The potential of debt-for-climate and nature swaps in Latin America and the Caribbean

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Resumen Ejecutivo

Los Canjes de Deuda por Acción Climática y por Naturaleza (DFCNS, por sus siglas en inglés) son un instrumento en el que la operación de alivio parcial de la deuda está condicionada a que el deudor se comprometa a realizar inversiones relacionadas con el clima y la naturaleza. Proporciona tanto alivio de la deuda como inversiones destinadas al clima/naturaleza. Aunque inicialmente se aplicó en la década de 1980, en los últimos tres años se ha creado un notable aumento del interés por los DFCNS en todo el mundo, sobre todo en países de América Latina y el Caribe, como Belice, Ecuador, Barbados y Perú.

Estas operaciones de DFCNS han adoptado diversas formas y estructuras, con una tendencia a implicar a más partes interesadas y a abarcar mayores cantidades de deuda, especialmente los bonos soberanos comerciales más costosos. Estas exitosas iniciativas de DFCNS centradas en un solo país han supuesto un ahorro significativo en los costes del servicio de la deuda, desbloqueando así nuevos fondos para la conservación de la naturaleza y la acción climática. Esta tendencia pone de relieve el creciente impacto y relevancia de los DFCNS a la hora de abordar los retos medioambientales y financieros.

La región de América Latina y el Caribe ha experimentado un aumento de los niveles de deuda tras la pandemia del COVID-19, y varios países se enfrentan a un espacio fiscal restringido. Las proyecciones indican que se espera que persistan unos elevados ratios deuda/PIB en un número significativo de países de la región durante los próximos cinco años. Esta situación también va acompañada de un aumento de la deuda denominada en divisas y de los componentes de la deuda comercial en los países. Dadas estas difíciles circunstancias, la posibilidad de reestructurar la deuda es cada vez más pertinente para garantizar la sostenibilidad fiscal en la región, lo que convierte a los DFCNS en una opción convincente a explorar.

Existen otras oportunidades para que la región aproveche los DFCNS, como la considerable riqueza de experiencias entre los estados miembros en el diseño y la implementación de acuerdos DFCNS utilizando diversas estructuras y modalidades para abordar una serie de retos climáticos y naturales. Además, los abundantes y diversos ecosistemas compartidos de la región ofrecen una oportunidad para que América Latina y el Caribe considere los DFCNS como un medio de movilizar fondos para objetivos medioambientales comunes y, al mismo tiempo, aliviar la carga de la deuda. Esta sinergia entre la conservación de recursos naturales y la gestión de la deuda hace del DFCNS una opción atractiva para la región.

Para capitalizar estas oportunidades y abordar los retos que plantea la aplicación del DFCNS, es vital adoptar un enfoque integrado. Este documento recomienda una estrategia colaborativa e innovadora que se base en experiencias anteriores e incorpore a la vez nuevas soluciones. Cinco recomendaciones clave para una estrategia regional de colaboración incluyen **la creación de un marco regional**. Adicionalmente, la creación de un centro de conocimiento sería beneficioso para mejorar y amplificar las experiencias regionales con innovaciones y apoyar el marco regional. Asimismo, se recomienda identificar las acciones compartidas en materia de naturaleza y clima y explorar las posibilidades de mutualizar la deuda a escala regional o multinacional. Basándose en las experiencias nacionales, se recomienda considerar la creación de un fondo regional como vehículo para fines especiales. Estos pasos pretenden mejorar la eficacia y coordinación en la aplicación del DFCNS en la región.

Executive summary

Debt-for-climate and nature-swaps (DFCNSs) are an instrument in which partial debt relief is conditional on debtor commitments to undertake climate/nature-related investments. They provide both debt relief and investments towards low-carbon and climate resilient projects. While initially implemented in the 1980s, there has been a notable surge of interest in DFCNSs globally over the last three years, particularly in countries in the Latin America and the Caribbean (LAC) region such as Belize, Ecuador, Barbados and Peru. These DFCNS deals have taken various forms and structures, with a trend toward involving more stakeholders and encompassing larger amounts of debt, especially the costlier commercial sovereign bonds. These successful, single country-focused DFCNS initiatives have led to significant savings in debt servicing costs, thereby unlocking new funding for nature conservation and climate action. This trend highlights the growing impact and relevance of DFCNSs in addressing environmental and financial challenges.

The LAC region has witnessed a rise in its debt levels following the COVID-19 pandemic, with some countries facing a constricted fiscal space. Projections indicate that high debt-to-GDP ratios are expected to persist in a significant number of countries in the region for the next five years. This situation is also accompanied by an increase in foreign currency-denominated debt and commercial debt components in countries. Given these challenging circumstances, the potential for debt restructuring is becoming more pertinent to secure fiscal sustainability in the LAC region, making DFCNSs a compelling option to explore.

There are other compelling opportunities for the region in pursuing DFCNSs, including the considerable wealth of experiences among member states in designing and implementing DFCNS deals using various structures and modalities to tackle a range of climate and nature challenges. Furthermore, the region's abundant and diverse shared ecosystems offer an opportunity for LAC governments to consider DFCNS as a means to mobilize funds for common environmental objectives while simultaneously alleviating debt burdens. This synergy between environmental conservation and debt management makes DFCNSs an attractive option for the region.

To capitalize on these opportunities and address the challenges in implementing DFCNSs, an integrated approach is vital. This paper advocates for a collaborative and innovative strategy that builds upon previous experiences while incorporating innovations and centered around five key recommendations. Establishing a knowledge centre is recommended, to enhance and amplify regional experiences with innovations and support the regional framework. Identifying shared nature and climate actions and exploring the possibilities for regional/multi-country debt-pooling is also recommended. Building on country-level experiences, it is recommended to consider a regional fund be established as a special purpose vehicle. These steps aim to enhance coordination and effectiveness in implementing DFCNSs in the LAC region.

Introduction

The world is facing a triple planetary crisis of climate change; nature and biodiversity loss; and pollution and waste. In addition, the impacts of the COVID-19 pandemic have increased economic volatility in developing country markets, where high levels of debt are increasing the levels of vulnerability in the Latin America and the Caribbean (LAC) region (Economic Commission for Latin America and the Caribbean [ECLAC] 2021). Several LAC countries are now considering debt-for-climate and nature-swaps (DFCNSs) as an innovative solution to manage historically high levels of public debt exacerbated by the cost of responding to the COVID-19 pandemic. The proceeds from the application of the debt swap approach would then be used in an agreed manner with creditors and partners to fund projects to tackle climate change and/or nature conservation.

In this context, the United Nations Environment Programme (UNEP) and the UNEP Copenhagen Climate Centre worked to assist LAC countries in fostering discussions by crafting a working document concerning DFCNSs partly supported by the Nationally Determined Contribution (NDC) Support Project, funded by the Federal Government of Germany.

This working paper serves as a foundation for exploring potential multilateral strategies, a draft of which was deliberated by the group of LAC nations during the Forum of Ministers of Environment of LAC, as the region's longest standing space for political dialogue and collaboration on environmental matters. The objective is to formulate a collaborative regional stance on DFCNS initiatives. This paper includes an introductory section on DFCNSs and an examination of regional and global precedents, and proposes a collaborative regional approach. This approach is grounded in the current macroeconomic conditions prevailing in the region.

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01 Debt-for-climate and nature-swaps (DFCNSs)

1.1 Introduction and importance of DFCNSs

The year 2020 marked an important moment in global history, characterized by the onset of the COVID-19 pandemic and discussions surrounding the concept of the „new normal“. Additionally, 2020 was a critical year due to the sovereign debt crisis that unfolded. In both low-income and emerging market economies, government debt surged by nine percentage points, reaching 63 per cent of gross domestic product (GDP) within the span of just one year, the fastest single-year growth within the last three decades. Global macro-financial headwinds have raised concerns about the sustainability of public debt in many emerging markets and developing economies, including in the LAC region.

Even before the COVID-19 pandemic, public debt levels were increasing in the region. What makes these vulnerabilities even more pronounced is the composition of the debt. In many LAC countries, public debt is predominantly held by foreign non-residents and denominated in foreign currencies. In South America, this coincides with a change in the creditor base, where private bondholders have become the most significant creditors. In contrast, multilateral and bilateral lenders hold the majority of external debt in Caribbean countries. Despite relatively favourable amortization profiles for sovereign debt, the rollover of substantial short-term debt exposes these countries to financial market volatilities, especially following the post-COVID rise in interest rates (ECLAC 2023a).

