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Technical and statistical report

Sovereign debt-for-development swaps

Possibilities ahead

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UNCTAD Sovereign debt swap database glossary

Type	Explanation
C2D	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 United Nations Children's Fund (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	Focuses 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	Focuses on projects in the education sector, such as the construction of schools, teacher training programs, or expansion of scholarship programs.
Food	Focuses on projects promoting food security and improving nutrition, which includes Swaps conducted by the WFP (United Nations Fund Programme). 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	Focuses 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	Focuses 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.

Executive summary

1. This study addresses the choice and considerations surrounding the use of sovereign debt swaps in development finance, based on a database developed for this purpose and considers how a South-South platform could aid decision-making among developing countries on the appropriate use of debt swaps.
2. To undertake the study, UNCTAD developed a Sovereign Debt Swap Database based on public information on 235 swaps directed towards health, nature, climate, children and poverty reduction in 58 countries since 1987, with a combined value of over US$11.5 billion. However, the details of all debt swaps are not made public, so we make no claim of completeness. A debt swap platform where countries can learn about the design and experience related to such swaps may be more useful than a complete database.
3. The concept of sovereign debt-for-development swaps as a mechanism for mobilising development finance has gained significant attention, especially following successful debt-for-nature swaps in countries like Belize, Barbados, and more recently, Ecuador, and Egypt, which channelled 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 endeavours are considered.
5. While debt-for-development swaps have historical precedence and potential to mobilise 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 accessible to more countries, reducing the associated transaction costs and considering ways to build local capacity through repeated swap implementation is necessary.
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.
7. Furthermore, debt swaps are not a financially efficient funding option if the country concerned has access to capital on better terms. Regarding bilateral swaps, this means that the country can secure concessional financing at a lower cost than the monitoring and evaluation costs of bilateral debt swaps. In the case of multi-party swaps, debt swaps will not be financially efficient if the debtor country can access global capital markets at lower rates than prevailing spreads plus the transaction cost premium. Moreover, the likelihood of benefits from debt swaps being realised in future is reduced if the country is already experiencing high levels of debt stress.

8. Besides efficiency, other country-specific considerations have been advanced to justify the use of debt swaps, such as securing financing for conservation while signalling to global investors and philanthropic organisations the country's commitment to climate and development priorities (such as environmental conservation and investment in health and education). Moreover, creditors' considerations have also been advanced, such as meeting Official Development Assistance (ODA) and Paris Agreement's commitments and supporting foreign direct investments by domestic multilateral corporations.

9. For debt-for-development swaps to be consistent with the development priorities of the debtor country rather than advance the agendas of third parties, they need to be aligned with and integrated into the national development plans of the borrower. Improved reporting and standardisation of practices are also crucial to enable informed decision-making by countries pursuing them. This can help address the lack of transparency in the debt swap ecosystem. Establishing 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.

10. 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 developing countries. Establishing a platform with developing country experiences will enable more nuanced decision-making in this regard.

Introduction

Historical background

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 first emerged during the global debt crisis that originated in Latin America in the 1980s and spread to many parts of the globe. Commercial banks, which held significant amounts of sovereign debt from developing countries, grew increasingly concerned about the risk of default. The international financial community began to explore ways to reduce the banks' exposure to developing countries' debt, which created potential systemic risks, while assisting debtor nations in managing their obligations. The search for solving this dual problem led to the conceptualization of debt swaps, where debt could be exchanged for equity, thus altering the risk reward ratio for both debtors and creditors. The pioneering countries that used debt for equity swaps to reduce their debt burdens were Chile in 1985 and Mexico. While debt swaps, together with Brady bonds, were judged to have contributed to alleviating the debt crisis of that time, their broad implementation was curtailed by debtor governments due to their perceived inflationary impacts, and in an attempt to limit the share of foreign ownership and control in the economy - particularly in strategic sectors.

Following a relatively successful experience with these new financial instruments, they further evolved into debt-for-development swaps, where debt was exchanged for funding for social development projects, such as education, health, and poverty alleviation programs. This type of swap became an integral part of Paris Club debt restructuring agreements and became one of the standard agreement clauses under the HIPC debt alleviation mechanism. In parallel, since 1987 when Conservation International entered into an agreement with Bolivia to buy and cancel a portion of the country's sovereign debt in exchange for a commitment by the government to fund conservation projects, debt-for-nature swaps emerged. As the awareness of climate risks increased over the years, debt-for-nature swaps started gaining prominence and in 2023 Ecuador implemented the largest debt-for-nature swap to date by buying back approximately USD 1.6 billion of debt at a 60 percent discount and channeling the generated debt servicing savings into the conservation of the Galapagos Islands.

