G20 BRASIL 2024

BUILDING A JUST WORLD
AND A SUSTAINABLE PLANET

Second Joint Finance-Health Task Force (JFHTF) Meeting

Sovereign Debt-for-Development Swaps

A report for the G20 JFHTF

October 28th, 2024

TABLE OF CONTENTS

UNCTAD SOVEREIGN DEBT SWAP DATABASE GLOSSARY

TYPE	EXPLANATION
C2D[1]	The French "Debt Reduction-Development Contract" aims at reducing bilateral ODA debt obligations. Swaps finance a wide range of projects in different sectors such as infrastructure, education, agriculture, and health.
Children	Projects conducted by UNICEF focused on improving the well-being of children. These can include programmes investing in health care, education and sanitation as well child protection.
Climate	Focus on climate adaptation and mitigation projects, encompassing a wide range of initiatives such as promoting renewable energy and sustainable agriculture, as well as infrastructure projects improving climate resilience, such as the construction of roads, dikes, and breakwaters.
Education	Focus on projects in the education sector, such as the construction of schools, teacher training programs, or expansion of scholarship programs.
Food	Focus on projects promoting food security and improving nutrition, which includes Swaps conducted by the WFP. These projects focus on providing direct food and nutrition assistance, as well as addressing underlying causes of malnutrition, such as promoting school attendance or investing in health services.
Health	Focus on projects in public health, including Debt2Health programs by the Global Fund and health-related projects by other entities. These projects aim at treating and preventing specific diseases such as HIV, Malaria, or Tuberculosis, as well as improving a country's general health system
Nature	Focus on projects in nature conservation and environmental protection, which include projects aimed at establishing conservation areas, promoting biodiversity, preventing soil contamination, or reducing deforestation
Other	Projects include reconstruction of infrastructure after natural disasters as well as the promotion of ecotourism through the construction of hotels and safari lodges.

1. Similar swaps were advanced by other bilateral creditors such as Switzerland and Italy but have not been included in this analysis due to the absence of detailed information relating to their value and purpose.

EXECUTIVE SUMMARY

1. The Brazilian G20 Presidency requested UN Trade and Development (UNCTAD) to prepare this paper as an input into a broader examination of the potential for debt-for-health swaps conducted by the G20 Joint Finance and Health Task Force (JFHTF) in coordination with the G20 International Financial Architecture Working Group (IFAWG). It presents an analysis of the choice and considerations surrounding the use sovereign debt swaps in development finance, based on a database developed for this purpose.

2. The UNCTAD Sovereign Debt Swap Database currently includes public information on 235 swaps concluded in 58 countries since 1987, with a combined face value of over US$11.5 billion that was directed towards health, nature, climate, children and poverty reduction.

3. The concept of sovereign debt-for-development swaps as a mechanism for mobilizing development finance has gained significant attention, especially following successful debt-for-nature swaps in countries like Belize, Barbados, and Ecuador, which channeled increasingly large amounts of resources towards underfunded developmental projects. This is particularly relevant in the context of rising debt levels in developing countries and limited development financing observed in recent years.

4. Debt-for-development swaps have emerged as one possible tool from a wider financing "toolbox" that can be used to create fiscal space for varying developmental objectives, while reducing some of the debt burden on developing countries. The use of sovereign debt swaps; the conditions under which countries may find them a financially efficient option; considerations around their scaling up; how better development outcomes can be extracted; and possible measures to support developing countries in these endeavors are considered.

5. While debt-for-development swaps have historical precedence and potential to mobilize resources for development, their high transaction costs limit their applicability to countries considering them. In particular, the complexity of multi-party swaps (as employed recently for debt-for-nature swaps) necessitates higher face values to justify their higher transaction costs. To scale up these instruments and make them more accessible to more countries, it is necessary to reduce the associated transaction costs and consider ways to build local capacity through repeated swap implementation.

6. Countries must also consider that debt swaps can render attempts at debt relief and restructuring more complex and may introduce new senior creditors. Conditionalities in swap agreements can also expose the debtor country to additional risks. Furthermore, debt swaps do not constitute a financially efficient funding option if the country concerned has access to capital at better terms, or if they are already experiencing high levels of debt stress that reduce the likelihood of benefits being realised in future.

7. For debt swaps to be consistent with the development priorities of the debtor country rather than advance the agendas of third parties, swaps need to be aligned with, and integrated into, the national development plans of the borrower. Improved reporting and standardization of practices are also crucial to enable informed decision-making by countries pursuing debt-for-development swaps. This can help in addressing the issue of lack of transparency in the debt swap ecosystem. The establishment of an information-sharing platform could also significantly assist all stakeholders by providing technical assistance for project development, assessing the suitability of debt-for-development swaps, supporting negotiation processes, and improving transparency.

8. Lastly, despite their potential to generate some debt relief and redirect flows to development finance, debt-for-development swaps should not be viewed as a primary tool for debt restructuring. There is a significant risk that an excessive focus on them could distract from the urgent need to address sovereign indebtedness and debt distress, which are critical obstacles to the development agendas of many countries.

INTRODUCTION

The topic of sovereign debt swaps as a tool for mobilizing development finance has attracted considerable interest following the conclusion of recent debt-for-nature swaps, such as those concluded by Belize, Barbados and Ecuador, which have redirected increasing larger amounts of resources to under-financed initiatives. This has raised the question as to how such instruments might be useful in directing scarce and needed resources towards other development objectives ranging from health and education to climate and poverty reduction related initiatives in the context of higher debt levels in developing countries and constrained financing for development.

As a financial instrument, sovereign debt swaps are not new. They have been employed in several contexts including debt management, debt restructurings and financing operations to free up fiscal space.[2] However, these forms of liability management[3] are not typically what is meant by debt-for-development swaps — which is the focus of this paper.

Instead, sovereign debt-for-development swaps are associated with the creation of fiscal space in exchange for government commitments to invest in targeted development-oriented projects or initiatives in sectors aligned with the SDGs. These swaps may take many different forms but typically involve the rechannelling of debt service payments or the repurchase of certain categories or types of debt at a discount. The resulting fiscal space is redirected to specific predefined developmental purposes.

Debt swaps are not considered a substitute for comprehensive debt restructuring mechanisms, or an effective tool in handling unsustainable debt situations in isolation due, amongst other things, to their historically low face value, their comparatively high transaction costs, and the additional complexity they can give rise to in respect of creditor seniority.

The Brazilian G20 Presidency requested UN Trade and Development (UNCTAD) to draft this paper as an input into a broader examination of the potential for debt-for-health swaps conducted by the G20 Joint Finance and Health Task Force (JFHTF) in coordination with the G20 International Financial Architecture Working Group (IFAWG). To undertake this analysis, UNCTAD has developed a stylised database of available financial data, types and characteristics of debt-for-development swaps. This paper discusses the potential to scale up debt swaps and the caveats and conditions for their use. More specifically it addresses i) trends in the evolution of their form, size, frequency and purpose; ii) forms of debt-for-development swaps; iii) when they may be applicable from a financial efficiency perspective; iv) experience with debt-for-health swaps, v) the potential for scaling up debt-for-development swaps; vi) the implications of scaling up; vii) how better development outcomes can be extracted from them; and viii) measures required to increase their scale.

2. Debt swap operations are commonly used for liability management. In this context, the objective of this tool relates to reducing or smoothing debt servicing payments, reducing vulnerabilities to external shocks, or supporting the development/maintenance of a market for government securities. Liability management seeks to reduce sovereign risk which might be associated with "rollover risk, interest rate risk, exchange rate risk or liquidity risk". See Medeiros et al 2007.

3. See IMF eLibrary, "What is a debt swap?: Exchange operations play increasing role in managing liability and dealing with crises," January 2001. https://www.elibrary.imf.org/view/journals/023/0030/012/article-A006-en.xml

I. DEBT-FOR-DEVELOPMENT SWAPS — WHAT AVAILABLE DATA TELLS US

In the context of development finance, the aim of debt-for-development swaps is to free up fiscal resources in exchange for commitments by the debtor country to invest in development related objectives. To date, sovereign debt-for-development swaps have been implemented to support a range of areas including education, health, children, food, climate, nature, and other development purposes. The first debt-for-development swap was agreed in 1987 and was concluded between the government of Bolivia and Conservation International, which bought back US$650'000 of Bolivia's debt at a discount in exchange for the government's commitments to nature conservation. Costa Rica and Ecuador soon implemented their own agreements, and this led to an increase in debt-for-development swaps targeted at supporting children, education, health and the environment.[4]

In the absence of formal reporting, debt-for-development transactions are not easily traceable, making comprehensive data on current practices elusive. Nonetheless, initial data collected from public sources by UNCTAD on 235 swaps concluded in 58 countries since 1987 provides some insights into the evolution of debt swap practices.[5] Collectively, these swaps had a combined face value of over US$11.5 billion and directed funds towards health, nature, climate, children and poverty reduction.[6]

Figure 1 shows the aggregate annual face value of new debt swaps concluded each year, disaggregated by their apparent purpose. Debt-for-nature swaps have had the largest aggregate face value of the categories examined over the entire period. The peaks in the value of debt swaps post-2020 are associated with debt-for-nature swaps and are not caused by a significant increase in the number of swaps issued under this purpose. Rather, they reflect an increase in the face value of the individual swaps, most notably the US$580 million Belize[7] swap in 2021, the 2022 US$150 million Barbados[8] swap, and the US$1.6 billion Ecuador[9] and US$500 million Gabon[10] debt swaps in 2023.