The climate, nature and debt crises are intricately connected macroeconomic challenges. There exists a correlation between climate vulnerabilities and fiscal risks. Countries that are more susceptible to climate risks tend to experience elevated risks of fiscal crisis. In low-income and developing nations, climate change has the potential to amplify debt crises, while economies already grappling with debt-distressed conditions are poorly positioned to effectively tackle the challenges posed by climate change (ECLAC 2023a). Consequently, tackling one of these issues without simultaneously addressing the other in the context of debt and climate challenges is unsustainable. What is urgently required is a coherent, integrated and expedited plan of action aimed at fortifying economies with sustainable debt levels and securing the necessary financing for climate action. Hence, strategies and instruments capable of addressing both climate/nature and debt challenges have garnered increased attention.

Debt instruments designed for climate and nature are innovative financial instruments. These instruments offer the dual benefit of promoting sustainability and environmental protection while also helping nations manage their increasing debt burdens. They possess the potential to enhance debt sustainability and unlock fresh streams of capital with enticing terms. Among these strategies, DFCNSs are particularly prominent. DFCNSs offer a holistic means of addressing the intertwined challenges of debt, climate and nature.

Various institutions provide different definitions of DFCNSs. The International Monetary Fund (IMF) has defined it as a "partial debt relief operation conditional on debtor commitments to undertake climate/nature-related investments" (IMF 2023). This definition has been used as the working definition in this paper. The core concept of DFCNSs revolves around obtaining discounts for debt and debt servicing, contingent on the commitment to allocate the resulting proceeds or savings from debt servicing to earmarked climate and/or nature actions, especially those highlighted in NDCs, Long-term Low Emission Development Strategies (LT-LEDS) and/or National Biodiversity Strategy and Action Plans (NBSAPs).

It has been observed that in DFCNSs the design and execution modalities have evolved over time. One significant change is the types of debt considered under DFCNSs. In the early days of DFCNSs in the 1980s, it primarily cantered on bilateral debt forgiveness extended by creditor countries to debtor nations. However, in more recent times, the focus has shifted towards encompassing commercial loans, including International Sovereign Bonds (ISBs).

In a bilateral DFCNS scenario, one country that has extended debt to another country and subsequently forgives that debt relieves the debtor nation of its full debt servicing obligation. As a result, the funds that were previously allocated for repaying both the interest and principal of the loan to the lending country become available for the debtor country. These freed-up resources can then be redirected towards financing their initiatives related to climate and nature conservation. In a commercial debt-for-swap arrangement, the aim is usually to refinance commercial loans, which are typically obtained directly from the private sector or through ISBs.

On the whole, commercial loans are considered the costliest form of sovereign debt, with higher interest rates, and they often come with shorter repayment periods relative to most bilateral or multilateral debt agreements. Therefore, the savings or the proceeds, and the extent of debt relief achieved through a commercial debt swap, are typically greater than those realized through bilateral debt swaps.

In contrast to conventional climate finance instruments like grants and concessional loans, DFCNSs stand out as a distinct instrument. Climate-conditional grants or loans are incremental and singularly earmarked for climate-related investments, leaving no room for diversion. DFCNSs also allow a country to repurpose or redirect resources previously allocated to debt servicing toward mutually agreed-upon public investments or climate actions. It could be considered as unlocking finance to reach NDC, LT-LEDS or NBSAP targets.

Numerous prominent organizations, spanning both economic and climate sectors, including the IMF and the Green Climate Fund (GCF), have expressed support for DFCNSs. They recognize that DFCNSs have demonstrated their effectiveness in generating economic and climate-related benefits. As a result, these organizations advocate for the scalability of DFCNSs as a viable instrument for addressing both economic and environmental challenges (Georgieva *et al.* 2022).

1.2 Application principles

Selecting a DFCNS as a financial instrument can be a complex decision that is highly contingent on the specific circumstances at hand. Nevertheless, some common factors exist that can be taken into account when evaluating the suitability and feasibility of implementing a DFCNS.

Top-level political commitment and multifaceted stakeholder involvement

Commencing DFCNS processes with the endorsement and support of top-level political leadership is an absolute prerequisite. The successful implementation of a DFCNS hinges significantly upon the presence of political determination. Given the intricate web of external and internal stakeholders engaged in the DFCNS process, unwavering commitment and active involvement at the highest national level is needed. The political engagement process can also have a strong connection with foreign policy and international relations, particularly when dealing with bilateral debt, where the involvement of national political leadership becomes pivotal.

Traditionally, national leadership in debt-related matters has typically been assumed by ministries of finance. However, it is essential to broaden the spectrum of participation to include climate, environmental and other stakeholders including national planning. These distinct domains inherently prioritize divergent objectives in decision-making processes. Therefore, it is incumbent upon the highest national leadership to facilitate a harmonious convergence of these different priorities, facilitating a unified approach towards the effective execution of DFCNS initiatives.

Comprehensive evaluation of DFCNSs: Maximizing dual benefits

In assessing the efficacy of a DFCNS solely from either a climate or economic standpoint, countries must consider the composite advantages it offers. Dealing with debt and climate issues can, in theory, be addressed separately. Debt relief and fiscal adjustments can be implemented on one hand, while climate and nature financing, through other instruments including grants and concessional loans, can be employed on the other. Utilizing multiple tools offers added flexibility. For instance, debt relief can be applied to restore debt sustainability where necessary, while concessional finance can be tailored to tackle climate and nature challenges.

However, the DFCNS offers a multifaceted approach. It not only addresses immediate climate concerns but also has the potential to unlock additional funding for nature and climate actions while contributing to long-term economic resilience. Therefore, a comprehensive evaluation encompassing both aspects is crucial to fully harness the potential of a DFCNS in achieving relevant sustainable development goals. This evaluation is closely tied to the overarching political will at the highest leadership level guiding the entire process.

Furthermore, DFCNSs have the potential to generate additional benefits such as relieving pressure on foreign currency flows, influencing country credit ratings, promoting improvements in trade balances and reducing the need for additional climate-related investments. These diverse advantages should be thoroughly examined as integral components of the evaluation.

Creditor consent

The feasibility of DFCNSs is contingent upon the willingness of creditors to grant debt relief. In the context of bilateral debt, this process assumes a sensitive political dimension, and debtor countries may assess the prospects of securing support from their bilateral creditors independently. Historically, members of the Paris Club have demonstrated an inclination to endorse DFCNS initiatives advanced by their debtor counterparts, as described in Section 2.

In the case of commercial debt, the conversion or swapping of ISBs often entails utilizing discounted secondary market valuations or pursuing refinancing through lower-cost financial instruments. In this context, individual consent becomes pivotal, contingent upon bondholders' readiness to transact at market-reflective prices. For other forms of commercial debt swaps, creditor consent is typically mandated by the stipulations outlined in the underlying debt agreements.

Determining the potential quantum of swap proceeds and impacts

The quantum of the proceeds generated through the DFCNS process is contingent upon several key factors. Notably, the DFCNS process itself entails specific investments, encompassing execution and administrative costs. Therefore, the ultimate amount of swap proceeds relies on the following variables: the scale of the existing debt stock, the extent of debt discount or relief negotiated, and the associated execution expenses.

It is crucial to recognize that the efficacy of a DFCNS hinges on whether the resulting proceeds prove sufficient for earmarked climate or nature conservation initiatives and whether they make a substantial impact on debt sustainability. If the final proceeds fall short of meeting these criteria, the effectiveness of the DFCNS initiative may be called into question. Therefore, it becomes imperative to conduct a comprehensive assessment encompassing the total debt stock, the potential discount or relief, execution costs (inclusive of refinancing expenses) and any potential co-financing options related to climate and nature conservation. This meticulous evaluation is essential for optimizing the outcomes of DFCNS endeavours.

Macroeconomic outlook of the country

The macroeconomic landscape of a country plays a major role in the feasibility and success of DFCNSs. Several critical factors must be taken into account:

Rating and default status: A country's credit rating is a significant determinant. DFCNSs can become costlier when a country is in a default category, as it increases the refinancing costs with higher risks and complexities in negotiations. Historically, in most of the cases of DFCNSs, the total debt service reductions were not significant enough compared to the desired level of debt reduction or restructuring, with a couple of exceptional cases. Therefore, a DFCNS alone is normally not sufficient for a country to gain positive sovereign ratings.

Limitations in distressed situations: It is essential to recognize that DFCNSs are not a substitute for comprehensive debt restructuring during times of distress or near-distress. Rather, a DFCNS represents a component of potential solutions under these circumstances.

A nuanced understanding of the macroeconomic context is imperative when assessing the feasibility and impact of DFCNS initiatives. It underscores the importance of aligning DFCNSs with the broader economic conditions and debt management strategies of the country in question.

Appropriate structuring of DFCNS

The structure of a DFCNS deal, which includes financing and partner engagement, holds a pivotal role in determining its success and impact. This structure must be carefully crafted, taking into account all the factors mentioned earlier, in order to optimize economic and environmental benefits for all parties involved. As a result, the identification of all potential stakeholders, fostering inclusive stakeholder engagement, conducting a comparative analysis of the „with and without scenarios" of a DFCNS in terms of both climate/nature and economic aspects, and quantifying synergies all emerge as crucial elements in designing an effective and efficient DFCNS deal.