Overall, sovereign debt swaps are associated with the creation of fiscal space in exchange for government commitments to invest in targeted development projects in areas such as health, nature and education, and they typically involve the rechannelling of debt service payments or the repurchase of certain categories or types of debt at a discount. As the resulting fiscal space is redirected to specific purposes, the new expenditure paradigm that is created through long-term budget commitments for health, education or nature conservation can have long-lasting developmental impacts by embedding the focus on these sectors into policy debates on national priorities.

> Debt swaps should not be considered a substitute for comprehensive debt restructuring mechanisms

It is important to note that debt swaps should not be 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, their potentially inflationary effect and the additional complexity they can introduce in respect of creditor seniority.

Box 1
UNCTAD and debt swaps

UNCTAD participated in the discussions on debt swaps since their emergence in the 1980s. Initially, the involvement of UNCTAD in the global debate on debt swaps centred on the exchange of views among member states in the Trade and Development Board, but since the 1990s it was complemented by technical assistance projects and by providing updates on developments in this area in the Secretary General's Reports to the General Assembly on Debt and Debt Sustainability in Developing countries. While the early discussions during the era of debt for equity swaps focussed on the trade-offs between debt reduction and loss of domestic ownership of key assets, such as mining, industry and banking, since the 1990s the focus of discussions on policies for optimizing the benefits of debt swaps has shifted towards the maximisation of their developmental impact. Thus, UNCTAD created projects and policy analysis aimed at providing the tools to developing countries to understand the intricacies of these mechanisms and provide them with technical expertise to negotiate the best debt swap terms with their creditors. Of particular importance in the development of this area of work was a donation from the Italian government in the mid-1990s to provide technical assistance and capacity building to developing countries interested in pursuing debt swaps. Through its work in the Paris Club, where UNCTAD holds an observer status alongside the IMF and the World Bank, UNCTAD was able to argue for a more active role for debt swaps in the HIPC and HIPC 2 initiatives and report on the progress of deal characteristics and their implementation to interested developing countries. As the debt swap debate has regained momentum in recent years with an increased interest in these mechanisms to assist in tackling the effects of climate change, UNCTAD's long history and expertise in this area have led to an increased demand for the institution's contributions on the potential benefits of debt for nature swaps and ways to overcome obstacles for their broader implementation.

1.
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 over 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$650k 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[1].

In the absence of formal reporting, debt-for-development transactions are not easily traceable, making comprehensive data on current practices elusive. Nonetheless, 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[2]. 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[3].

1 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

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

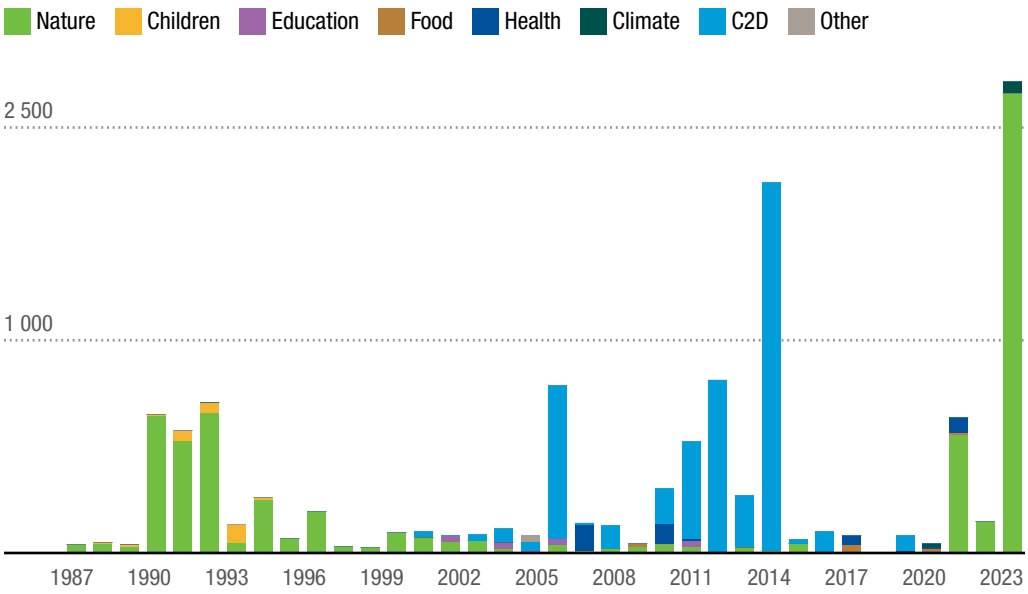
3 Eg, France's Debt Reduction-Development Contract (C2D) that supported poverty reduction programmes to supplement HIPC debt relief for beneficiary countries.