4. See p. 10; OECD. "Lessons Learnt from Experience with Debt-for-Environment Swaps in Economies in Transition," 2007. https://www.oecd.org/environment/outreach/39352290.pdf.

5. This database is under continual development, as additional information is incorporated the number of swaps and country coverage is subject to revision.

6. Eg, France's Debt Reduction-Development Contract (C2D) that supported poverty reduction programmes to supplement HIPC debt relief for beneficiary countries. Other countries — such as Switzerland and Italy — also engaged in variants of debt-for-development swaps in the early 2000s but the details of these transactions were not available at the time the UNCTAD database was constructed and are therefore not included.

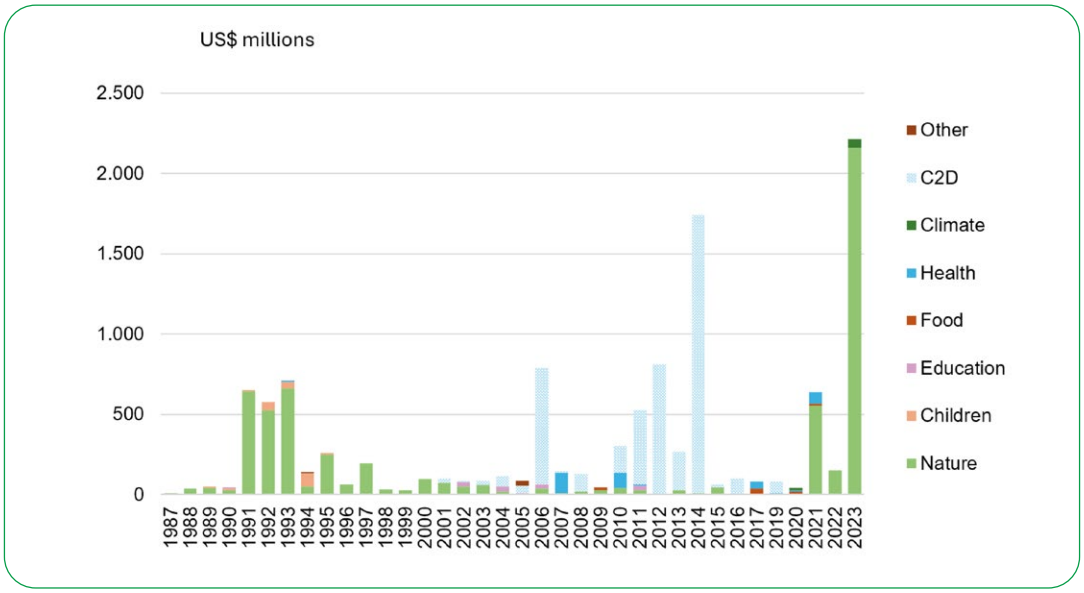
7. Belize US$364M debt conversion https://www.greenfinanceinstitute.com/gfihive/case-studies/government-of-belize-debt-conversion-for-marine-conservation/.

8. Barbados US$150 million debt conversion: https://www.nature.org/en-us/newsroom/tnc-announces-barbados-blue-bonds-debt-conversion/.

9. Ecuador US$1.6 billion debt swap: https://www.reuters.com/world/americas/ecuador-seals-record-debt-for-nature-swap-with-galapagos-bond-2023-05-09/.

10. Gabon US$500 million debt conversion: https://www.nature.org/en-us/newsroom/tnc-announces-debt-conversion-for-ocean-conservation-in-gabon/.

Figure 1: Face value of debt swaps by purpose



Source of data: UN Trade and Development Sovereign Debt Swap Database, 2024

Reduction-Development Contract (C2D)[11] debt swaps between 2001 to 2019 emerge as a major example of bilateral development-oriented debt swaps. Under different modalities, Italy's debt-for-development program in 2000-2023 swapped 1.37 billion euro in counterpart funds 2023, mostly in countries with sustainable debt with aim of providing additional fiscal space.[12] [13] With the exception of the Belize, Gabon and Ecuador swaps, the face value of the swaps concluded recently was relatively small and was focused on health, food and climate. The C2D[14] and debt-for nature-swaps were generally larger.

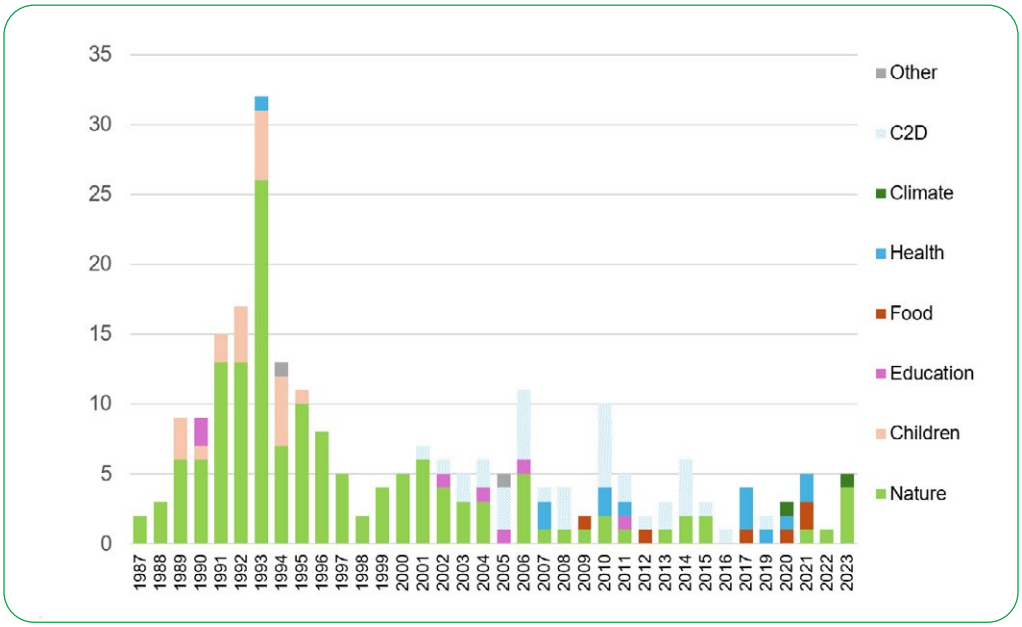
11. The mechanism developed by the Agence Française de Développment https://www.afd.fr/en/c2d-mechanism-relieve-indebted-countries

12. https://documenti.camera.it/_dati/leg18/lavori/documentiparlamentari/indiceetesti/183/elenco.htm

13. Inputs for these swaps are being incorporated into the revised version of the database.

14. https://www.afd.fr/en/c2d-mechanism-relieve-indebted-countries

Figure 2: Number of debt swaps concluded by purpose



Source of data: UN Trade and Development Sovereign Debt Swap Database, 2024

Debt swaps implemented with multilateral intermediaries such as the United Nations Children's Fund (UNICEF) and the UN World Food Programme (WFP) served to redirect resources to development-oriented programs under their mandates. For example, the debt swaps facilitated by UNICEF between 1989 and 1995, served to support their work in countries where the Fund was active. Using US$29 million of their own funds and debt donations to purchase debt with a face value of US$199 million generated US$53 million of developmental funds in the countries in which swaps were concluded.[15] Similarly, the debt-for-food swaps undertaken by the WFP between 2009 and 2021 redirected US$87.8 million to food programmes under their mandate.[16]