1.3 Global experiences and DFCNS lessons

The history of DFCNSs and its precursor debt-for-nature-swaps (DFNSs) goes back to the 1980s. A DFNS took place in Bolivia in 1987 through an agreement between the Government of Bolivia and Conservation International, a United States-based non-profit organization. The latter purchased US$650,000 worth of government debt from the secondary market at a discounted rate of 85 per cent in this swap agreement. The government allocated 3.7 million acres of land in the Amazon basin for conservation activities in exchange for the forgiven debt.

This model has been explained as an "asset-linked swap model" by some researchers, as the government allocated land for conservation rather than investing proceeds for nature conservation. This model was later scaled up, with the United States supporting DFNSs with other creditor countries and cancelling around US$2 billion of debt owed by 21 low- and middle-income countries, representing a substantial 64 per cent share of all bilateral agreements of this kind. Other bilateral creditors including the United Kingdom also replicated the model (Hebbale and Urpelainen 2023).

Tables 1 and 2 provide summaries of significant DFCNSs that occurred in the LAC region and other parts of the world, highlighting key lessons learned.

Table 1: Examples of DFCNSs from LAC countries

<table>
<tr><th colspan="2">DFCNS DETAILS</th><th>KEY LESSONS</th></tr>
<tr><td colspan="3">Bolivia 1987</td></tr>
<tr><td>Type</td><td>This is the very first example of a DFNCS, with bilateral debt with the United States swapped.</td><td rowspan="4">The swap provided debt relief and a longer timeframe to repay the balance.
The government allocated additional land exclusively for conservation.
This model has been explained as an “asset-linked swap model” by some researchers.</td></tr>
<tr><td>Modality</td><td>Bipartite mode – An agreement between the Government of Bolivia and Conservation International, a United States-based non-profit</td></tr>
<tr><td>Debt restructuring</td><td>Conservation International purchased US$650,000 worth of government debt from the secondary market at a discounted rate of 85 per cent.</td></tr>
<tr><td>Creditor commitment</td><td>The Government of Bolivia allocated 3.7 million acres of land in the Amazon basin for conservation activities in exchange for the forgiven debt.</td></tr>
<tr><td colspan="3">Belize 2021</td></tr>
<tr><td>Type</td><td>This swap dealt with ISBs and had multiple partners.</td><td rowspan="4">The swap created a local endowment fund that acted as a potential mechanism to continue nature investments beyond the swap timelines.
It had a substantial macroeconomic impact on Belize. The face value of the ISBs swapped through this transaction amounted to a staggering 30 per cent of the country’s GDP, at a time when the country’s debt-to-GDP ratio had reached approximately 130 per cent.
As a result of this transaction, Standard & Poor’s upgraded Belize’s sovereign credit rating to B–, underscoring the positive transformation it brought to the country’s financial standing and economic outlook. This shows the greater macroeconomic potential of DFCNSs as an instrument.</td></tr>
<tr><td>Modality</td><td>This swap can be characterized as a tripartite+ model, involving the Government of Belize, the ISB holders, and The Nature Conservancy (TNC). Notably, the United States Development Finance Corporation (DFC) also played a significant role within this model through the provision of political risk insurance coverage, to mitigate the credit risk taken by TNC.</td></tr>
<tr><td>Debt restructuring</td><td>Under the swap, ISBs of a total face value of US$553 million were repurchased. The bondholders were extended a 55 per cent bond-for-cash exchange offer based on the face value, and they accepted it.
To facilitate the transaction, TNC utilized the proceeds from a „blue bond“ to provide financial support to the Belize government through a „blue loan“, which was allocated for the repurchase of the ISBs.</td></tr>
<tr><td>Debtor commitment</td><td>The Government of Belize committed to establishing an endowment fund for marine conservation, channelling US$23.4 million of the debt service savings toward this crucial cause. In addition to this, the government also pledged an annual investment equivalent to US$4.2 million in local currency for marine conservation efforts. Furthermore, Belize made a commitment to expand its protected ocean area from 16 per cent to 30 per cent by 2026.</td></tr>
</table>

DFCNS DETAILS		KEY LESSONS
Barbados 2022		
Type	Tripartide+ model, with Barbados being enabled to repurchase Eurobonds.	This example shows that a significant debt discount can be obtained through commercial/bond restructuring. Multiple stakeholders can offload risks associated with swaps. The importance of wider multistakeholder participation, especially the private sector, insurers, reinsurers and fund managers, has been central in the swap.
Modality	Barbados was enabled to repurchase debt through a "blue loan" provided by Credit Suisse and CIBC FirstCaribbean and guaranteed by both the Inter-American Development Bank (IDB) and TNC. The debt service savings were used to create and fund the Barbados Environmental Sustainability Fund (BESF).	
Debt restructuring	Under the swap, Barbados repurchased US$77.6 million of its 2029 Eurobond (6.5 per cent) at a price of 92.25 cents on the dollar and US$72.9 million of its Domestic Bond Series E (8 per cent) at par. Credit Suisse and CIBC FirstCaribbean agreed on a 15-year amortizing "blue loan" of US$146.5 million (50 per cent in US$ and 50 per cent in BBD). The IDB (US$100 million) and TNC (US$50 million) guaranteed equally the "blue loan" covering the outstanding principal and one semi-annual coupon.	
Debtor commitment	In exchange, Barbados committed to binding marine conservation targets and directing 100 per cent of its savings from the debt servicing towards conservation over 15 years. This resulted in the creation and capitalization of the BESF as an independent conservation fund to issue grant funding to conservation practitioners in Barbados. On average, US$1.5 million per year flows into the BESF for grant funding and a US$17 million endowment is expected to grow to US$27 million (est.) by 2037.	
Ecuador 2023		
Type	This is the largest DFCNS in history, carried out with the engagement of multiple partners (tripartite+ model).	Similar to the experience in Belize in 2021, this shows the importance of political risk insurance and credit guarantees offered by a multilateral bank. Additionally, it underscores the substantial debt involved in a single swap, contributing to significant overall proceeds. A DFCNS at this scale was possible with broader collaboration among parties including significant private sector participation to make it attractive to stakeholders, cost-effective and low risk. The engagement of institutions that supported the development of the initial concept, financing structures and early development capital was a key success factor for this large-scale swap arrangement. The improved governance mechanism of the newly established fund with multi-stakeholder engagement was also an important factor in the success of the swap deal.
Modality	Credit Suisse purchased the debt, the IDB provided a credit guarantee and DFC provided political risk insurance. In addition, the Climate Fund Managers (CFM), operating a marine ecosystem initiative known as the Oceans Finance Company (OFC), played a significant advisory role in the project. Collaborating closely with the Pew Bertarelli Ocean Legacy Project, CFM conceptualized the idea and also took charge of the financial structuring. Furthermore, they made a substantial investment of US$2 million in the initial development stages. This investment was made through their Climate Investor Two Fund, a financing vehicle dedicated to supporting initiatives related to oceans, water and sanitation. A group of 11 private insurance companies provided more than 50 per cent of the reinsurance to facilitate the project. The future of the program lies with the newly established the Galapagos Life Fund (GLF). This fund is overseen by an 11-member board of directors, made up of five Ecuadorian government ministers and six non-government representatives from diverse sectors such as tourism, fisheries and local communities. The GLF will receive support from OFC and the Pew Bertarelli Ocean Legacy.	
Debt restructuring	Credit Swiss Bank paid only US$644 million for bonds with a face value of US$1.6 billion (approx. 40 per cent discount), thus saving the country roughly a billion dollars in repayments over 17 years. The old bonds have been replaced with a cheaper-to-service US$656 million in new "Galapagos Bonds", due to mature in 2041. This bond issue has been provided a US$85 million credit guarantee by the IDB and US$656 million in political risk insurance by the United States International Development Finance Corporation (DFC), similar to the Belize swap in 2021.	
Debtor commitment	Ecuador committed to spend about US$18 million annually for at least the next 20 years on conservation in the Galapagos under the swap.	

A similar nature swap agreement was also announced in September 2023 by the Government of Peru and the United States. It resulted in US$20 million in investments towards the conservation of the Amazon Forest (Radwin 2023).

