Debt-for-Climate Swaps and Illicit Financial Flows: A call for caution in designing climate finance infrastructures

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December 1, 2023

Ahead of COP28, there have been widespread calls for the adoption of 'debt-for-nature' and 'debt-for-climate' swaps as an alternative climate finance system to address funding gaps in developing countries. Typically, these swaps involve a debtor country repurchasing its debt securities at substantial discounts or converting official bilateral debt into environmental assets, which enables more fiscal savings to be redirected toward conservation objectives. Unlike most climate finance instruments, these debt swaps avoid burdening countries in the Global South with additional unsustainable debt, thus allowing for a more effective response to the climate crisis without sacrificing spending on other development projects. Depending on the specific transaction, the entire conservation funding may be provided upfront on day one or over the life of the

deal.

These calls align with emerging debt-for-nature swap agreements in various countries, including Zambia, Kenya, Pakistan, Colombia, Argentina, and Eswatini, and are projected to exceed $800 billion in global public and private deals in the coming years. For instance, in May 2023, Ecuador secured the largest deal of its kind by refinancing $1.6 billion (£1.3 billion) of its commercial debt at a discount in exchange for a consistent revenue stream dedicated to conservation around the Galápagos Islands. Additionally, in February 2023, Portugal agreed to forego €12 million in yearly repayments of Cape Verde's €150 million of long-term debt, redirecting the funds to clean-energy transition, climate adaptation, and nature protection in the Cape Verdean archipelago. Similar deals are expected to follow for private sector debts owed by Cape Verde to Portuguese companies.

Although debt-for-nature transactions have roots dating back to the 1980s, the renewed interest in them can be attributed to the recent increase in the debt vulnerability of many countries, a direct outcome of the COVID-19 pandemic. In 2020, global debt surged, contributing an estimated $19.5 trillion to global deficits. Also, the need for financial firms to boost their Environmental, Social, and Governance (ESG) metrics has played a complementary role. In August 2022, the IMF published a working paper highlighting the intersection between climate change and excessive debt levels. The paper explores how climate change can worsen debt vulnerabilities and how countries with substantial debt face limited fiscal flexibility for climate mitigation and adaptation. Of the 59 developing economies most vulnerable to climate change, 34 are also at high risk of fiscal crises. Therefore, the paper suggests that 'debt-climate swaps could be useful to expand fiscal space for climate investment when grants or more comprehensive debt relief are just not on the table.'

This concept holds particular significance for African countries. For instance, Africa is home to most of the world's most climate-vulnerable countries but struggles to mobilize the financial resources needed to address climate change. Simultaneously, these countries contend with high levels of debt acquired through loans and bonds from international donors and banks. Now, 21 African countries are at high risk of or in debt distress, yet ongoing debt restructuring negotiations are yielding minimal results in terms of debt relief. What is

particularly concerning in this context is that the African continent contributes the smallest share of global greenhouse gas emissions, yet it is the most vulnerable region in the world, experiencing consistently extreme weather events, droughts, and rising sea levels.

The intersection of climate change and unsustainable debt in the Global South, particularly in African countries impedes economic development, exacerbates poverty, and hinders progress toward achieving Sustainable Development Goals (SDGs). This debt places them at a disadvantage in attracting investments for climate adaptation and mitigation measures, including transitioning to cleaner energy sources, implementing sustainable agriculture practices, and improving infrastructure to withstand climate-related disasters, as their budgets are burdened by debt servicing.

The unique financial innovation of debt-for-climate swaps has the potential to address these challenges simultaneously, although this point has been disputed by some commentators. Others prefer a climate finance structure of an ' ecological debt for fiscal debt swap.' In either case, these swaps represent 'a game-changing way' to accelerate climate finance to vulnerable developing countries. Debt conversion, whether based on ecological debt or sovereign debt, can provide much-needed financial relief to African countries, helping them meet their climate commitments outlined in the Paris Agreement and supporting investments in renewable energy, sustainable agriculture, and environmental protection. This includes initiatives like drought-resistant seeds, sea walls, resilient buildings, and environmental restoration. For instance, in 2015, the National Conservancy announced a deal that saw approximately $22 million of Seychelles' national debt written off. Consequently, Seychelles progressed from protecting 0.04% to more than 30% of its national waters, covering 410,000 square kilometres of the ocean after developing 13 new marine protected areas.

Avoid Legitimization of IFFs

While debt-for-climate swaps present potential benefits in terms of both debt relief and climate finance, it is crucial to design and monitor them carefully to prevent inadvertent facilitation and legitimization of illicit financial flows (IFFs) in the Global South, including African nations. IFFs refer to money that is

illegally earned, transferred, or used across borders, encompassing corruption, tax evasion, money laundering, and other illegal activities. Despite the high incidence of IFFs in Africa – every year, an estimated $86.6 billion leave the continent as IFFs - discussions on IFFs have not received adequate attention in the context of debt swaps. In this paper, we call for caution in executing debt conversion transactions and for IFFs to be a central component of climate finance discussions.