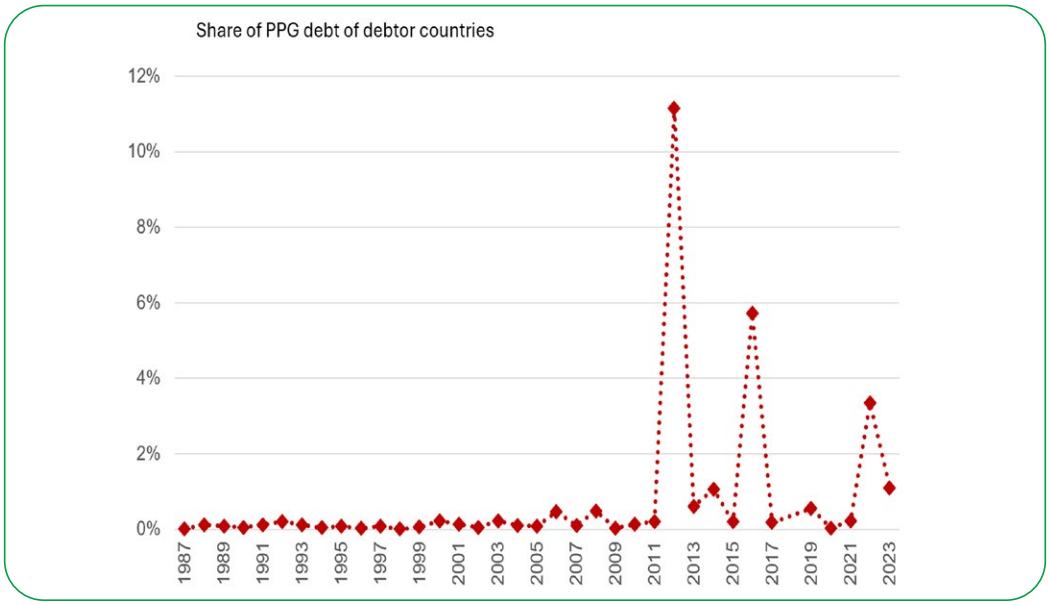
Figure 3 shows the ratio of the total face values of the debt-for-development swaps to the total PPG debt stock of the debtor country.[17] Despite increases in swap sizes, the ratio generally remained well below 2 per cent of PPG debt stock levels for debtor countries. The spikes in 2012 and 2016 reflect C2D swaps that were implemented to further supplement the Heavily-Indebted Poor Country (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI). In these instances, the significant change in the ratio reflects the simultaneously larger face value of the C2D swaps and a reduction in the PPG debt stock resulting from the HIPC initiative.

15. https://docplayer.net/4792857-Overview-of-debt-conversion.html

16. https://scalingupnutrition.org/wp-content/uploads/2021/10/WFP_SUN-Debt-for-food-Swaps-Presentation.pdf

17.The total face values of the debt-for-development swaps to the total PPG debt stock of the debtor country ratio was calculated by summing the face values of the debt swaps issued in the year of the debt swap, then dividing this amount to the sum of the PPG debt stock of the borrower countries of the debt swaps in the same year. Thus, Figure 3 only considers the debt swaps where the face value of the swap, and the historical PPG debt data of a given country are both available

Figure 3: Ratio of the total face value of debt swaps concluded to the value of public and publicly-guaranteed (PPG) debt of the debtor country/s



Source of data: UN Trade and Development Sovereign Debt Swap Database, 2024

II. DEBT SWAP DESIGN

The bespoke nature of debt-for-development swaps has been implemented via various arrangements and with considerable differences in their modalities. There is no standardization of practices or rule book on the implementation of debt swaps. They may vary substantially in terms of design, stakeholders, terms of financing, conditionalities and monitoring and implementation. This paper analyses debt swaps under two general categories: bilateral and multi-party swaps.[18] While certain types of swaps — such as the debt-for-health swaps facilitated by the Global Fund — have traditionally followed a fairly common form, this is not necessarily the case in other contexts. The purpose for which the liberated funds are used is essentially agnostic of the form of the swap (whether bilateral or involving multiple parties).

Generally, the degree of complexity of a swap is a function of the number of creditors and intermediaries involved, the institutional design that accompanies it, and the conditionalities that the swap imposes on the contracting parties. In this context, bilateral swaps are the least complex, while multi-party swaps that may include a range of measures such as buy-backs of existing debt, use of special purpose vehicles (SPVs), the issuance of new bond instruments, the establishment of trusts or endowments to oversee and manage the proceeds, separate institutions to monitor and evaluate performance and numerous contractual clauses defining, amongst other things, conditions of default are at the other

18. For overview of practices see: Fresnillo, Iolanda (2023). "Miracle or mirage? Are debt swaps really a silver bullet?" Eurodad. https://www.eurodad.org/miracle_or_mirage

end of the complexity spectrum. The degrees of complexity have significant implications for transaction costs and the minimum size of the swap required to generate positive financial returns. The latter also has systemic implications for sovereign debt sustainability.

a. Bilateral debt-for-development swaps

Bilateral debt swaps entail an agreement between an official creditor[19] and a sovereign debtor, which can be initiated by either party and typically involve non-bonded debt, such as a loan. Upon initiation, negotiations ensue to establish the terms and parameters of the agreement, which vary case by case. Generally, bilateral swaps involve some degree of debt relief aimed at creating fiscal space by reallocating debt service payments towards a specific project or development policy objective. In most bilateral contexts, liberated funds are disbursed in local currency, thereby mitigating foreign exchange risk for the debtor. Disbursement to the targeted investment is coupled with predetermined monitoring and evaluation requirements that the debtor country must adhere to ensure accountability throughout the process.

b. Multi-party debt-for-development swaps

Multi-party debt swaps involve one or more third-party intermediaries. The modalities of their implementation vary considerably across a spectrum in terms of their complexity and range of stakeholders.

On the simpler end of the spectrum of multi-party debt swaps, a multilateral or multi-stakeholder intermediary plays the role of the mediator or facilitator in the negotiations between the official creditor and the debtor country. As with bilateral debt swaps, a degree of debt relief is granted in the transaction and an agreed portion of the liberated resources are diverted to targeted development programs. The funds are often disbursed to the intermediary who is typically responsible for implementing projects in the country,[20] or overseeing their implementation. This may have the advantage of reducing transaction costs as there is potentially no need for the debtor country to establish separate mechanisms or procedures of implementation and monitoring.[21]

Further across the spectrum of complexity, multi-party swaps can also involve third-party private intermediaries. These may be a non-governmental organizations or private foundations. Stakeholders to such swaps may include commercial banks, multilateral development banks, development finance institutions, insurance companies, legal and financial advisors, and other private financial institutions and investors. In this case, a SPV may be created and financed by either issuance of a new bond or a loan from a financial

19. "bilateral official creditors, representing government-to-government loans"; see page 2 https://researchdatabase.minneapolisfed.org/downloads/5q47rn88v.

20. Fresnillo (2023)[19] highlights some examples of debt swaps of this kind that have been negotiated in several countries by the World Food Programme and the Global Fund.

21. In the case of the Global Fund, the intermediary also takes on the responsibility to ensure that the programs are aligned with national priorities and provide for transparency, accountability, and measurable impact.

institution. The SPV loans money to the country so that it can buy back its debt at a discount on the secondary market or engage in direct negotiations for the repurchase of official debt from bilateral creditors. The terms of the loans from the SPV to the debtor country often remain opaque, potentially reflecting the conditions of the newly issued bond or incorporating a markup on the interest rate to cover transaction costs. This approach has two potential financial savings, which draw from the size of the discount on repurchased debt and the potentially improved terms of the newly issued debt.[22] Recent debt-for-nature deals have incorporated credit enhancing guarantees from third parties and institutions to further reduce financing costs and extend maturities. As part of these transactions, countries commit to direct resources to development objectives that are financed by a dedicated trust or endowment.

One example is the recent debt swap by Ecuador that resulted in an unprecedented $1.6 billion debt-for-nature swap that bought back some of the country's debt at a near 60 per cent discount and issued a US$656 million blue "Galapagos Bond". The debt buyback was financed by a loan from a SPV that was funded by the issuance of a marine conservation bond arranged by Credit Suisse. The new bond has a 5.645 per cent coupon, which is substantially lower than the interest rates of 17 to 26 per cent on sovereign bonds that prevailed at the time of issuance.[23] The improved terms of the new bond were facilitated by an US$85 million credit guarantee from the Inter-American Development Bank (IADB) and US$656 million political risk insurance cover by the US International Development Finance Corporation (DFC). It should be noted that, to finance transaction costs, the loan to Ecuador by the SPV carries an interest rate of 6.975 per cent, a 133-basis point increase on the coupon of 5.645 offered on the "Galapagos Bond".[24] The transaction will generate an estimated $323 million of funding for marine conservation that will be split between operational activities and an endowment fund that will support marine conservation beyond the term of the transaction. The non-profit Galapagos Life Fund was established to manage the funding according to agreed conservation objectives.[25]

The specific modalities of debt swaps can vary considerably from transaction to transaction, and this can translate into differences in the benefits they may deliver in terms of development resources generated, the extent of debt relief, improvements of financing terms and terms of conditionalities. In addition, the creation of SPVs and endowments introduce additional considerations regarding legal and governance structures for managing, distributing, and monitoring the use of funds diverted for development objectives.