Table 2: Examples of DFCNSs from outside LAC region

<table>
<tr><th colspan="2">DFCNS DETAILS</th><th>KEY LESSONS</th></tr>
<tr><td colspan="3">Seychelles – 2016</td></tr>
<tr><td>Type</td><td>This is the very first example of a swap performed by pooling debt from multiple bilateral donors (Paris Club members).</td><td rowspan="4">This was the first example of pooling debt from several bilateral creditors for a single swap.
The swap shows the potential of engaging multiple stakeholders, the potential for pooling debt from multiple creditors and the potential for using proceeds to provide initial capital for a fund.
The newly established fund acted as a vehicle to mobilize further finances from other donors and sources.
The "asset link" feature of the previous DFCNS design was not very strong in this model as the conservation agreement was not with a "creditor country" but with a non-profit conservation institution for debt relief.</td></tr>
<tr><td>Modality</td><td>Tripartite mode – An agreement between the Government of Seychelles represented in the newly established special purpose vehicle/fund, Paris Club creditors and TNC.</td></tr>
<tr><td>Debt restructuring</td><td>US$21.6 million of public bilateral debt, from the Paris Club creditors was purchased at a discounted rate of 6.5 per cent (a US$20.2 million total discount). US$22 million of proceeds went to marine conservation.
The government obtained finances required for the swap through private philanthropic funding and securing a loan through TNC's NatureVest conservation investment unit.
These funds were then employed to acquire the debt through the establishment of the Seychelles Conservation and Climate Adaptation Trust (SeyCCAT) as a special purpose vehicle. In exchange, the government issued two promissory notes totalling US$21.6 million. These notes serve the dual purpose of repaying the TNC loan and endowing SeyCCAT.
This swap was facilitated by TNC with a group of Paris Club member countries (mainly the United Kingdom, France, Belgium and Italy) in 2016.
SeyCCAT took over the ownership of the debt, enabling the government to extend the repayment period and repaying in local currency, which in turn offered significant relief in terms of cash flow for debt servicing. Since the repayment to SeyCCAT was done in local currency, there was an additional benefit.</td></tr>
<tr><td>Debtor commitment</td><td>The Government of Seychelles made a commitment to safeguard 30 per cent of its marine territories, conserve 15 per cent of its high-biodiversity regions and implement a marine spatial plan to inform the enhancement of coastal zone management, fisheries and marine policies.</td></tr>
<tr><td colspan="3">Gabon 2023</td></tr>
<tr><td>Type</td><td>Gabon is the fourth country to work with TNC on a blue bonds project after Seychelles, Belize and Barbados. This was a tripartide+ model, with Gabon being enabled to repurchase Eurobonds.</td><td rowspan="4">This was the first blue bond-based DFCNS in Africa.
The experience is similar to the recent DFCNS deals in Seychelles and Ecuador. Establishing a local fund/special purpose vehicle is a common feature that was capitalized initially by part of the proceeds and blue bonds. It is also expected to mobilize funds and leverage from other sources.</td></tr>
<tr><td>Modality</td><td>Gabon partnered with TNC, Bank of America and the DFC to refinance US$500 million in national debt in order to support the country's marine conservation efforts. The swap proceeds supported to capitalize a local fund/special purpose vehicle.</td></tr>
<tr><td>Debt restructuring</td><td>DFC provides political risk insurance of up to US$500, while the Gabon Blue Bonds are expected to generate US$163 million in new financing. The new US$500 million 15-year blue bond was initially priced with an interest rate of 6.097 per cent, approximately 200 basis points above United States Treasuries at the time. This means cheaper bonds were being partially bought back, which paid coupons of between 6.625 per cent and 7 per cent.</td></tr>
<tr><td>Debtor Commitment</td><td>Gabon agreed to invest US$5 million a year from the savings of this debt swap, over 15 years, on marine conservation. Specifically, these funds will be used for advancing key conservation goals, protecting endangered species and supporting the country's sustainable blue economy.
Combined, this should expand the legally designated marine protected areas from 26 per cent to 30 per cent.</td></tr>
</table>

1.4. DFCNS trends and related instruments

The DFCNS instrument has evolved significantly over time, with various models and designs being explored. The following is a list of salient evolutionary aspects to note.

The shift in focus from bilateral debt to commercial debt swapping, where commercial debt, being the most expensive type of debt, offers substantial potential in terms of both the quantum of proceeds it can generate and the reduction in debt service burdens through commercial debt swaps. This shift reflects a strategic adaptation in DFCNS initiatives, recognizing the financial leverage and impact that can be achieved by addressing commercial debt within these innovative mechanisms.

The DFCNS approach, structure and design have notably innovated over time, transitioning from asset-linked swaps to more inclusive and participatory approaches. This evolution has aimed to engage a more and broader range of parties in swap agreements, making the deals more appealing to creditors. An additional innovative aspect, exemplified by Seychelles, involves pooling debt from various creditors to expand the debt stock eligible for DFCNS deals, presenting further exploration opportunities.

Countries have been utilizing the proceeds of these swaps for a variety of conservation purposes, and what is particularly notable is that many of these actions have transboundary impacts such as marine conservation (Belize and Barbados) and forestry (Bolivia). This highlights the potential for increased collaboration among nations, fostering collective efforts to enhance environmental impacts. By working together on a regional and transboundary level, countries can amplify the positive effects of their conservation initiatives. Such collaborations not only maximize the effectiveness of environmental protection, but also promote mutual understanding and cooperation, emphasizing the interconnectedness of global ecosystems and the importance of collective action in addressing environmental challenges.

The trends also show that interest in supporting DFCNSs is on the rise. In recent swap agreements, a significant number of stakeholders have directly participated. This includes multilateral agencies, support organizations, insurers/reinsurers, non-profit organizations and more that are contributing to various aspects such as risk reduction, concept development, financial structuring and even the provision of initial capital.

It is also evident that an increasing number of organizations and countries view DFCNSs not solely as a financing instrument with a dual solution for debt and climate change or the environment. Instead, DFCNSs are now recognized as an effective instrument with the potential to significantly enhance sustainable development, promote ecosystem preservation and contribute to economic stability. Influential institutions like the IMF, the World Bank, United Nations agencies and academia are advocating for a holistic approach to DFCNSs without looking at a single project implementation perspective.

They emphasize the importance of considering the broader context and potential co-benefits associated with these initiatives. This approach aims to amplify synergies and create a more comprehensive, integrated strategy that can address multiple challenges simultaneously, yielding positive outcomes across various dimensions of global development and environmental conservation.


Credit: ©Nick dietrich/unsplash.com

02 Macroeconomic status of LAC countries and the region

2.1 Economic status of LAC countries

The global economic landscape, especially in emerging markets and developing economies like the LAC region, is facing concerns over public debt sustainability due to factors such as weakening global economic activity, high inflation and market volatility. These adverse conditions could worsen the economic outlook following a decade of already low economic growth, with projections indicating an average growth rate of only 0.8 per cent from 2014 to 2023, even lower than the growth during the 1980s debt crisis.

Additionally, limited monetary and fiscal policy options to stimulate demand, along with higher interest rates and sovereign risk, have made public debt management more complex. Consequently, strategic debt management practices are crucial in navigating these challenging macroeconomic conditions (ECLAC 2023b).

Economic growth forecasts for 2023 from ECLAC indicate a slowdown in growth across all LAC subregions compared to the previous year.

- **South America:** ECLAC predicted that South America's economic growth would be 1.2 per cent in 2023, significantly lower than the 3.7 per cent growth experienced in 2022. This suggests a notable deceleration in economic activity in the subregion.
- **Central America and Mexico:** The subregion comprising Central America and Mexico was expected to grow by 3.0 per cent in 2023, slightly lower than the 3.4 per cent growth seen in 2022. While the slowdown is less pronounced compared to South America, it still reflects a moderation in economic expansion.
- **Caribbean (excluding Guyana):** ECLAC forecasted a growth rate of 4.2 per cent for the Caribbean region (excluding Guyana) in 2023, down from the higher growth of 6.3 per cent in 2022. Although growth remains positive, it is expected to be at a reduced pace.

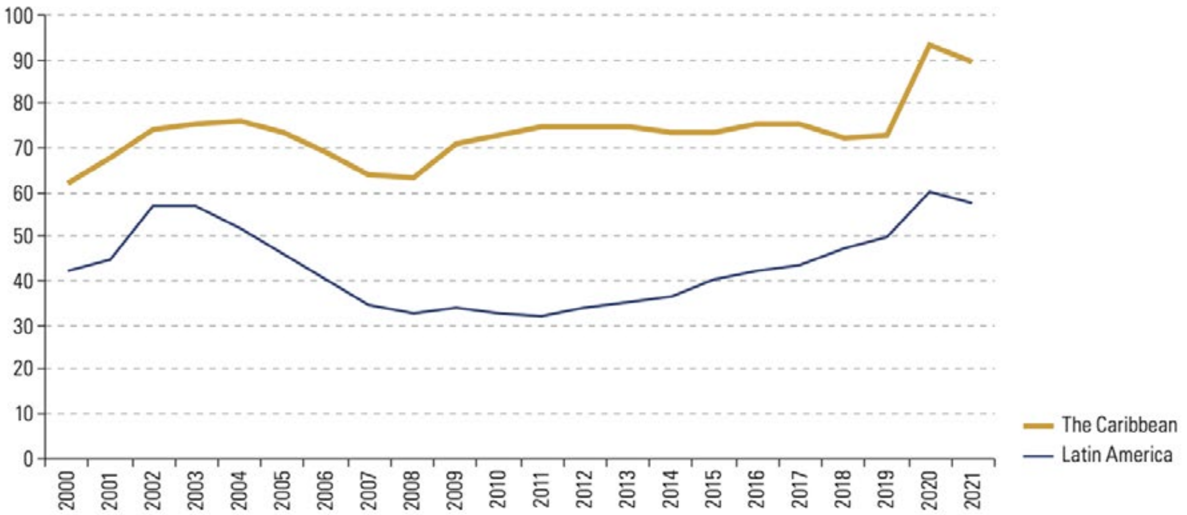
In the context of the economic crisis caused by the pandemic, 2022 marked the beginning of a recovery. However, it appears that 2023 was a crucial year, as it showed significant changes compared to the preceding year. Addressing climate change and establishing sustainable development pathways is a formidable challenge in the LAC region. Success will likely depend on various factors, though investment will play a significant role in determining outcomes. The investments required to reduce emissions and adapt to climate change, while achieving the Sustainable Development Goals, are significant and must compete with other fiscal pressures, e.g. for greater social spending. Public investment can play a catalytic role, though the heavy lifting will need to be done by private capital funds.

