Promotion of Developing Countries

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Debt for Nature Swaps in German Financial Co-operation

As an element of debt-relief schemes for developing countries, so-called “debt-for nature swaps” (DNS) have gained considerable importance in terms of securing long-term finance for protecting ecosystems in those countries. This paper intends to outline in brief the main features and aspects of such swaps concerning German Financial Co-operation (FC).

1. Procedural Steps

Step 1: In the framework of the Paris Club (PC)[a)] debt relief procedures, a „swap clause“ is generally agreed upon. which constitutes the formal basis for a swap. This may include sectors like health, education, environment and presupposes that the debtor country’s Government agency in charge (usually Ministry of Finance) supports such an exercise.

Step 2: On the basis of a Government–to-Government Agreement, a Debt Conversion Agreement between the Government of the partner country and KfW is concluded: outstanding sovereign debt resulting out of FC can be redeemed at 100 %, whereby – in return – the partner country provides a defined amount of counterpart funds in local currency for the designated purpose.

Step 3: Within the designated sector, “suitable” programmes or initiatives are selected, prepared and appraised – generally as complement to ongoing FC projects/ programmes funded through KfW Entwicklungsbank.

Step 4: Based on the selection process, a “Separate Agreement” between Government and KfW is concluded – stipulating technicalities like implementation procedures etc.

Step 5: Debt relief and provision of local („counterpart“) funds are effected as per agreement.

Step 6: Implementation of agreed “sector” activities

2. Scope

To date, Bolivia, Ecuador, Honduras, Madagascar, Nicaragua, Peru, Philippines and Vietnam have embarked on DNS in the FC context – at a total relief volume of far above EUR 100 million. Further schemes are under preparation for Indonesia and Kenya.

Protected area management in developing countries is frequently hampered by limited recurrent budgets. DNS can mobilise substantial complements (here: boundary demarcation in Ecuador; photo: J. Hartmann)

3. Initial Assessment of DNS Suitability

Before launching a DNS, the contracting partners should have clarified the following:

- Is the partner country in a position to comfortably mobilise the required local funds?
- Is the administrative effort commensurate with the expected outcome?
- Will debt relief be swift and significant?
- Is professional financial management ensured (investment risk, level of return etc.)?
- How stable is the legal, institutional and sectoral framework?

4. Design Options

In putting the agreed counterpart funds to use, basically the following options exist:

- „Classical“ projects / programmes (like equipping/ upgrading a protected area/ PA)
- Supplementary measures:

  directly: funding recurrent expenses for PA management (e.g. staff salaries for park rangers, consumables etc.);

  indirectly: staff training, expert services, mitigation of environmental impacts etc.

A preferred mechanism are so-called “Conservation Funds” (also known as “trust funds”, depending on supervisory and ownership structures), in the form of either

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sinking funds, whose volume is to be exhausted over time, or

endowment funds, which use only the interest generated, i.e. without consuming the "capital stock"

5. Beneficiary Institutions

Institutions in charge of DNS can be public sector /governmental agencies OR bodies with a mixed public sector / civil society (e.g. non-governmental organisations/ NGO's) governance, especially in the case of funds or trusts. In particular, experience with the mixed "trust" approach has been largely positive.

In various cases, mixed institutions do not exist – or are only in their infancy stage. Tasks and mandates may therefore have to be "tailored" according to circumstances. Particular attention should to be paid to the following:

- asset management
- allocation of funds/ proceeds (according to set criteria like professional management and operational planning)
- monitoring (of fund management as well as of implementation and expenditure)
- direct implementation (often through public conservation agencies and/or NGO's)

6. Disbursement Options

In effecting DNS, disbursement mechanisms can range from a one-off relief (i.e. one "tranche" only, with concomitant provision of counterpart funds in one stroke) to more gradual procedures like several tranches or even progress-related disbursement *cum* relief. Prominent arguments for or against the respective mechanisms are the following:

- One tranche only:

Major *advantages* of this approach are swift debt relief, low administrative costs and the secured provision of counterpart funds in one stroke. On the *downside*, an increased investment risk (if structured as an endowment), a low "performance incentive" and an increased cash-flow strain for the partner country are particularly noteworthy.

- Several tranches / progress-related:

Spreading out disbursement over time reduces investment risk, allows for flexible, more targeted application of resources and – by tendency – provides a higher "performance incentive". On the other hand, debt relief is slowed down (which might be important from a Treasury perspective) and administration tends to become more complex; furthermore, this approach entails a higher risk concerning the timely availability of "counterpart funds".

7. Major Impacts

Debt for Nature Swaps – especially, if conceived through a "trust" structure – can effectively complement ongoing initiatives / projects and promote their financial „sustainability":

"Conventional" FC project or programme support by design cannot sustainably resolve current funding constraint for PA's and thus constitute a necessary (albeit often not sufficient) precondition for ecosystems conservation. DNS can effectively complement this support by providing resources for covering running expenses, which are often constrained in developing countries.

In terms of institutional sustainability, a high degree of stakeholder participation in a "mixed structure" (governmental/ non-governmental, private business) can contribute towards promoting civil society structures

As compared to conservation projects (which often tend to focus on certain areas or regions), debt swaps tend to have a high potential for "structural impact" – by, e.g., addressing issues of governance and thus working towards an "enabling sectoral framework".

8. Perspectives

- As "Highly Indebted Poor Countries" (HIPC) are no longer dealt with in the Paris Club, there is – if at all – reduced scope for debt conversion in the HIPC initiative's framework.

- The potentially diminishing opportunities at HIPC level notwithstanding, there is continued (and possibly increasing) interest from the "low-middle income" countries' camp (e.g. Indonesia, Kenya).

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[a] = PC, an informal group of official creditors whose role is to find co-ordinated and sustainable solutions to the payment difficulties experienced by debtor nations