Criticism has been raised around the terminology used to label 'blue bonds', which was used in newly issued bonds in recent swaps conducted in the Seychelles, Barbados, Gabon, Belize, and Ecuador. Some suggest that the term is misleading or may constitute a form of 'greenwashing', as proceeds from these bonds are primarily utilized for debt buybacks, with only a fraction allocated towards ocean conservation efforts. Consequently, this

22. See page 4: Clifford Chance "Debt-for Nature Swaps: A new generation," November 2023. https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2023/11/debt-for-nature-swaps-a-new-generation.pdf

23. https://www.reuters.com/world/americas/ecuador-seals-record-debt-for-nature-swap-with-galapagos-bond-2023-05-09/

24. https://ire.finanzas.gob.ec/content/2023/05/16.05.2023_Debt_for_Nature.pdf

25. See page 7: https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2023/11/debt-for-nature-swaps-a-new-generation.pdf

labelling may exaggerate the impact of debt swaps on conservation projects but also risks inflating creditors' financial commitments to environmental protection. Due to the ambiguous nature of this bond typology, the International Capital Market Association (ICMA), in collaboration with UN agencies, the IFC, and the ADB, published voluntary market guidance on blue bonds in 2023. The guidance emphasizes that proceeds from the issuance of blue bonds should not be directed towards repurchasing outstanding debt but should be exclusively committed to financing ocean conservation projects'.[26]

III. WEIGHING FINANCING OPTIONS: WHEN CAN DEBT SWAPS BE CONSIDERED?

Developing countries have a range of financing tools at their disposal when considering the financing of development priorities and objectives. A country should conduct a thorough analysis of its debt sustainability to determine whether it has the capacity to acquire additional debt to finance its development objectives. This should take into consideration its debt levels, debt servicing capacity, fiscal performance and external financing needs.

The best external source of development funding for countries lagging behind in achieving the SDGs are grants and unconditional concessional loans. However, the volume of these resources and eligibility are limited. For countries with limited access to capital markets and little to no access to concessional finance or grants, the next preference is debt relief, for which availability and eligibility are also limited.

In this context, where development needs are ever increasing while resources to fund these projects are finite, countries may look pragmatically to debt-for-development swaps as one tool in a wider toolbox — especially when other favoured options are unavailable.

a. Financial evaluation of the potential of debt swaps

Chamon, et al (2022)[27] present a comprehensive overview of the analysis, design, and execution of debt swaps. They posit that debt swaps represent a viable option to incorporate financial gains when fiscal risk is pronounced, and debt levels are not inherently unsustainable and suggest that they may be more advantageous to debtor countries than conditional grants under certain circumstances. Additionally, they also note that debt swaps may be preferred to debt restructuring, which could entail reputational costs or economic disruptions. It should, however, be noted that the conditions and structure of debt swaps can have profound implications for debt sustainability, and the ability of participating countries to engage in debt restructuring in the future.

26. ICMA, 2023: https://www.icmagroup.org/assets/documents/Sustainable-finance/Bonds-to-Finance-the-Sustainable-Blue-Economy-a-Practitioners-Guide-September-2023.pdf

27. See p. 5; Chamon, Marcos, Erik Klok, Vimal Thakoor, and Jeromin Zettelmeyer (2022). "Debt-for-Climate Swaps: Analysis, Design and Implementation," IMF Working Paper WP/22/162. Washington, DC. https://www.imf.org/en/Publications/WP/Issues/2022/08/11/Debt-for-Climate-Swaps-Analysis-Design-and-Implementation-522184

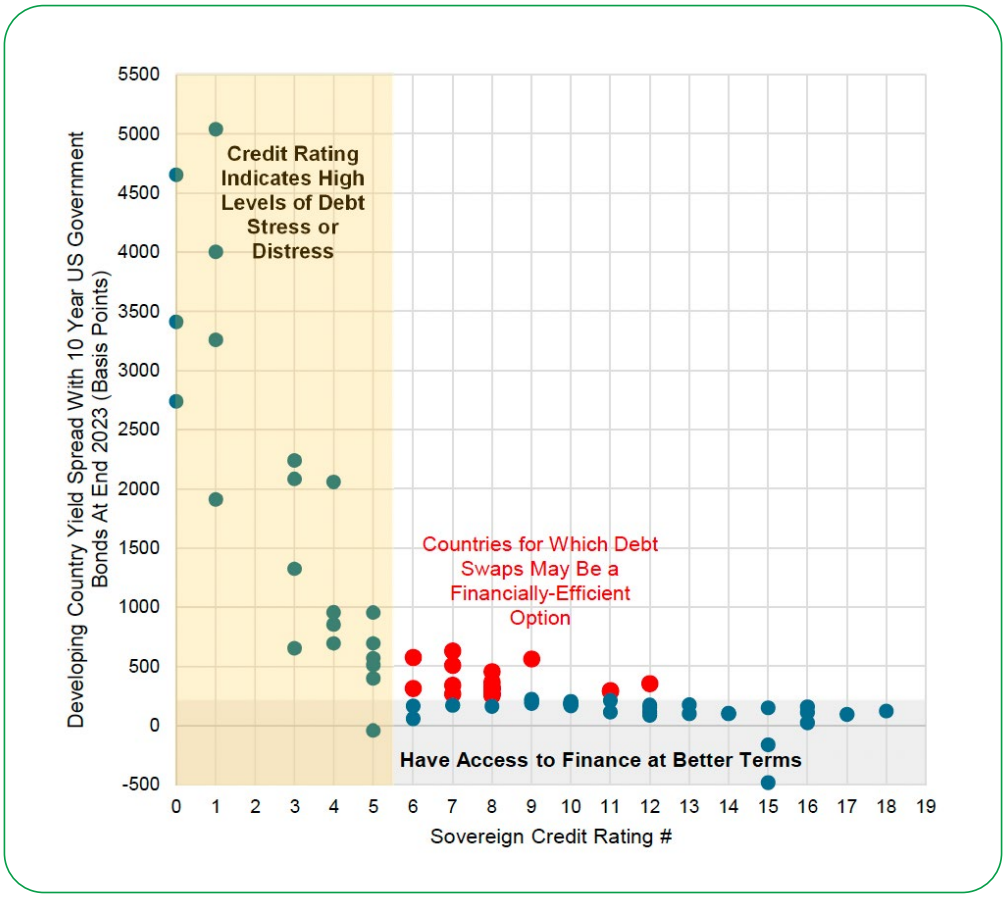
While debt swaps should, ideally, incorporate some degree of credit enhancement, they are not a comprehensive or effective debt restructuring instrument — due largely to their historically small values and high transaction costs. These arise from their relative novelty for many countries (which often results in limited "in-country" expertise and the need to contract international advisors), their size (where traditionally they have been of relatively low value), costs associated with creating and operating a SPV, long lead times to allow for the necessary consultation and coordination (including the procurement of guarantees and/or insurance), and subsequent monitoring and evaluation to ensure that targets are met. Available data on some recent debt swaps indicates that transaction-related costs could account for 40 per cent or more of any financial benefits generated.

Even with full guarantees, any blue bonds or alternative financing mechanisms will need to be priced at a premium above US benchmark rates to accommodate these high transaction costs. If countries can access global capital markets at rates lower than this premium, debt swaps constitute an inefficient financing option for them. At the same time, any potential financial benefits for the borrower country evaporate if it is likely to default during the period of execution of the swap agreement,[28] sso debt swaps do not constitute a financially efficient funding option if the country concerned has access to capital at better terms, or if they are already experiencing high levels of debt stress.

Figure 4 identifies which countries may benefit financially from debt swaps: It highlights those developing countries whose costs of accessing the market are higher than a premium above prevailing US benchmark rates (and so they cannot access finance at better terms) and those that have moderate levels of debt stress (reflected in mid-to higher sovereign credit ratings). Based on transaction costs linked to recent swaps and the range of yield spreads associated with countries with the same credit rating, we initially assume a premium of 250 basis points above prevailing US benchmark rates as the benchmark to cover transaction costs for market access. Further, we consider countries with credit ratings of B- or lower as too debt-stressed to financially benefit from debt swaps. To illustrate this, we have converted the sovereign credit rating to an ordinal scale from 0 to 20 (where 0 represents weakest credit rating C/D, 5 reflects a rating of B- and 20 is AAA). Under these assumptions, debt swaps would have been a financially efficient option for a relatively small number (around 8 per cent) of developing countries at the end of 2023.

28. In considering the potential benefits of a swap, the present value of expected future financial benefits is multiplied by the probability that it will not default (i.e. 1 — the probability of default). A high probability of default means that the present value of financial benefits from the swap that are likely to be realized will be significantly reduced.