Indeed, it will be necessary to align fiscal policies with climate objectives, all the while balancing public accounts, and new measures will be required to crowd-in private investment with various level of risk appetite. Without a coordinated and multilateral push to invest in climate-resilient growth, the region will likely find itself increasingly exposed to the economic and social impacts of climate change, which will exacerbate existing structural injustices and income gaps that hinder sustainable and inclusive development.

2.2 External debt status of LAC countries

In the decade prior to the COVID-19 pandemic, public debt levels in the LAC region experienced a notable increase. However, following the onset of the pandemic, these debt levels escalated even more sharply. This dual trend of rising public debt reflects the region's economic challenges and the significant fiscal pressures brought about by the pandemic. It underscores the importance of prudent fiscal management and sustainable debt policies to ensure the region's long-term economic stability and resilience.

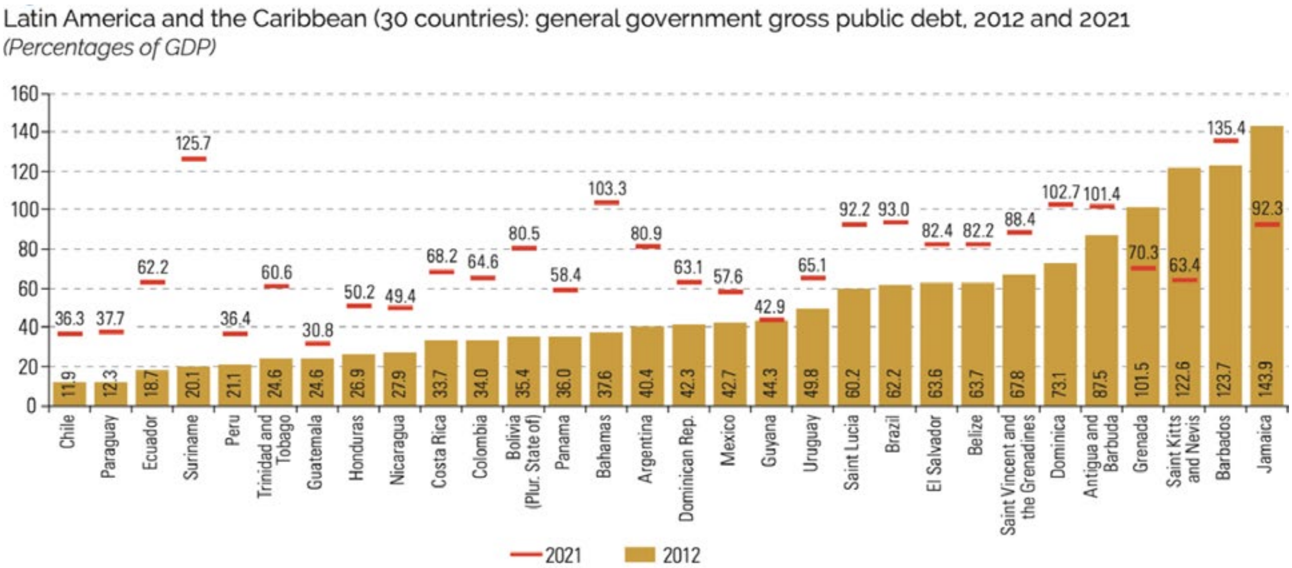
Figure 1: Gross national public debt of LAC (percentage of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of International Monetary Fund (IMF), *World Economic Outlook: Countering the Cost-of-Living Crisis*, Washington, D.C., October 2022; for Uruguay: P. Mauro and others, "A modern history of fiscal prudence and profligacy", *IMF Working Papers*, No. 13/5, IMF, 2013.

Note: Simple averages. Excludes Aruba and the Bolivarian Republic of Venezuela.

Figure 2: Government gross public debt in 2012 and 2022 of LAC (percentage of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of International Monetary Fund (IMF), *World Economic Outlook: Countering the Cost-of-Living Crisis*, Washington, D.C., October 2022.

Figures 1 and 2 show that a majority of LAC governments experienced increased public debt levels in 2021 compared to 2012 (Kose *et al.* 2022). Table 3 shows that the estimated external debt levels of LAC countries will remain high in the coming years, increasing the exposure to shifting currency values.

For countries with significant stocks of foreign currency debt, the cost of servicing this debt has the potential to rise significantly in national currency terms, which is a common scenario that adds pressure to raise taxes and/or cut public spending to meet debt obligations. Currency depreciations in the LAC region in 2021 highlight the magnitude of these shocks, where the national currencies of several countries depreciated heavily against the dollar. This happened in Argentina (38 per cent), Suriname (35 per cent), Haiti (30 per cent), Chile (15 per cent) and Colombia (14 per cent), averaged over the course of 12 months. However, Chile is the odd one out, with an overall low debt-to-GDP ratio, limiting the magnitude of exchange-rate shocks to service its sovereign debts (Kose *et al.* 2022).

Table 3: Current and estimated gross debt trajectories of LAC countries

	GROSS DEBT POSITION (% OF GDP)						
	2022	**2023***	**2024***	**2025***	**2026***	**2027***	**2028***
Antigua and Barbuda	90.56	84.87	79.91	76.14	73.01	70.10	67.64
Argentina	84.47	76.27	73.58	73.33	70.75	67.87	65.45
Bahamas	84.30	81.50	81.67	81.57	81.40	80.91	80.26
Barbados	126.83	118.66	111.53	104.19	97.57	91.75	86.77
Belize	64.14	60.43	58.45	57.01	55.83	54.67	53.50
Bolivia	82.62	82.31	83.08	83.71	83.94	83.61	83.06
Brazil	85.91	88.40	91.48	93.75	95.21	96.01	96.21
Chile	37.98	36.62	38.50	39.44	39.85	39.34	38.52
Colombia	63.63	61.97	61.10	60.94	60.08	59.17	58.31
Costa Rica	63.77	63.53	62.82	61.86	60.57	58.98	57.19
Dominica	110.73	99.98	95.99	92.99	92.41	92.15	91.87
Dominican Republic	58.92	58.30	57.95	57.26	56.53	55.69	54.77
Ecuador	57.30	no data	no data	no data	no data	no data	no data
El Salvador	77.24	76.10	78.33	78.66	80.79	82.74	83.89
Grenada	64.51	62.43	59.66	53.91	50.70	48.18	46.08
Guatemala	30.13	28.63	28.10	27.89	27.73	27.64	27.52
Guyana	27.81	29.82	24.21	24.10	18.90	18.76	18.60
Haiti	25.01	20.29	19.90	19.95	20.43	21.18	22.85
Honduras	50.02	no data	no data	no data	no data	no data	no data
Jamaica	87.96	81.29	77.09	72.73	66.71	61.90	54.70
Mexico	56.03	55.59	55.79	56.32	56.92	57.48	57.94
Nicaragua	45.96	44.52	45.01	45.40	46.53	46.81	46.11
Panama	54.89	54.34	53.58	52.70	51.86	51.00	50.26
Paraguay	40.87	40.43	40.26	39.15	38.46	37.66	36.71
Peru	33.37	33.00	33.29	33.25	32.80	32.33	31.88
Puerto Rico	16.31	15.15	14.56	13.85	13.11	12.39	11.65
Saint Kitts and Nevis	64.75	62.99	62.53	61.84	61.25	60.43	59.75
Saint Lucia	85.27	83.74	84.32	84.17	83.66	83.21	82.70
Saint Vincent and the Grenadines	86.80	86.32	90.06	89.67	85.69	81.85	77.93
Suriname	123.16	112.23	103.16	96.25	89.59	83.63	78.92
Trinidad and Tobago	52.10	53.78	53.61	53.93	54.74	55.37	55.96
Uruguay	61.00	62.31	62.70	63.05	63.45	63.66	63.78
Venezuela	157.81	no data	no data	no data	no data	no data	no data
Low-Income Developing Latin America	41.50	38.90	39.56	39.59	40.15	39.31	40.48

Source: IMF International Financial Statistics (2023): https://data.imf.org/?sk=4c514d48-b6ba-49ed-8ab9-52b0c1a0179b.

