potential upward impact on the price of the bonds in the secondary market and the share of the savings that will be rechannelled towards the financing of the SDG goals would have to be assessed ex-ante.

[3] A multilateral debt conversion framework is neither desirable nor realistic as MDBs preferred creditor status ought to be protected, and MDBs would be very reluctant to participate in such a scheme of debt cancellation which may endanger its triple A status

[4] This scheme applies for private debt since it is hard for bilateral creditors to set up debt swaps as their debt is not marketable. Indeed, a buy-back combined with a debt swap for developing countries is mostly feasible if the bought-back debt trades at a strong discount

4/ How to support quality debt swaps operations?

(i) Proposing high-level principles as useful reference for debt swaps operations:

- ***Regarding official debt:*** creditors should inform each other on an annual basis on debt swap operations they may have granted.
  - Debt swaps on the basis of a debt restructuring agreement:
    - Debt swap should be **on a voluntary case-by-case basis, subject to an *ad hoc* agreement, such as a relevant clause in a debt restructuring agreement, in the relevant creditor fora and contingent on the existence of related domestic legislation in the creditor countries. Debtors and creditors should also assess impact on the fair burden sharing principle.**
    - Debt swaps should **not primarily be used in order to restore debt sustainability** and should therefore not interfere with debt treatment negotiations. **After a successful debt restructuring, they can be implemented as an additional effort**;[5]
    - **Debt swaps should be designed in a way to reduce transaction costs and ensure a swift implementation.**
    - **Maximum amount in percentage of the outstanding amount of debt and in nominal value for non-ODA debt**. Swaps on ODA debt should not, a priori, be capped.
  - Debt swaps outside of a debt restructuring agreement:
    - **Debt swaps outside of a debt restructuring agreement should be at the discretion of the creditor on a voluntary case-by-case basis, for countries that are indebted but not overindebted or in debt distress**. Relevant information on these considered ODA debt swaps should be provided to other creditors in a timely manner ahead of their implementation, for an exchange of information purposes.
    - **Debt swaps should be designed in a way to reduce transaction costs**. Contracts could be standardized.

- ***Regarding sovereign debt issued to private creditors*:**
    - A combination of debt-swap and buyback is considered recommendable, when bonds trade with a high haircut compared to their face value.
    - This type of debt swaps could benefit for credit enhancement by multilateral creditors, regional or national development finance institutions and private stakeholders.
    - Debtor should commit a major present share of the savings originated by the buyback to SDGs investment projects. Monitoring of these commitments should be implemented.

(ii) Supporting debtor countries to assess potential risks and opportunities for "debt swaps" on their sovereign debt issued to private creditors. Support from relevant IFIs (IMF, IaBD, WB etc) and NGOs is crucial to avoid difficulties such as a potential subsidization of private creditors by means of public sources (e.g. MDBs); potentially protracted risks to future debt treatments if the guarantor, if benefiting from a Preferred Credit Status, inherits the private claim, effectively making initially privately held debt "non-restructurable".

[5] Paris Club creditors offer debt conversion since 1990. Paris Club agreements sometimes included such clauses allowing for debt swaps when justified to provide additional efforts or to address specific reimbursement constraints.