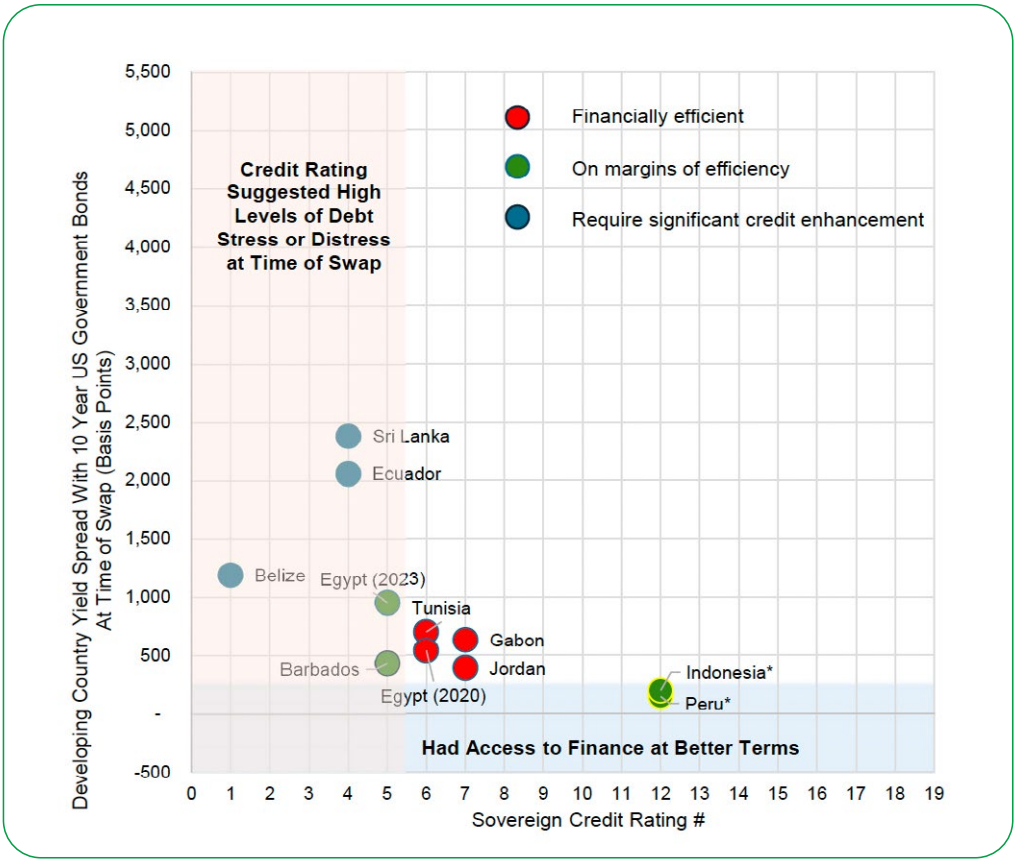
Figure 4: Identifying countries for which debt swaps might have been a financially efficient option at the end of 2023



Source of data: Refinitiv, www.worldgovernmentbonds.com
* Excludes 54 developing countries that do not have sovereign credit ratings. It is assumed that most of these countries have relatively high levels of debt stress and would therefore be unsuited to debt swaps from a financial efficiency perspective.
# A rating of 19 equates to a sovereign credit rating of AA+, a rating of 10 equates to BB+ and a rating of 0 to C/D

Expanding this number is dependent on reducing the transaction costs associated with debt swaps. For example, if the required transaction cost funding premium over US benchmark rates was reduced from 250 to 150 basis points, the share of developing countries for which swaps could be a financially efficient option would almost double — to close to 15 per cent of developing countries.

Figure 5: Indicative financial efficiency of debt swaps concluded since 2020



Source of data: Refinitiv, , www.worldgovernmentbonds.com
* Both Indonesia and Peru had similar credit ratings and yield spreads with 10Y US Government Bonds at the time of debt swap issuance.
# A rating of 19 equates to a sovereign credit rating of AA+, a rating of 10 equates to BB+ and a rating of 0 to C/D

Figure 5 reflects the application of this approach to the 14 debt swaps conducted since 2020, in which 11 of these swaps are represented.[29] Four of these swaps (coloured in red) fall within the scope of countries that would — with prevailing assumptions of transaction costs and default risk — have been able to undertake debt swaps in a financially-efficient manner at the time of the swap. An additional four swaps (coloured green) were on the margins of financial efficiency, and a further 3 swaps (coloured blue) would have required significant additional guarantees and other credit enhancements, and/or had to achieve significantly lower transaction costs to be classed as financially efficient.

However, making debt swaps work for development requires not only a financial benefit (although some may argue this is key), but also that this benefit is aligned with national expenditure priorities and strategies and is accompanied by sound institutional and governance arrangements to ensure positive development outcomes.

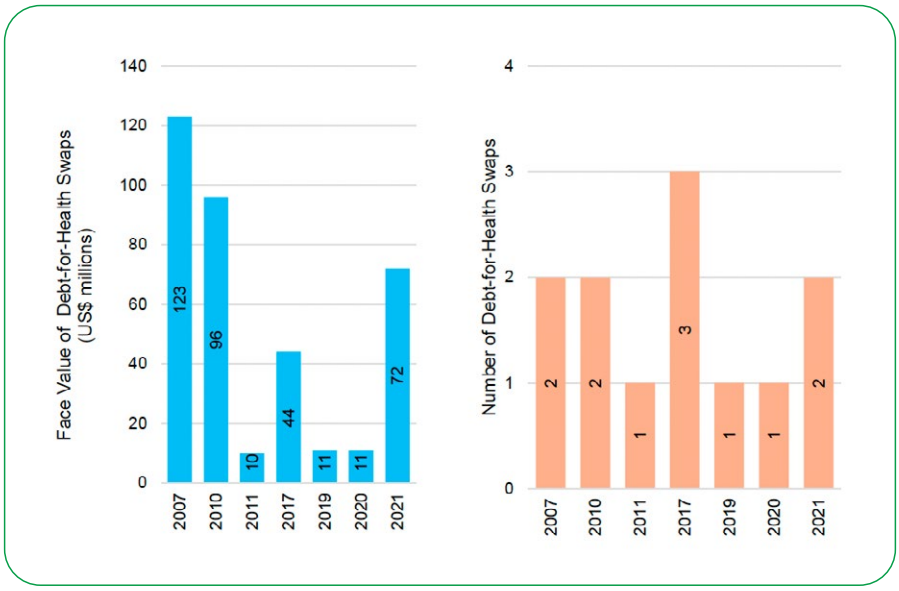
29. The remaining three swaps could not be included in this analysis because the countries either did not have access to secondary capital markets (and hence did not have an indicative yield spread) or did not have a sovereign credit rating.

IV. DEBT-FOR HEALTH SWAPS

A total of 13 debt-for-health swaps, with a combined face value of US$368 million and average face value of US$28.3 million are recorded on the UNCTAD sovereign debt swap database. Apart from a 1993 debt swap between Nigeria and the River Blindness Foundation,[30] , they all form part of the Global Fund initiative. Indonesia concluded three of these debt-for-health swaps — in 2007, 2010 and 2021 — but the other 10 debtor countries (6 of which are in Africa) only concluded a single swap with this purpose.

Apart from debt-for-health swaps, as part of its more general mission, the Global Fund disbursed US$5.2 billion to fight HIV, tuberculosis and malaria, support COVID-19 Response Mechanism (C19RM) activities and strengthen the systems for health that underpin any pandemic response. In 2023, the Fund approved 152 grants with a combined value of US$9.2 billion to 70 different countries, that are to be disbursed between 2024 and 2026.[31] Annual disbursements by the Fund are over 14 times greater than the combined face value of all 13 debt-for-health swaps on record to this point.

Figure 6: Total value and number of debt-for-health swaps concluded



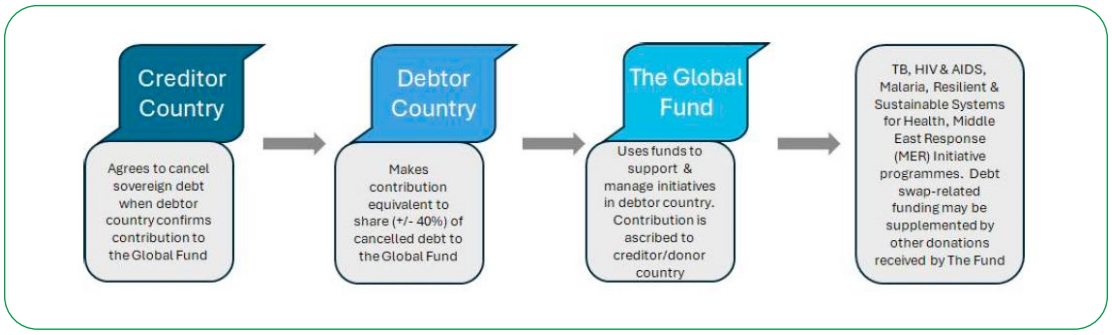
Source of data: UN Trade and Development Sovereign Debt Swap Database, 2024

The Global Fund's approach to D2H debt-for-health swaps is a variant of a bilateral swap and appears to have changed little since 2007 when its first swaps were recorded — although it notes that the approach can easily be adapted to meet the requirements of creditor governments or institutions mandated by them.