Unfavourable sovereign debt scenarios are expected to persist across most of the LAC region, further reducing fiscal headroom. Several factors are contributing to an upward trend in debt levels in the region, including weak economic growth, rising interest rates and the potential risk of currency depreciation. The interest rate-growth differential, which is a key driver of debt dynamics, has worsened over the past decade. Economic growth has been slowing down gradually, while effective interest rates have remained high. This combination can lead to higher debt burdens as interest payments become a larger share of government expenditures.

Additionally, the vulnerability to currency depreciation is a concern. Exchange rate fluctuations can affect debt dynamics, and if currencies depreciate significantly, it can increase the debt burden when measured in local currency terms.

The figures in Table 4 and 5 show that a majority of LAC governments have experienced increased public debt levels. The table shows that the estimated external debt levels of LAC countries will remain high in the coming several years for public debt denominated in foreign currency, which remains significant in several LAC countries, increasing the exposure to currency shifts. As previously mentioned, for countries with significant foreign currency debt stocks, the cost of debt servicing has the potential to rise significantly in national currency terms, creating pressure to either raise taxes or cut public spending.

Table 4: Debt composition of Central American countries as of 2021 (US$ millions)

	Belize	Dominica	Grenada	Guinea	Guyana	Haiti	Jamaica	St. Lucia	St. Vincent & Grenadines
Long-term External debt stocks	1,379.50	312.30	528.60	3,590.70	1,467.30	2,101.60	13,650.30	716.50	469.80
Public and publicly guaranteed debt from:	1,276.40	312.30	528.60	3,590.70	1,342.40	2,097.50	8,985.20	716.50	469.80
2. Official creditors	872.30	246.90	432.40	3,307.90	1,312.30	2,056.80	3,634.40	473.00	465.90
2.1. Multilateral	485.30	191.40	329.00	1,457.80	910.20	85.90	3,012.60	335.90	408.20
of which: World Bank		..	187.00	-	-	-	-	150.20	202.00
2.2. Bilateral	387.00	55.50	103.30	1,850.10	402.10	1,971.00	621.80	137.10	57.70
2.3.Private creditors	404.20	65.40	96.30	282.80	30.20	40.70	5,350.80	243.60	3.90
2.3.1. Bondholders	17.30	41.50	94.80	-	-	-	5,350.80	243.60	2.70
2.3.2. Commercial banks and others		23.90	-	282.80	30.10	-	-	-	-
2.4. Private non-guaranteed debt	103.10	-	-	-	124.90	4.00	4,665.10	-	-
2.4.1. Bondholders		-	-	-	-	-	1,750.00	-	-
2.4.2.Commercial banks and others	103.10	-	-	-	124.90	4.00	2,915.10	-	-
3.0 External Debt to GNI%	85.00	69.10	67.90	33.60	26.60	12.40	133.90	51.20	59.50
3.0 External Debt to Exports%	138.10	322.20	175.90	45.80	113.80	202.90	371.40	95.70	400.30
Use of IMF Credit and SDR allocations	60.90	48.00	76.60	885.60	365.80	502.50	1,791.70	79.00	56.30

Table 5: Debt composition of Central American countries as of 2021 (US$ millions)

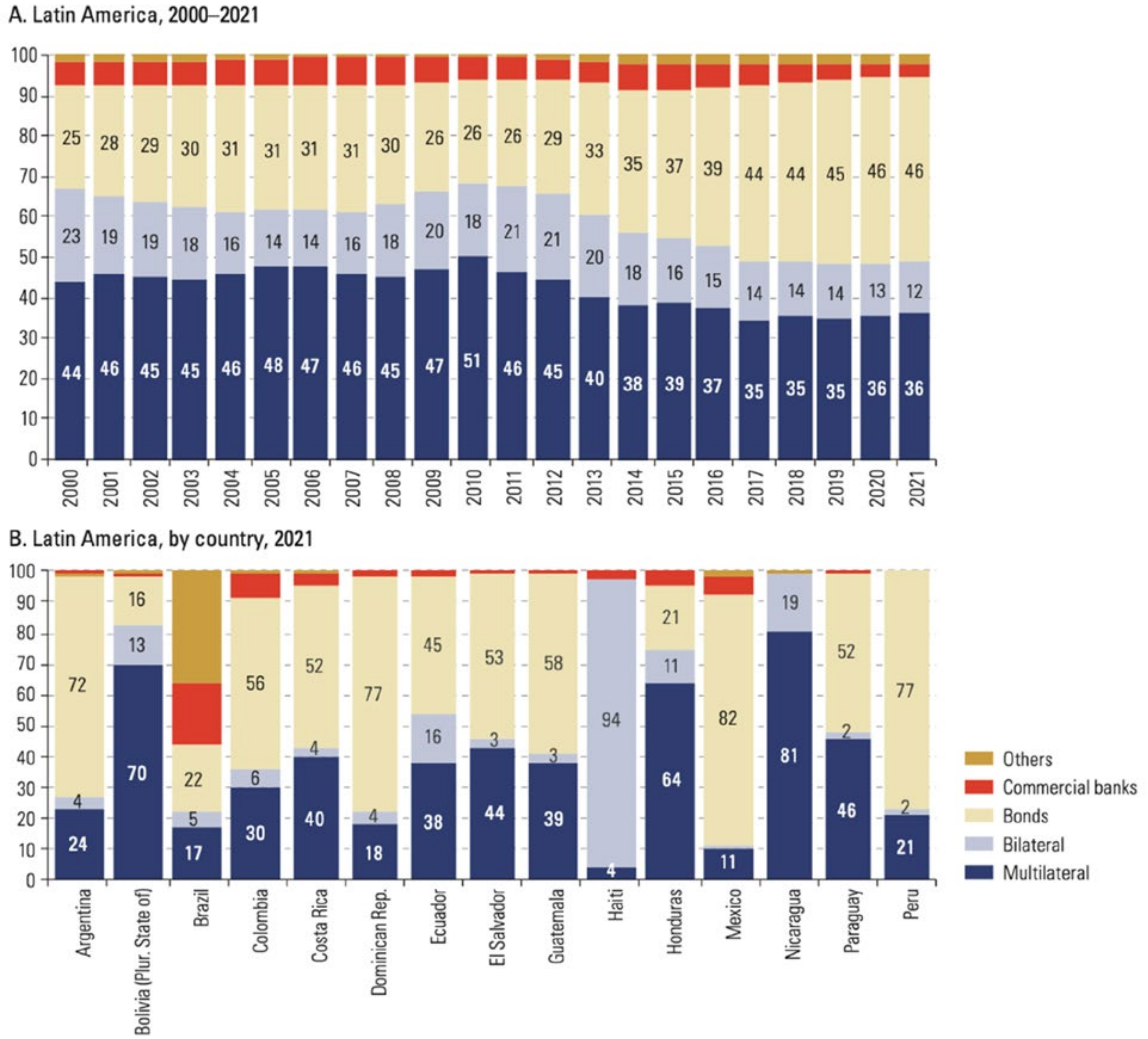
	Argentina	Bolivia	Brazil	Colombia	Costa Rica	Dominican Republic	Ecuador	El Salvador	Honduras	Mexico	Nicaragua	Paraguay	Peru
Long-term External debt stocks	154,277.6	14,653.0	508,878.6	147,194.6	27,584.1	39,800.10	48,634.50	16,896.9	9,734.00	539,265.90	12,575.20	16,295.3	74,536.1
Public and publicly guaranteed debt from:	114,750.4	12,281.4	200,521.9	93,900.70	12,386.3	32,506.50	38,706.90	11,462.5	8,627.30	290,868.10	6,407.50	11,346.6	39,853.7
2. Official creditors	31,411.60	10,181.0	43,863.10	33,587.00	5,362.90	7,134.10	20,950.90	5,335.50	6,489.40	33,843.70	6,386.30	5,490.10	9,131.30
2.1. Multilateral	27,107.00	8,631.40	34,502.20	28,051.20	4,911.00	5,778.50	14,776.20	4,987.30	5,554.50	31,144.30	5,193.10	5,230.10	8,270.90
of which: World Bank		1,416.30				1,184.70	2,897.30	768.20	-	-	-	881.90	-
2.2. Bilateral	4,304.60	1,549.60	9,360.90	5,535.90	451.80	1,355.60	6,174.70	348.20	934.90	2,699.40	1,193.10	260.00	860.40
2.3.Private creditors	83,338.90	2,100.30	156,658.9	60,313.60	7,023.50	25,372.40	17,756.10	6,127.10	2,137.90	257,024.50	21.20	5,856.40	30,722.3
2.3.1. Bondholders	82,219.40	2,000.00	45,019.60	52,915.60	6,500.30	24,892.90	17,494.00	6,071.40	1,800.00	237,189.90	..	5,856.40	30,722.3
2.3.2. Commercial banks and others	1,119.40	100.30	111,639.3	7,398.00	523.20				-	19,834.50	21.20	-	-
2.4. Private non-guaranteed debt	39,527.20	2,371.60	308,356.7	53,293.90	15,197.7	7,293.60	9,927.60	5,434.40	1,106.70	248,397.70	6,167.70	4,948.70	34,682.5
2.4.1. Bondholders	15,354.50		48,156.60	9,604.40	1,250.00	1,007.00		-	300.00	97,285.90	..	1,450.00	18,344.7
2.4.2.Commercial banks and others	24,172.70	2,371.60	260,200.1	43,689.50	13,947.7	6,286.60	9,927.60	5,434.40	806.70	151,111.90	6,167.70	3,498.70	16,337.8
3.0 External Debt to GNI%	51.10	40.60	38.90	56.20	56.40	48.80	55.70	74.40	45.30	48.00	108.80	56.20	42.20
3.0 External Debt to Exports%	274.00	138.70	174.80	303.60	140.60	207.30	198.20	233.90	147.20	113.80	216.20	148.90	129.70
Use of IMF Credit and SDR allocations	48,055.30	551.80	18,853.00	9,024.40	1,520.40	1,600.80	8,182.60	1,016.50	1,102.80	15,946.40	705.00	403.40	2,643.80