There are three ways in which IFFs may feature in debt swap transactions: diversion, greenwashing, and tax evasion. Firstly, freed-up funds emanating from debt swaps can be diverted for private profit or kickbacks to public officials and other stakeholders. For instance, a recent evaluation of Australia's Emissions Reduction Fund (ERF) reveals that 70 to 80% of carbon credits intended for carbon emission reduction projects do not go to those projects.

ERF has been described as an 'environmental and taxpayer fraud' and a waste of billions of dollars. Another example is the first debt-for-nature swap in Africa regarding Gabon. The transaction was structured by the Bank of America. The deal has been criticized for lacking transparency in sustainability frameworks and reporting procedures. Commenting on the possibility of Gabon's funds being diverted for personal gains, Daniel Hardy, a researcher at the Vienna Institute for International Economic Studies, and former head of the IMF's debt and capital market instruments division stated that 'If they decided to spend all the money on the president's private airplane, so be it.' There is no guarantee that the funds derived from the debt relief would be invested in climate-resilient infrastructures.

This problem is exacerbated by the complexities of debt conversion. The financial structures of debt-for-climate swaps can be intricate, involving negotiations between debtor countries, creditors, banks, and international organizations. For example, the debt swaps to protect oceans in Seychelles, Belize, and Barbados in 2018, 2021, and 2022, respectively, were highly complex and included multiple stakeholders. The involvement of various parties creates opportunities for technical and challenging-to-track financial transactions, making them susceptible to corrupt practices and hidden financial dealings.

Secondly, debt-for-climate deals, if not properly designed, can provide an avenue for multinational banks to collect substantial fees, with only a relatively small fraction allocated to the environment, especially 'if the funds to repurchase debt are supplied by a third party funding itself via ESG-labeled bonds.' For instance, in the Belize case, only $84 million of the $553 million deal was dedicated to marine conservation, making a mockery of the whole idea. Also, there is the Gabon deal, where Bank of America, the structuring agent, refused to disclose its transaction fees or follow the International Capital Markets Association Principles for green and sustainability-linked bonds casting doubt on the purported commitment to sustainability. These transactions have been described as greenwashing because significant portions of the funds from the debt swaps are directed toward transaction costs. While it may appear to be a sustainable transaction, it serves as a façade for channelling profits into private quarters. The fiscal savings that are actually going into nature conservation and climate change are inconsequential as most of the funds end up in the pockets of intermediaries such as credit providers, consultants, and insurers.

Furthermore, in some cases, proceeds from debt relief or climate finance may be funnelled through offshore accounts or tax havens. This is likely to occur in circumstances where the debt-swap transaction is settled through intermediaries, such as foreign firms, special purpose vehicles, and insurance companies. These tax havens are known for their secrecy and may facilitate the concealment of assets from domestic taxes, potentially legitimizing IFFs.

If these issues are not addressed, the potential benefits of debt conversion will be undermined, and countries may continue to resort to costly external borrowing to address the climate crisis, as the fiscal savings resulting from debt forgiveness are not properly directed. So, the policy of debt-for-climate swaps needs to be well-designed and properly implemented to minimize the risk of facilitating or legitimizing IFFs, particularly in Africa. This could be achieved, in our view, through four main initiatives: transparency, centering community interest, oversight structures, and civil society engagement.

Firstly, there is a need for transparency and integrity in the transaction process. Transparency has been widely acknowledged as a critical tool in combating IFFs. The terms of any debt-for-climate swaps should be made accessible to the

public, including the amount involved, the projects to be financed, and the parties involved. This involves not just public disclosure, but also allowing the public to obtain and review the relevant transaction documents. The swap should also be open to independent second-party opinions and third-party verification, as required by the International Capital Markets Association Principles for green and sustainability-linked bonds.

Secondly, the transaction should prioritize the interests of people, communities, and ecosystems impacted by climate change as the prevalent consideration. It should be viewed as both a corporate social responsibility and a commitment to the SDGs, rather than a profit-making venture. So, transaction costs should be kept at a reasonable level by excluding unnecessary intermediaries, using domestic firms, and keeping the deal as simple as possible.

Also, there is a need for robust accountability mechanisms to track the use of funds and ensure they are directed toward legitimate climate projects through the establishment of oversight and enforcement bodies, similar to the proposed Anti-Corruption Court or independent domestic monitoring organizations. The recipient of such funds should be accountable to the oversight bodies, whose operations should also be transparent. The oversight and enforcement mechanisms for debt-for-climate swaps should be strong and adequately resourced to detect and prevent IFFs.

Furthermore, it is important to promote the active engagement of civil society organizations in the processes of debt-for-climate swaps. Their role would be to ensure that the involved parties adhere to principles of transparency, accountability, and minimal transaction costs. Involving civil societies in these processes brings in a stakeholder with a public interest focus, adding an extra layer of oversight.

In summary, as stakeholders gather and discuss at the COP28 summit in Dubai, it is important for them to bear in mind that while debt-for-climate or ecological debt for fiscal debt swaps offers a promising approach to addressing debt and climate challenges simultaneously, they need to be implemented with careful attention to transparency, accountability, and integrity. Otherwise, it could become just another pathway to facilitate IFFs in Africa, which have the potential to undermine the fiscal benefits that should ordinarily result from these swaps.

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