30. https://pdf.usaid.gov/pdf_docs/pnacb287.pdf

31. corporate_2023annualfinancial_report_en.pdf (theglobalfund.org)

Figure 7: Illustrative debt swap approach adopted in Global Fund-facilitated debt-for-health swaps

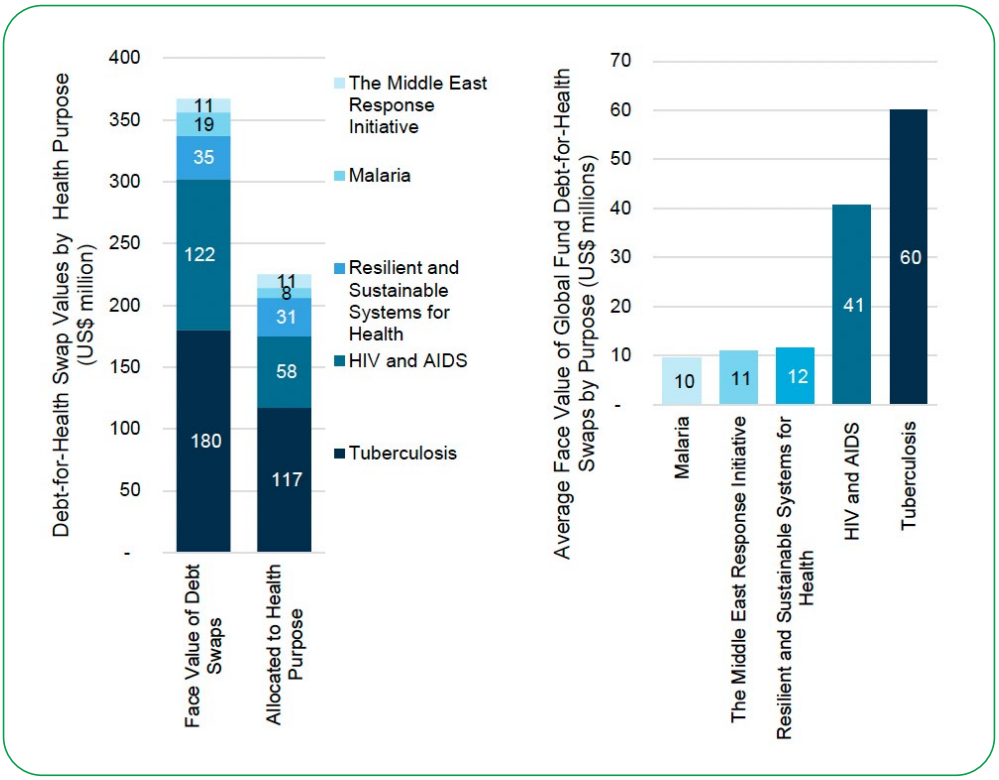


Source: Derived from the Global Fund (undated) publication_debt2health_overview_en.pdf (theglobalfund.org)

The principal difference between the D2H model and a bilateral swap is that instead of channelling debt service costs to development programmes under its control, the debtor country makes a donation — equivalent to some portion of the amount of debt cancelled by the bilateral creditor — to the Global Fund. This donation supplements other donations and commitments received by the Fund to finance its work. In 2022, the Fund's operational expenditure was equivalent to 5.1 per cent of the pledges received in that year, excluding in-country costs, which are not specified.[32]

32. corporate_2023annualfinancial_report_en.pdf (theglobalfund.org)

Figure 8: Aggregate face value, allocated and average face value of Global Fund Debt2Health health swaps by purpose



Source of data: The Global Fund publication_debt2health_overview_en.pdf (theglobalfund.org)

As has been noted, the form that a swap takes is independent of the purpose for which any liberated funds are used. While the Global Fund model is essentially the only example of debt-for-health swaps on our database, there is no reason why health-related development projects could not be funded by the proceeds of traditional bilateral swaps, or by all, or part, of the proceeds of much larger (and more complex) multi-party swaps.

Global Fund debt swaps tend to be creditor- and Fund-driven but utilise national committees (Country Coordinating Mechanisms) to submit funding applications and oversee grants on behalf of their countries. Members of these committees are drawn from academic institutions, civil society, faith-based organizations, government, multilateral and bilateral agencies, nongovernmental organizations, people living with diseases that form part of the Fund's focus, the private sector and technical agencies. The committees are supposed to ensure linkages and consistency with other national health and development programmes.[33]

33. publication_debt2health_overview_en.pdf (theglobalfund.org)

While the Global Fund argues that the underlying claims of its D2H swaps are typically ODA debts already earmarked for development cooperation,[34] and that this ensures rigorous compliance standards in the creditor country, similar levels of accountability from the debtor country cannot be assured.

Similarly, the lack of ringfencing of the donation by the debtor country to the Fund means that it is hard to monitor and evaluate performance and cost-effectiveness of the swap in isolation from the broader performance of the Fund at the country level.

V. WHAT CONSTITUTES SCALING UP OF DEBT-FOR-DEVELOPMENT SWAPS?

Proponents of debt swaps argue that positive spillovers from larger or more frequent swaps can affect the cost of future commercial borrowing if they materially affect the country's debt sustainability, especially if the debt swap neutralizes an expensive or opaque debt commitment. Assuming that positive spillovers can be attained, the primary routes to scaling up debt swaps are expanding the number of countries engaging in swaps; increasing the number of swaps concluded by individual debtor countries; and raising the face value of swaps concluded.

a. Extending debt swaps to more countries and increasing the number of swaps of participating countries

As discussed above, debt swaps do not constitute a financially efficient funding option if the country concerned has access to capital at better terms, or if they are already experiencing high levels of debt stress. Expanding the number of countries that can engage in swaps therefore depends on lowering the associated transaction costs — especially for those countries that are either undertaking debt swaps for the first time, or that have not concluded a swap for an extended period.

According to the UNCTAD sovereign debt swap database, 58 different countries engaged in debt swaps between 1987 and 2023. However, 20 of these countries have only concluded one swap, eleven of which were concluded before the 2008 global economic crisis. Fourteen of the 235 swaps on record were undertaken during, or after, the COVID-19 pandemic — 4 of which were by countries that had not previously undertaken swaps. Madagascar engaged in a series of 13 debt swaps between 1989 and 1996 and a further 4 swaps between 2003 and 2012. Mexico engaged in 16 debt swaps during the 1990s, but nothing since then, and Indonesia undertook 10 swaps between 2002 and 2011 and then concluded additional swaps in 2014 and 2021.

It is likely that those countries that engaged in several swaps in relatively close succession would have developed experience and institutional capacity that should have helped to lower the transaction costs of subsequent swaps. However, it is not certain that this capacity would have been retained if the country concerned has not engaged in further swaps for

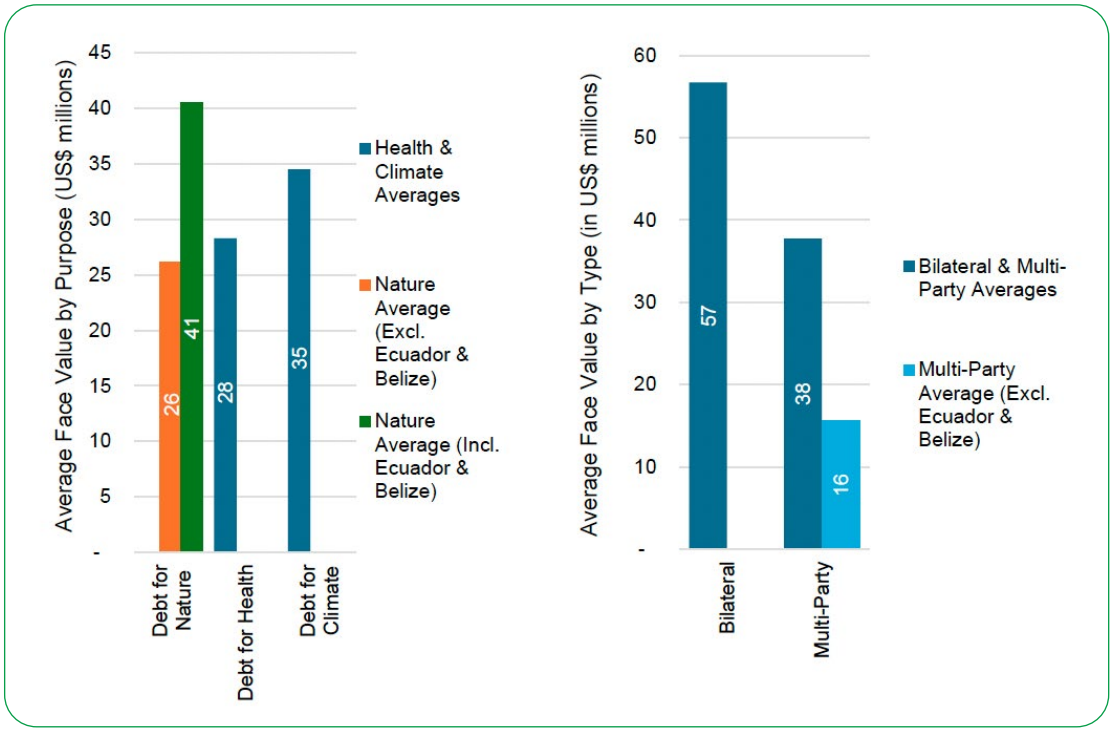
34. publication_debt2health_overview_en.pdf (theglobalfund.org)

the past 10 years or more. Debt swaps have also been subject to ongoing innovation, so prior experience may not always be consistent with current best practices.