Debt composition and trends:

The composition of the debt of the countries in the LAC region shows some interesting trends. Private investors have become the most significant external creditors for Latin American governments. Since the financial crisis of 2008/9, there has been a significant shift in the composition of Latin America's creditors. The predominance of multilateral and bilateral lenders declined throughout the 2010s as external public debt became increasingly concentrated in the hands of bondholders (as shown in Table 4 and Table 5). The share of multilateral and bilateral creditors, which peaked at 69 per cent in 2010, had fallen to 48 per cent by 2021. It is worth noting that the share of multilateral and bilateral debt did not, on average, increase across the LAC region during the COVID-19 pandemic.

The increasing role and importance of bondholders is evident in many LAC countries, accounting for more than half of total public external debt in Argentina, Colombia, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Mexico, Paraguay and Peru. However, multilateral, and bilateral lenders still play a significant role for countries with limited access to international financial markets. This includes Bolivia, Haiti, Honduras and Nicaragua. This shift in creditor composition has implications for debt management and financial stability in the region.

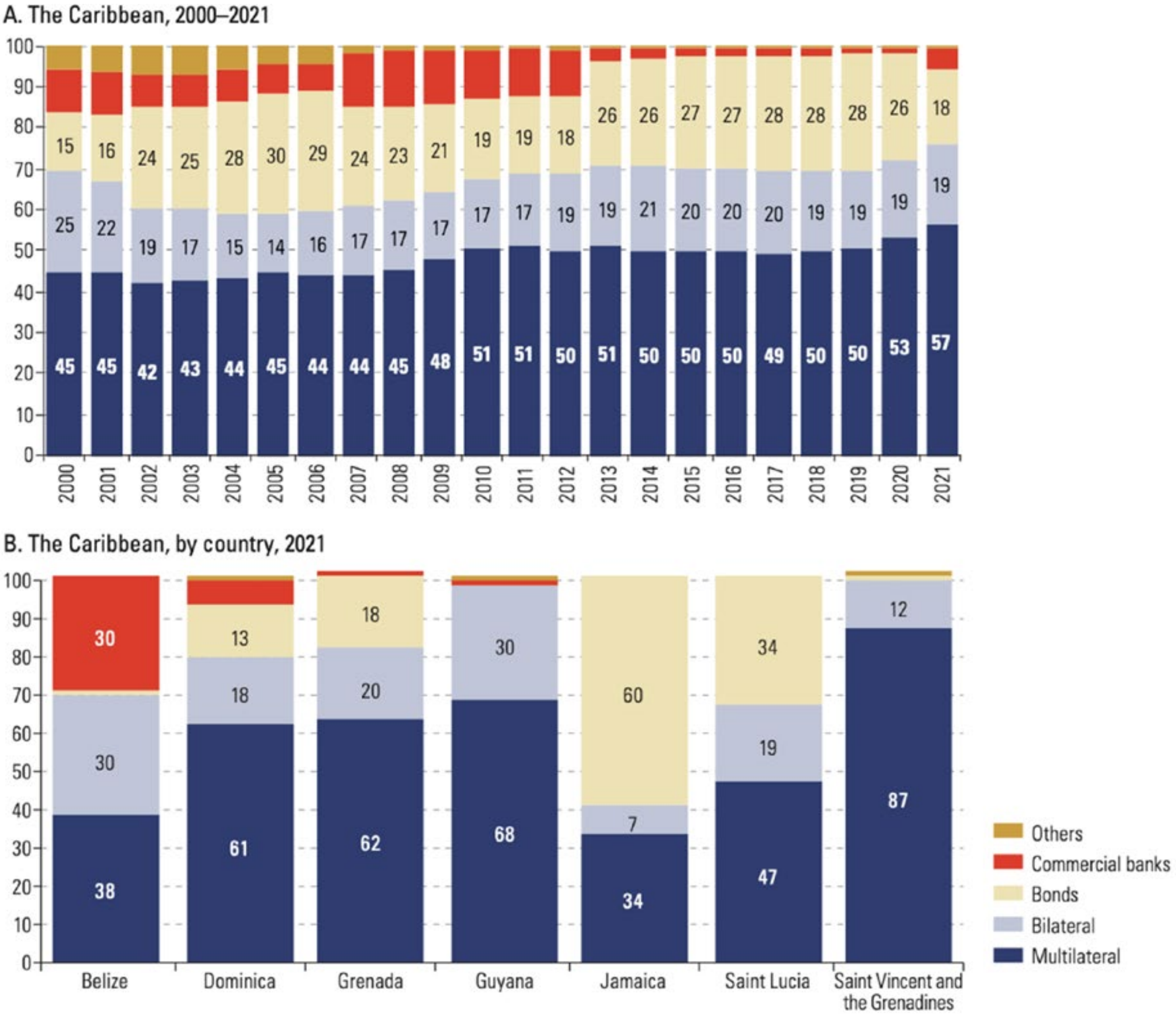
Figure 3: Trends in the composition of total external sovereign debt of Latin American countries



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of World Bank, "International Debt Statistics (IDS)" [online] https:/ worldbank.org/en/programs/debt-statistics/ids.

Note: Simple averages.

Figure 4: Trends in the composition of total external sovereign debt of Caribbean countries



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of World Bank, "International Debt Statistics (IDS)" [online] https://www.worldbank.org/en/programs/debt-statistics/ids.

Note: Simple averages.

According to the Economic Commission for Latin America and the Caribbean (CEPAL) in a 2018 report *The Climate Change Economy in Latin America and the Caribbean*, climate change impacts could cost the LAC region between 1.4 and 4.3 per cent of annual GDP by the end of the century. As the same time, the report states that the benefits of investing in climate action extend beyond avoiding economic losses. Specifically, increasing resilience and climate adaptation alone could potentially yield US$7.1 trillion in net benefits for the LAC region, leading to improved financial security.

Credit: ©Mario Gyss/dreamstime.com

03 Application of DFCNSs in LAC region

Many countries in the LAC region are on a trajectory of maintaining higher debt-to-GDP ratios over the next five years. The looming global recession, coupled with the potential for higher interest rates and reduced economic activity, increases the risk of these countries approaching a distressed debt situation. Analysis of economic, climate and debt dynamics in the region highlights a promising opportunity to implement and replicate DFCNSs. Despite pressing challenges in these areas, the region can draw upon past debt-swap successes and the support of creditor countries, private creditors and climate-focused institutions like the GCF to create a conducive environment for DFCNS expansion.

3.1 Unlocking the potential: DFCNS implementation opportunities in LAC

To implement DFCNS mechanisms in the LAC region, there are some potential opportunities based on the economic status of the region and previous regional and global experiences deploying DFCNS agreements.

Debt restructuring requirements in the region: As previously highlighted, the LAC region is anticipated to maintain elevated debt-to-GDP ratios in the coming five years. In light of these challenging circumstances, the prospect of debt restructuring becomes increasingly relevant to ensure fiscal sustainability. Therefore, taking a proactive stance in exploring DFCNS can emerge as an attractive strategy within the context of debt restructuring efforts. This approach offers countries the opportunity to concurrently address their debt burdens and advance climate and nature conservation goals, presenting a versatile solution to navigate economic uncertainties while fostering long-term sustainability and resilience.

