# Briefing

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## Policy pointers

**Debt instruments for** climate and nature can potentially benefit LDCs by improving fiscal space, pro-poor economic growth and debt sustainability, as well as increasing finance for climate and nature investments to help achieve the SDGs.

**LDC governments** should lead the development of debt instruments linked to climate and nature, via seven straightforward steps that include consideration of national debt profile, negotiation with major creditors to achieve commitments to addressing climate and nature priorities.

**LDC governments** should ensure that their key performance indicators for climate and nature are based on existing national commitments and the inclusive consultation of key ministries, civil society and parliamentarians.

**Together, LDCs can:** call on the international community to support an international debt, climate and nature initiative that benefits them; and advocate for collective negotiations on debt with creditors including bi- and multi-laterals and private creditors.

# Financing an inclusive, green recovery in Least Developed Countries: debt instruments for climate and nature

The COVID-19 pandemic has hit Least Developed Countries (LDCs) hard. Even before the pandemic, LDCs were experiencing growing debt distress and the climate and nature crises were slowing development. The pandemic's economic consequences have amplified this trajectory and the situation is likely to worsen if interest rates rise and immediate international support falls. Debt instruments for climate and nature, such as debt conversions or sustainability-linked bond issuances, can be part of financing an inclusive, green recovery for LDCs. These instruments can generate fiscal space or new capital that can be used for poverty-reducing and growth-enhancing climate adaptation, mitigation and nature investments. This briefing sets out seven steps LDCs can take to design debt instruments to support climate and nature. LDCs can complement this national action by advocating collectively for engagement from their creditors to achieve better outcomes. A mechanism for collective negotiation may be an international debt, climate and nature initiative, building on the platform being developed by the World Bank, the International Monetary Fund, the Organisation for Economic Co-operation and Development and the United Nations.

## LDCs and the triple crisis of debt, climate change and nature loss

The 46 LDCs, 33 of which are in Africa, are among the most vulnerable to the triple crisis of debt, climate change and biodiversity loss.[1] COVID-19 has multiplied LDC exposure and poverty. Even before the pandemic, LDCs were struggling to achieve the Sustainable Development Goals (SDGs). The rate of extreme poverty in LDCs, measured as the population living below US$1.90 per day, was about 35% in 2018. The pandemic's impact on poverty has wiped out years of progress.[2,3]

Funding is needed to address the pandemic's impacts, but LDCs collectively only managed to increase direct and indirect pandemic fiscal support by 2.6% of their gross domestic product (GDP) in 2020, compared to an average stimulus for developed countries of 15.8% of their much larger GDP.[2] At the same time, increased LDC government spending contributed to a growing debt crisis, with LDC debt rising from a low of

24% of gross national income (GNI) in 2012 to 32% of GNI in 2019.

Less than half of LDCs have got a sovereign credit rating, and existing ones are infrequently updated and are below investment grade. LDCs generally lack access to markets to issue bonds for new financing. The pandemic's impacts have further reduced LDCs access to capital markets, with no LDC being able to issue a sovereign bond in 2020. Only a few LDCs, particularly those that have been building up a track record, have been able to issue bonds in 2021, including Benin, Ghana and Senegal.[4]

*Solutions to debt challenges need to address the causes of debt and not just suspend some payments*

This LDC debt situation has not been adequately addressed. The Debt Service Suspension Initiative (DSSI),[5] in which 31 LDCs participated, provided much-needed liquidity, but its scope has been limited. The subsequent G20 Common Framework for Debt Treatments Beyond the DSSI, which was introduced to address countries with unsustainable debt, has had a lukewarm reception, with only three countries participating. Solutions to LDCs' debt challenges need to address the causes of the debt situation and not just provide a suspension of some debt payments. The pandemic has highlighted gaps in the current international sovereign debt restructuring architecture that should be urgently addressed to reduce the likelihood of future debt crises,[2] One solution could be to link to climate and nature outcomes (see Box 1).

This briefing sets out the broad process for LDCs to create debt instruments linked to tackling climate and nature loss. Climate is a priority, as although LDCs have contributed least to climate change — indeed they are responsible for less than 1% of global annual carbon emissions — they suffer most from its impacts on agriculture, infrastructure and the costs of responding to climate-related disasters. In terms of biodiversity loss, many LDC economies predominantly depend on natural resources but, according to some studies, these are being rapidly depleted, at a rate of over 9% of GNI per year in 2017.[6] During times of crisis such as the pandemic, the pressure on natural resources increases.

### Box 1. How can LDCs benefit from linking debt with climate and nature?

The instruments can help LDCs address all three crises while also supporting immediate financing needs. The approach can result in several economic benefits:

▲ Expanded fiscal space in the debtor country's government budget

▲ Growth increased through sustainable investments

▲ Increased investment for climate and nature

▽ Reduction in the debt stock sufficient to improve debt sustainability

▽ Decline in poverty through pro-poor investments

## What are debt instruments for climate and nature?

Debt instruments for climate and nature can be part of a coherent response to tackle this triple crisis.[7] Debt restructuring involves a creditor and a debtor agreeing to convert the debt in some way, for example, via a change in the terms or by buying the debt at a cheaper rate on the secondary market, or by supporting conversion to a different financial vehicle. This may include some degree of debt relief through a reduction on the principal. LDCs in stronger economic positions with access to the markets may choose to issue general purpose performance bonds for climate and nature, such as sustainability-linked bonds (SLBs), with incentives provided by coupon or principal reductions. These debt transactions deliver additional finance for climate and nature by redirecting the funds the debtor would have had to pay back for debt servicing, or by adding additional flows through issuing a bond.