b. Increasing the face value of debt swaps

With a few notable exceptions, the average face value of debt swaps has traditionally been relatively low — as reflected in Figure 9. Swaps relating to nature, health and climate have averaged between US$25 million and US$35 million, with climate-related swaps (for which there are relatively few examples) on the upper end and debt-for-nature swaps on the lower end. Health-related swaps averaged US$28 million. Bilateral debt swaps accounted for 59 per cent of the total number of swaps on record and 68 percent of their total face value. They had an average face value of US$57 million. The average face value of multi-party swaps is significantly distorted by the inclusion of the Belize and Ecuador swaps. When these are excluded, this type of swap only had an average face value of less than US$16million, but this jumps to close to US$38 million with their inclusion. The average value of all swaps on record was US$49 million (US$40 million if the Belize and Ecuador swaps are excluded).

Figure 9: Average face value of debt swaps by purpose (left) and type (right)



Source of data: UN Trade and Development Sovereign Debt Swap Database, 2024
Note: The Ecuador and Belize swaps were both multi-party debt-for-nature swaps, so they do not impact health, climate and bilateral averages.
.

VI. IMPLICATIONS OF SCALING UP

Scaling up debt swaps can be seen from two dimensions: the face value of the debt swaps and their replicability over a period of years. While it is assumed that the size of the financial benefits of the debt swap will have some limitation (see caveats below), repeating the process is likely to enhance national capacity to utilise this instrument for development.

a. Implications of scaling up bilateral swaps

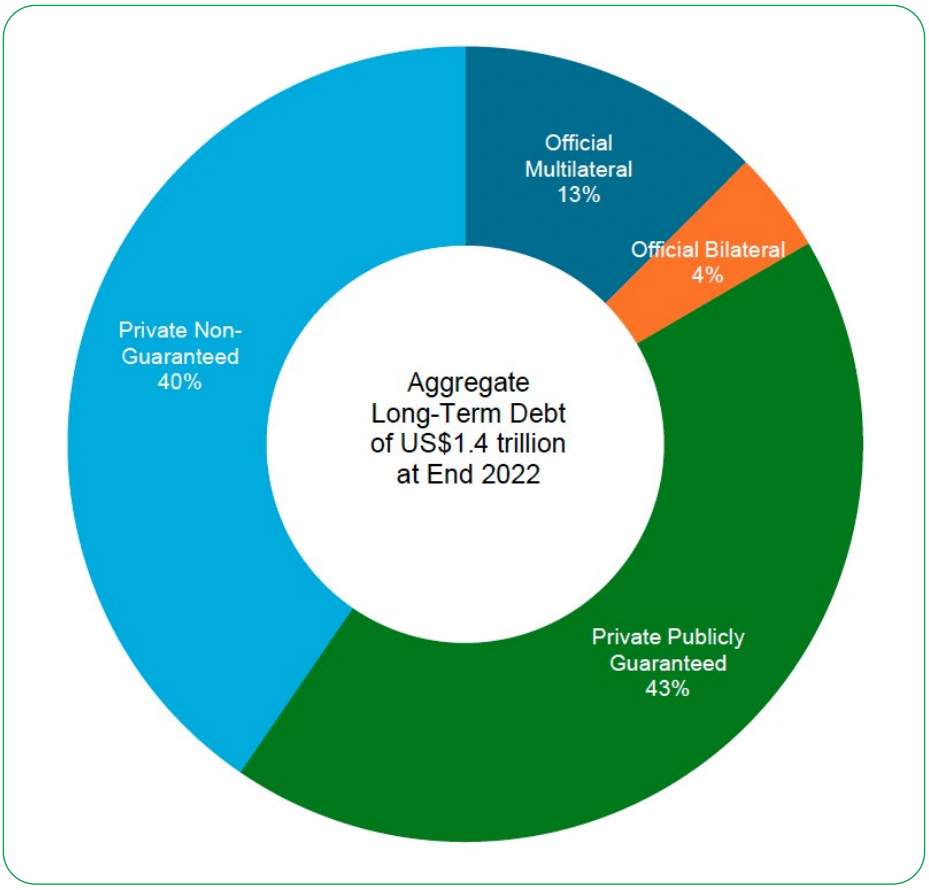
While they can take different forms, bilateral debt swaps are — in addition to being the most numerous and having the highest average value — generally the least complex to conclude. To the extent that they incorporate the repurposing of the debtor country's debt service payments to one of its bilateral creditors, they can give rise to a series of successive swaps, each reflecting a face value equivalent to the debt servicing costs for a particular period in question. The amount of fiscal space generated will be limited by the value of the principal debt under consideration, the interest rates applicable to it (this debt may have been concessional) and the number of periods for which repayments by the debtor country may be rechannelled. With this structure, the resulting stream of liberated funds may be better suited to funding projects and programmes that require ongoing financial support, rather than "lumpy" infrastructure projects that require large upfront capital investment. In the climate realm, that may favour adaptation projects over mitigation activities.

At the level of an individual debtor country, scaling up could incorporate the inclusion of more of the principal bilateral debt into the debt swap, extending the duration for which the service costs are rechannelled, replacing existing bilateral debt with debt with better terms (more concessional rates and/or longer tenor) and extension of swap arrangements to other bilateral creditors. Any one of these forms of expansion would assist in creating additional fiscal space for the debtor country from which additional funds could be channelled to priority areas. The debt restructuring potential of these swaps will tend to be small and will depend on the extent to which portions of the original debt are written off by the creditor countries and to which swap arrangements result in lower debt service costs overall.

The total face value of bilateral swaps on record in the UNCTAD database accounted for less than 0.4 per cent of the total external public and publicly guaranteed (PPG) debt of the participating debtor countries. Scaling this up to just 1 per cent would result in an increase of over US$21 billion in the total face value of this type of swap (from around US$8 billion at the end of 2023). The fact that official bilateral debt swaps can be classed as part of the official development assistance (ODA) of creditor countries could also be used to facilitate their scaling up.

Figure 10 indicates the composition of the long-term debt stocks of the 16 developing countries for which debt swaps may have been a financially efficient option at the end of 2023. It reveals that only 4 per cent (US$57 billion) of their US$1.4 trillion in debt was bilateral debt. In 2022, the average principal and interest repayments on the PPG debt of these countries amounted to 10.3 per cent of the corresponding debt stock suggesting a bilateral debt swap potential of around US$6 billion per year if all bilateral debt service costs were included

Figure 10: Composition of the long-term debt of countries for which debt swaps may have been a financially efficient option as at end 2022



Source of data: World Bank, International Debt Statistics, 2023

b. Implications of scaling up multi-party swaps

In total, the face value of multi-party swaps on record amounted to US$3.7 billion over 97 different swap transactions. This represents less than 0.15 per cent of the total external PPG debt of the participating debtor countries. If this was scaled up to 1 per cent, it would result in an increase of over US$24 billion in the aggregate value of this type of debt swap.

To offset the high transaction costs arising from their increased complexity, it may be necessary to either increase the face value of any multi-party swaps (along the lines of the recent swaps by Belize and Ecuador) or engage in several discrete smaller swaps within a relatively short period of time. Provision of necessary guarantees to reduce the political and default risks facing new creditors will aid efforts to increase the face value of these swaps. As with bilateral swaps, repeated multi-party swaps can benefit from the sunk costs associated with the initial transaction — particularly as they relate to stakeholder engagement and project and programme identification.