The number of debt swaps concluded over the past decade is modest, but the face value of some recent swaps reached record levels

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[4] swap in 2021, the 2022 US$150 million Barbados[5] swap, and the US$1.6 billion Ecuador[6] and US$500 million Gabon[7] debt swaps in 2023.

Figure 2 shows the number of debt swaps executed for development purposes since 1987. Activity over the last decade is modest compared to the 1989 to 1995 period. France's Debt Reduction-Development Contract (C2D)[8] 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[9,10]

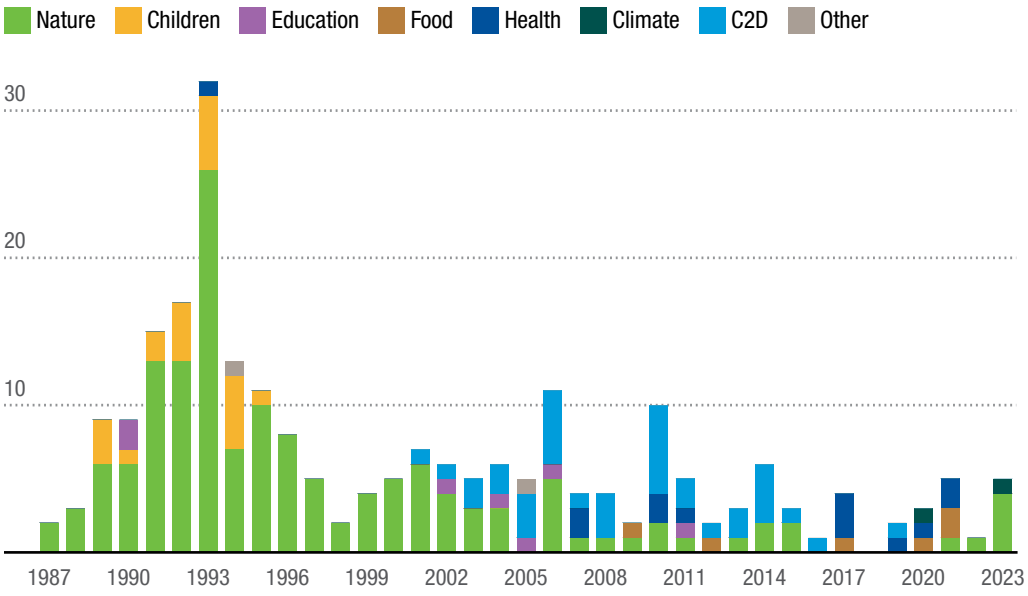
Figure 1
Face value of debt swaps by purpose



Source: UNCTAD Sovereign Debt Swap Database, 2024.

4 Belize US$364M debt conversion https://www.greenfinanceinstitute.com/gfihive/case-studies/government-of-belize-debt-conversion-for-marine-conservation/
5 Barbados US$150 million debt conversion: https://www.nature.org/en-us/newsroom/tnc-announces-barbados-blue-bonds-debt-conversion/
6 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/
7 Gabon US$500 million debt conversion: https://www.nature.org/en-us/newsroom/tnc-announces-debt-conversion-for-ocean-conservation-in-gabon/
8 The mechanism developed by the Agence Française de Développment https://www.afd.fr/en/c2d-mechanism-relieve-indebted-countries
9 https://documenti.camera.it/_dati/leg18/lavori/documentiparlamentari/indiceetesti/183/elenco.htm
10 Inputs for these swaps are being incorporated into the revised version of the database.

Figure 2
Number of debt swaps concluded by purpose



Source: UNCTAD Sovereign Debt Swap Database, 2024.

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[11] and debt-for nature-swaps were generally larger.