Both debt conversion and new bond issuance can be upscaled to have a major impact on debt, climate and nature by linking the debt instrument with key climate and nature performance indicators drawn from existing debtor government commitments. These selected key performance indicators (KPIs) should focus on poverty-reducing and growth-enhancing climate adaptation, mitigation or nature investments. Such KPIs could focus on climate-smart agriculture, renewable energy, sustainable fisheries management or labour-intensive soil and water conservation.

As this is a 'general purpose' debt instrument, the funds are paid into the debtor government's budget, so can also be used for other funding needs to free up fiscal space, as only a portion of the total debt financing would be directed to climate and nature activities.[8] The debtor country would have ownership on the use of the funding, provided the overarching KPIs — put forward by the debtor and agreed with the creditors — are being met. These would be monitored through national systems and independently verified.

So far, only a few LDCs are exploring debt instruments for climate and nature. This may be because this type of instrument is new. However, the growing pressure to reduce debt, along with global commitments to climate and nature, and the urgency brought on by the pandemic, have opened up opportunities for LDCs — particularly given the LDCs' leadership and commitment to a low-carbon climate-resilient pathway (Box 2).[9]

This briefing sets out a straightforward seven-step process that LDCs and developing countries can follow in order to execute debt instruments for climate and nature, which is further explored in a 'how to' guide produced by IIED and the Potomac Group LLC in partnership with UNECA, UNESCWA and UNDP.[10]

## Seven steps for climate and nature debt instruments

Countries should develop a deal offer to be negotiated with creditors; this will help ensure that the transaction is on their own terms. The process will be slightly different for every country, depending on their debt, climate and nature context, but there are seven clear steps to complete a debt transaction for climate and nature outcomes:

1. Create an inter-ministerial taskforce and agree on national objectives
2. Access capacity building and advice
3. Choose the type of sovereign debt transaction: debt conversion or new instrument
4. Structure climate and nature KPIs or other relevant performance criteria
5. Design financing aspects of the transaction
6. Take market soundings with creditors, credit rating agencies and investors
7. Execute the debt transaction

### 1. Create an inter-ministerial taskforce and agree on national objectives

The first step is the creation of an inter-ministerial taskforce, usually led by the Ministry of Finance, and involving the input from a wide range of other government actors and civil society. The Ministry of Finance would review the country's debt portfolio and make an initial analysis of debt sustainability. The Ministry of Environment can agree climate and nature objectives with key sectors such as the Ministry of Agriculture or Energy.

### 2. Access capacity building and advice

Countries will want to take guidance from international organisations and private advisors on the best financial and climate and nature options. They may also be able to access financial support for designing the debt instrument.

### 3. Choose the type of sovereign debt transaction: debt conversion or new instrument

Countries that are in serious debt distress or near debt default may not be able to wait for an elaborate process. These countries may need to make a request under the G20 Common Framework with a proposal to link debt relief with climate and nature outcomes. Countries not in serious debt distress but with limited fiscal space may decide to take advantage of conversion, for example through a debt swap, which would reduce debt as well as channel some funds towards climate and nature outcomes. LDCs with access to non-concessional borrowing may opt to refinance existing marketable debt or issue new debt linked to climate and nature outcomes.

### 4. Structure climate and nature KPIs or other relevant performance criteria

After deciding on the type of instrument (step 3), climate and nature targets should be identified, prioritised and validated in consultation with country stakeholders from government, civil society and parliament. This information should be developed into a logical framework of KPIs, including indicators, baseline, targets, assumptions, sources of data (ie which government strategy has been used), as well as the costs of achieving the targets. As much as possible, the KPIs should be quantifiable and measurable. Steele, Patel and Beauchamp lay out steps for developing a KPI framework.[13] The framework will also need to present proposed

## Box 2. Why LDCs need to engage in an international debt–climate–nature initiative

The World Bank, International Monetary Fund (IMF), United Nations, and the Organisation for Economic Co-operation and Development (OECD) are currently developing a platform to link debt to climate and nature.[11] The LDCs need to engage with the platform and ensure it supports LDC needs.

The need for more comprehensive global support for debt during, and following on from, the pandemic is becoming increasingly urgent. The Heavily Indebted Poor Countries Initiative (HIPC), established 25 years ago by the World Bank and the IMF, helped support developing countries to address their debt while addressing poverty reduction. The development of the HIPC initiative offers lessons for a new international debt initiative, including the benefits of having a clear outcome and the need for international champions that can drive forward the agenda to implement such an initiative. It also illustrates shortcomings to avoid: HIPC encountered problems that included limited ownership for debtor countries, and a lack of the use of finance in growth-supporting investments that led to rising future debt burdens.[12]

mechanisms for monitoring, reporting and verification, and will need to be negotiated with a country's creditors/investors.