The private publicly-guaranteed and private non-guaranteed debt of the developing countries for which debt swaps could have been a financially efficient option at the end of 2023 collectively accounted for 83 per cent (close to US$1.2 trillion) of their total long-term debt stocks. In 2022, principal and interest repayments on the private non-guaranteed portion amounted to 19.4 percent (around US$110 billion). This suggests that while multi-party debt swaps are significantly more complex, they offer greater potential for scaling up. However, a key condition for successful debt swaps is identifying development-minded investors to take the place of existing commercial creditors. It is unknown whether sufficient like-minded investors could be mobilized globally to facilitate that scale of increase of debt swaps.

c. Caveats related to scaling up swaps

Evaluating the financial benefits of small debt swaps sometimes leads to the conclusion that they could generate higher financial gains if they were bigger (relative, say to sovereign debt). However, a large debt swap may attract market (and credit rating agencies) attention and may be interpreted as a distressed exchange or indicate debt distress. For countries that have market access at the time of undergoing a debt swap, it should be borne in mind that given the wide range of debt swap architecture that is possible, a uniform and predictable response by credit rating agencies to debt swaps is unlikely. If all parties to the swap participate voluntarily and it gives rise to measurable credit enhancement for the debtor country, improving its future outlook, it is likely to secure credit rating agency approval. The swap could even result in upgrades to sovereign credit ratings. However, if swaps are structured in ways that result in existing creditors incurring losses, it could result in ratings downgrades. Potential credit rating downgrades can result in higher borrowing costs for the debtor country which could risk undermining future debt sustainability.

Crucially, as has been mentioned before, the benefits of debt swaps will only be realised if there is no default. Debt swaps will also render subsequent attempts at debt relief and restructuring more complex and may introduce new senior creditors (such as the guarantor). In this context, conditionalities in the swap agreements — especially those that define instances of non-compliance and default — can also expose the debtor country to additional risks that could have implications for their credit ratings and debt service costs over the longer term.

In addition, the completion of debt swap agreements is a lengthy process and can take several years or more to conclude. They are not a quick fix, as they often entail agreement on specific financing and institutional arrangements that create conditionalities on how the resources are used and monitored. This further creates the need for subsequent reporting on implementation, monitoring, and evaluation of the use of funds. These comparatively long lead times also expose the debtor country to additional risks arising from changing domestic and global financial and economic conditions.

VII. EXTRACTING BETTER DEVELOPMENT OUTCOMES FROM DEBT SWAPS

EExtracting beneficial development outcomes from debt swaps depends critically on the participation of "well-minded investors with developmental motives" who replace commercial creditors. The coming together of the various parties to the swap around a particular unified goal can be beneficial and can be leveraged to expand the scale and scope of swaps in a particular developing country. Private creditors can derive reputational gains from their participation.

Historically, debt swaps have been seen to advance the agendas of third parties and were not necessarily in the interests of the debtor country. To avoid this, swaps need to be aligned with, and integrated into, the national development plans of the borrower. Prevailing best practice suggests that debtor countries need to develop key performance indicators (KPIs) that guide the choice of projects to be funded and how they will be evaluated. These need to be determined in conjunction with local and affected communities and to be accepted by the other parties to the swap. While this process may be time-consuming and contribute to the long lags initially associated with debt swaps and their high transaction costs, this preparation can result in more efficient processes and lower costs for subsequent swaps.

The prospect of repeat and upscaled swaps is increased when the debtor country can demonstrate positive developmental outcomes from the liberated funds and continue to pursue avenues for further bilateral and/or multi-party swaps. Improved environment, social and governance (ESG) taxonomies, supported by independent third-party monitoring and evaluation, can create the necessary frameworks and benchmarks for this, and can assist in "crowding-in" other forms of funding. The conversion of foreign currency-denominated debt to local currency can also serve to reduce pressures on the country's foreign export and remittance earnings and capital inflows.

Debt swaps — particularly multi-party swaps — increasingly involve larger numbers of intermediaries, including guarantors, insurers, and parties providing advisory services around structuring, issuance and monitoring and evaluation. The complexity of these swaps is such that there may be fewer possibilities to significantly lower transaction costs.

The associated contractual arrangements of debt-for-development swaps have often been characterized by opacity and high barriers to entry. To avoid this, debt swaps should conform to best debt management practices and be accompanied by effective disclosure, civil society participation, and accountability to legislatures and other oversight structures.

VIII. MEASURES TO SCALE UP DEBT-FOR-DEVELOPMENT SWAPS

The identification, in conjunction with affected communities, of a pipeline of development projects and programmes that require funding is a time consuming and relatively costly process, but it is an essential first step to ensuring that the proceeds of debt swaps and/or other sources of secured funding are aligned with the debtor country's development agenda. Well-conceived programmes are more likely to deliver good developmental outcomes. However, many developing countries do not have the capacity and expertise required to undertake this process effectively.

The decision to pursue a debt-for-development swap is one that involves a lengthy and complex process for which many countries are ill-equipped. The scope for scaling up swaps could be best served through the provision of technical assistance to developing countries to support them in decision making and negotiations to ensure that pursuing a debt swap is the most appropriate course of action. The form of such assistance could broadly range from provision of cost-benefit assessments, debt sustainability analysis, support to negotiations, advocacy for national priorities, development of a bankable project pipeline, policy advice, risk management, development monitoring and evaluation mechanisms.

The provision of such technical assistance could be coordinated by an information platform or coordinating body to serve as a central point to request technical assistance or assistance in capacity building in support of a debt swap process. A central repository could also facilitate knowledge sharing among developing countries and stakeholders. This could provide opportunities for countries that have engaged in debt swaps to share their experiences and lessons learned. The repository could also host a comprehensive database on modalities of debt swaps to help guide decision making and promote transparency and accountability among stakeholders.

In addition, for countries for which it makes financial sense to implement a debt-for-development swap, development partners could consider the provision of a range of guarantees, such as for political risk or credit risk, which can play a significant role in scaling up debt swaps. This can serve to reduce risk for creditors by providing a form of insurance for the debt instruments being swapped and can increase creditor participation in debt swap programmes when concern for credit worthiness may have been a barrier. This constitutes a form of credit enhancement which can potentially improve the terms of the new debt instruments and may translate into lower interest rates or longer maturities.

Aligning swap programmes with national development objectives and repeating swaps transactions, creates scope to bring in additional service providers, which may have the benefit of creating competition, potentially reducing transaction costs, and enhancing transparency.

Finally, development partners should increase the debt relief element of a debt-for-development swap to support better development outcomes. In addition to improving the terms of the newly issued debt when accompanied by guarantees, greater debt relief can provide countries with greater fiscal space for development priorities, making it easier to scale up financing for targeted development initiatives.

IX. CONCLUSIONS

The preceding analysis has indicated the historical use and scale of debt-for-development swaps, the conditions under which they can be considered, the general form that they can take, and how they could be scaled up. Due to their high transaction costs, debt-for-development swaps are not suited to countries that a) have access to alternative sources of funding at rates lower than those required to cover the transaction costs (represented by a premium benchmark on prevailing US bond yields), and b) have high levels of debt stress. As a consequence, they currently represent a financially efficient source of funding for a relatively small number of developing countries. Scaling up therefore depends on reducing the associated transaction costs so that more countries can participate and so that participants can derive better developmental outcomes from the swaps they conclude. Repeated swaps afford debtor countries the opportunity to spread high initial transaction costs over more swap transactions and to develop local competence and capacity. The increased complexity of multi-party swaps such as those recently concluded by Ecuador and Belize require higher face values to offset their higher transaction costs but may not provide participating debtor countries with the opportunity to build local capacity due to their one-off nature. Furthermore, debt-for-development swaps can further complicate attempts at debt relief and restructuring as they may introduce new senior creditors, while conditionalities in the swap agreements can expose countries to additional risks.

An information platform could assist stakeholders considering debt-for-development swaps. This could focus on providing technical assistance relating to the development of a pipeline of projects aligned with their development agendas, assessing the suitability of debt swaps as a potential funding tool, and in negotiating with creditors and constructing debt swap agreements. Debt swaps could be further facilitated by improving reporting and standardization of practices to allow countries to make informed decisions and lower transaction costs. Lastly, it is vital that the key performance indicators (KPIs) incorporated into debt swap agreements are determined in accordance with the national development plans of debtor countries to ensure local ownership, while making sure that the debtor country in question has the capacity to monitor and report on said KPIs.

While debt-for-development swaps provide developing countries that cannot access alternative and preferential sources of funding with an opportunity to create some fiscal space and to channel funds to development priorities, they are not an effective tool for debt restructuring. There is a significant risk that too large a focus on them will serve as an unhelpful distraction from the urgent need to address high levels of sovereign indebtedness and debt distress that is causing the development agendas of many countries to stall.


G20
BRASIL 2024
BUILDING A JUST WORLD
AND A SUSTAINABLE PLANET