Regional DFCNS experiences: The LAC region has a significant history of successfully implementing various DFCNS models and structures across different types of sovereign debts. This positions the region uniquely to be able to share relevant knowledge and experiences and incorporate more innovative approaches into the instrument. Consequently, the region possesses a distinct advantage in seizing opportunities that simultaneously address debt, climate and nature-related challenges.

Stakeholder willingness to engage in DFCNS: There is a clear trend of increasing willingness to support DFCNS among various stakeholders, including creditors and multilateral agencies. This diversity of stakeholders is particularly noticeable in the involvement of multilateral agencies like the IMF, as well as various players from the private sector. This diversity creates a unique opportunity to implement DFCNSs in the LAC region, especially considering the region's challenges with high inflation and mounting debt levels (The Commonwealth 2021). Additionally, the active participation of dedicated climate funds such as the GCF in exploring DFCSs as a new instrument within their portfolio is a positive development. Linking the proceeds from DFCSs as co-finance to leverage GCF resources and swapping concessional loans provided by multilateral donors exemplifies the potential for a synergistic collaboration that can yield substantial benefits (GCF 2021).

Higher prevalence of expensive commercial debt: The prominence of commercial debt in the LAC region, particularly the high prevalence of ISBs in debt portfolios, offers substantial potential for DFCNSs. ISBs and commercial loans come with high debt servicing costs, but the prospect of negotiating favourable discount rates makes them attractive candidates for debt swaps. Recent experiences in the region have shown international partners' readiness to participate in DFCNS efforts. This includes repurchasing commercial loans from the secondary market, offering insurance and guarantees for low-cost climate/nature bonds, and supporting the development of DFCNS strategies. This presents a readily available avenue for LAC countries to address both their debt burdens and climate challenges concurrently, representing an easily achievable opportunity with significant benefits.

Bilateral debt composition: It's important not to overlook the potential of bilateral debt swaps given that a significant portion of debt portfolios in many LAC countries consist of bilateral agreements with donors. While the success of these swaps depends on the willingness of bilateral creditors to engage in the process, historical experiences suggest that such arrangements are viable in the LAC region. By drawing insights from the DFCNS model implemented in Bolivia, Seychelles and other successful cases, consolidating bilateral debt could be a workable approach in collaboration with bilateral donors. This avenue offers LAC countries an opportunity to explore innovative debt management strategies that align with their climate and nature conservation objectives while also addressing their debt challenges.

Potential for regional collaboration for climate and nature/ecosystem conservation actions: The region has common demands for addressing common transboundary climate and ecosystem issues as it shares globally sensitive and important ecosystems. The Amazon, large river basins and marine ecosystems are some examples of such ecosystems where conservation and climate efforts may generate impacts that can be regional benefits. This is in line with the scientific approach of an "ecosystem wide" approach that can generate synergetic impacts. Therefore, the region is in a better position to have a regional and a multicounty regional approach in deploying DFCNSs.

This collaboration can result in more effective conservation efforts and enhanced climate resilience. Additionally, it promotes regional cooperation and coordination, aligning with shared environmental goals and fostering a collective response to safeguard these vital ecosystems.

3.2 Navigating obstacles: Challenges faced by the LAC region in implementing DFCNSs

While there are opportunities worth capitalizing on, it is crucial to remain attentive to certain challenges. These challenges are not exclusive to the LAC region but rather of a more generic nature. Key challenges include integrating DFCNSs effectively into the broader debt management strategy and fostering collaboration among diverse stakeholders. Harmonizing the priorities between economic and environmental domains presents a common challenge for the region. Additionally, in some countries with smaller debt-stocks, the feasibility of the DFCNS option may be hampered by high transactional costs.


Credit: ©Michael Zysman/shutterstock.com

04 Way forward/ Recommendations

To address these challenges and maximize the opportunities at hand, it is essential to embrace an integrated and innovative approach. Past global experiences have demonstrated that the DFCNS instrument has evolved into a collaborative, multi-stakeholder process. The growing interest from bilateral, multilateral and private sector entities underscores the potential for a more comprehensive approach. The historical practice of continuously introducing innovations to the DFCNS instrument and approach indicates that there is still room for improvement. The proposed actions moving forward are therefore to explore a regional approach encompassing the following key strategic actions:

1. **Developing a regional framework for the design, development and execution of DFCNS:** Developing a regional framework for the holistic and integrated design, development and execution of DFCNS initiatives is a strategic move to ensure coordinated and effective action. Recent global experiences have often focused on small, project-based efforts. However, there is a growing recognition of the need for a more comprehensive approach. This shift aims to harness synergies and enhance the impact of DFCNSs on debt management, climate action and sustainable development.

   The framework should facilitate mutual understanding among member states, common converging points and solving divergent aspects. Boosting sustainable finance mobilization, unlocking additional resources and establishing decision-making mechanisms especially on equitable distribution of responsibilities and benefits in a regional DFCNS approach are also the potential important aspects to be covered in the secondary stage of the regional framework.

   Such an approach can align with regional climate and nature priorities, particularly in preserving large and sensitive ecosystems. The framework can also be expanded on the aspects of lowering transactional costs, mobilizing a broader cross-section of stakeholders and leveraging other finance sources. It is also suggested to have a regional political leadership forum to advocate for regional DFCNSs that can also provide the leadership to develop and negotiate for the regional framework on DFCNSs.

2. **Establishing a regional collaboration knowledge and study centre:** The LAC region has accumulated a wealth of experiences with DFCNS initiatives, with many of these swaps occurring within the region. Leveraging this collective experience presents a valuable opportunity for collaborative review and shared learning, which can significantly enhance the region's knowledge and expertise in DFCNSs. DFCNS initiatives demand a high level of technical expertise, therefore, a collaborative approach to reviewing past experiences and learning from them can be mutually beneficial.

   Establishing a regional knowledge and study centre focused on debt management, including comprehensive debt management encompassing DFCNS, is of paramount importance. Such a centre can serve as a hub for knowledge dissemination and capacity building, not only supporting countries in building their capabilities in this area but also facilitating broader stakeholder engagement.

By adopting a holistic approach to DFCNS and involving various stakeholders, including governments, civil society and international organizations, this centre can foster a more comprehensive understanding of the complexities and opportunities associated with DFCNSs. Moreover, having a regional knowledge and study centre dedicated to debt management will strengthen efforts to explore various potential models and designs for DFCNS initiatives. This exploration is critical for tailoring DFCNS approaches to the unique circumstances and needs of different countries within the LAC region.

3. **Identification of potential shared regional climate and nature actions:** Identifying common regional climate initiatives that can harness DFCNS mechanisms for financial mobilization is essential for fostering collaboration. These initiatives could revolve around shared ecosystems with transboundary impacts, such as the Amazon, river basins, marine reserves and other vital natural resources.

   Regional climate and nature conservation efforts offer ideal opportunities for collective action, acting as catalysts for DFCNS-based finance mobilization. Starting points for identifying these regional priorities can be found within the targets outlined in NDCs and NBSAPs. Furthermore, these targets can facilitate the development of regional and transboundary projects and programmes, bolstering the efficacy of climate adaptation and mitigation strategies across the LAC region.

4. **Exploring regional debt-pooling potential:** Exploring ways to increase the debt available for DFCNSs presents a significant opportunity. One option is to engage common bilateral creditors. Additionally, a thorough assessment of other debt categories like bonds may be necessary before considering consolidation. Another approach is to pool proceeds following a debt swap. This consolidation of debt resources can amplify the impact of climate and macroeconomic initiatives while reducing transaction and administrative costs, making it more appealing to financiers and collaborators. This approach enhances the efficiency and effectiveness of DFCNS efforts, generating substantial benefits for the LAC region. Although complex and challenging, it fosters innovation and collaboration.

5. **Exploring strategies for establishing a regional fund as a special purpose vehicle to bolster DFCNS:** The idea of establishing a regional fund or special purpose vehicle has been under discussion for some time. In 2018, ECLAC proposed a concept for a regional special purpose vehicle focused on climate change adaptation (ECLAC 2022). Creating a regional fund dedicated to supporting DFCNS initiatives and financing climate and nature conservation actions holds great potential for the region.

   Initial capitalization of this fund can come from DFCNS proceeds. The fund's design and operational approach can prioritize activities such as facilitating DFCNS arrangements, establishing mechanisms to pool proceeds from debt swaps, and tapping into additional financing sources to bolster its resources. This fund would be a valuable tool for financing regional climate and nature conservation efforts, promoting collaboration across the LAC region. Furthermore, it can be used to mobilize finances from other sources, including dedicated climate funds like the GCF, and other donors can significantly augment its initial capital.

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