**5. Design financing aspects of the transaction**

Finalising the terms and risks of a new debt instrument or transaction structure will be a key consideration for debt managers before attempting to go to market. Longer-term financing needs, risk mitigation and overall debt sustainability will be important factors to consider for each climate and nature transaction.

**6. Take market soundings with creditors, credit rating agencies and investors**

The creditor and investor strategy will depend on who these are likely to be. Some major LDC creditors may prefer one-on-one negotiations. Other creditors may be more willing to be approached collectively, allowing LDCs to benefit from presenting a united front. Credit rating agencies' views are still unclear, so it will be important to engage in active dialogue. This will be the most important part of the process, as without demand, transactions will go nowhere.

**7. Execute the debt transaction**

Completing the transaction will require financial, legal and communications strategies. Once agreement in principle is reached with the creditors, both sides will need to engage bankers and lawyers to support the deal structuring and terms sheet. A full legal agreement will need to be drafted and the terms of the transaction implemented. In the case of a new issuance, if this is in the form of a performance bond, the process would need to follow the procedure for bond issuances, which includes rating the bond, getting national clearance (from parliament or the cabinet), undertaking a bond roadshow, and other activities leading up to a bond issuance on the market.

## Conclusion

By carrying through these seven steps, LDCs can stay at the forefront of the exciting developments linking climate, debt and nature, and ensure that LDCs also benefit from these global initiatives.

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## Knowledge Products

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Established by the Economic and Social Council of the UN in 1958 as one of the UN's five regional commissions, ECA's mandate is to promote the economic and social development of its member states, foster intra-regional integration, and promote international cooperation for Africa's development.

UN-OHRLLS was established in 2001 and today serves 91 vulnerable Member States of the United Nations. The 46 Least Developed Countries, 32 Landlocked Developing Countries and 38 Small Island Developing States are facing their own unique sets of challenges in achieving sustainable development and internationally agreed goals.

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CLIMATE AMBITION SUPPORT ALLIANCE
Strengthening capacity for inclusive negotiations

## Notes

[1] Patel, S, Steele, P, Kelly, L and Adam, J-P (2021) Innovative financing for Africa: Harnessing debt for climate and nature. IIED, London. pubs.iied.org/20486IIED / [2] World Bank (7 October 2020) COVID-19 to add as many as 150 million extreme poor by 2021. www.worldbank.org/en/news/press-release/2020/10/07/covid-19-to-add-as-many-as-150-million-extreme-poor-by-2021 / [3] UN-OHRLLS (2021) State of the Least Developed Countries 2021: Building back better in response to COVID-19. www.un.org/ldc5/sites/www.un.org.ldc5/files/pdf/stateLDC_2021/stateldc_2021.pdf / [4] Bloomberg (16 July 2021) Benin reaps lowest cost yet with Africa's first social bond. www.bloomberg.com/news/articles/2021-07-16/benin-beats-ghana-to-issue-africa-s-first-social-bond-amid-boom; and Bloomberg (2 June 2021) Senegal to use Eurobond proceeds for fund spurred by youth riots. www.bnnbloomberg.ca/senegal-to-use-eurobond-proceeds-for-fund-spurred-by-youth-riots-1.1611635 / [5] World Bank (2021) COVID 19: Debt Service Suspension Initiative. www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative / [6] Davies, S (25 April 2017) Financing economic growth in LDCs: A tale of national savings and natural resources. https://blogs.worldbank.org/opendata/financing-economic-growth-ldcs-tale-national-savings-and-natural-resources / [7] Steele, P and Patel, S (2020) Tackling the triple crisis: Using debt swaps to address debt, climate and nature loss post-COVID-19. IIED, London. pubs.iied.org/16674IIED / [8] This is why a 'general-purpose' performance bond is distinct from a traditional green bond where all the funds are intended for environmental objectives. / [9] LDC Group (2019) LDC 2050 Vision: Towards a climate-resilient future. www.ldc-climate.org/wp-content/uploads/2017/12/LDC-Group-Vision-1.pdf / [10] IIED, Potomac, UNECA, UNESCWA and UNDP (forthcoming) Linking sovereign debt to climate and nature outcomes. A guide for debt managers and environmental decision makers. IIED, London. / [11] Shalal, A (7 April 2021) Exclusive: World Bank, IMF eye ways to link debt relief to climate change spending. Reuters. www.reuters.com/article/us-imf-world-bank-climate-change-debt-ex-idUSKBN2BU3FO / [12] Useree, D (2021) Redesigning debt: lessons from HIPC for COVID, climate and nature. IIED, London. pubs.iied.org/20276iied / [13] Steele, P, Patel, S and Beauchamp, E (2021) Key Performance Indicators for climate and nature outcomes for debt management. IIED, London. pubs.iied.org/20281g