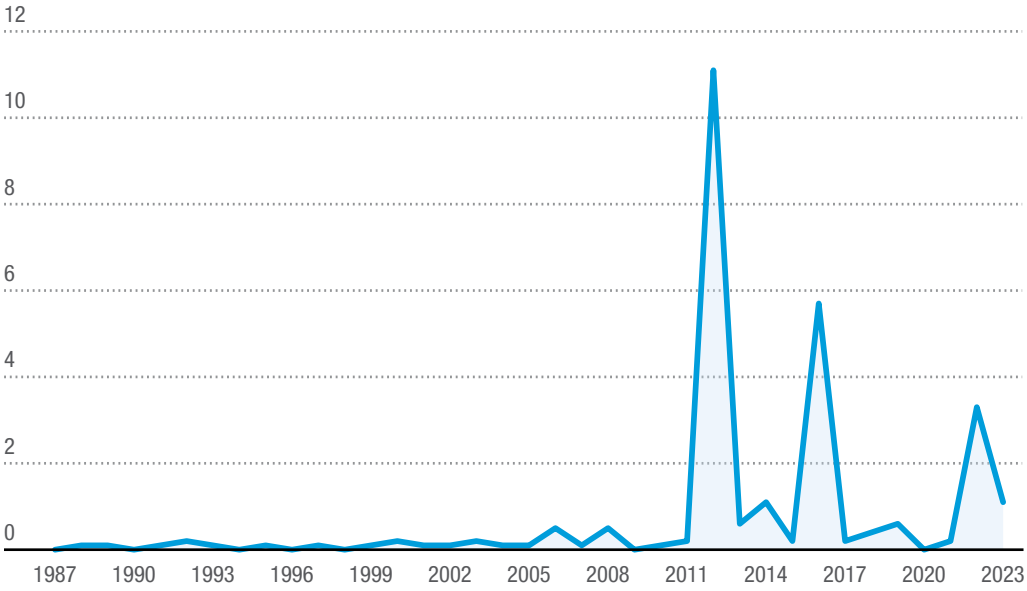
Debt swaps implemented with multilateral intermediaries such as the United Nations Children's Fund (UNICEF) and the UN World Food Programme (WFP) served to redirect resources to development-oriented programs under their mandates. For example, the debt swaps facilitated by UNICEF between 1989 and 1995, 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[12].

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[13].

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[14]. 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.

[11] https://www.afd.fr/en/c2d-mechanism-relieve-indebted-countries
[12] https://docplayer.net/4792857-Overview-of-debt-conversion.html
[13] https://scalingupnutrition.org/wp-content/uploads/2021/10/WFP_SUN-Debt-for-food-Swaps-Presentation.pdf
[14] 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
(Per cent)



Source: UNCTAD Sovereign Debt Swap Database, 2024.

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2.
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 standardisation 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 study analyses debt swaps under two general categories: bilateral and multi-party swaps[15]. 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 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.

Debt swaps lack standardization, varying in design, stakeholders, financing terms, conditionalities, and implementation

[15] 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

Bilateral debt-for-development swaps

Bilateral debt swaps entail an agreement between an official creditor[16] 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.

In complex debt-for-development swaps, SPVs loan funds to countries, often with opaque terms and potential interest markups

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[17], 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[18].

Further across the spectrum of complexity, multi-party swaps can also involve third-party private intermediaries. These may be non-governmental organisations 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, an SPV may be created and financed by either issuing a new bond or a loan from a financial 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[19]. 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.

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

[17] Fresnillo (2023) 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

[18] 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.

[19] 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

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[20]. 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, in order 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"[21]. 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.[22]

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 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'[23]

SPVs and endowments require legal and governance frameworks to manage, distribute, and monitor funds for development objectives

[20] https://www.reuters.com/world/americas/ecuador-seals-record-debt-for-nature-swap-with-galapagos-bond-2023-05-09
[21] https://ire.finanzas.gob.ec/content/2023/05/16.05.2023_Debt_for_Nature.pdf
[22] See page 7: https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2023/11/debt-for-nature-swaps-a-new-generation.pdf
[23] ICMA, 2023: https://www.icmagroup.org/assets/documents/Sustainable-finance/Bonds-to-Finance-the-Sustainable-Blue-Economy-a-Practitioners-Guide-September-2023.pdf

3. 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.

Financial evaluation of the potential of debt swaps

Chamon, et al (2022)[24] 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.

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 an 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.

Available data on some recent debt swaps indicates that transaction-related costs could account for 40% or more of any financial benefits generated

[24] 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

Debt swaps are inefficient if a country has access to capital at better terms or faces high debt stress

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[25], so 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.

Reducing transaction cost premiums from 250 to 150 basis points doubles the financial viability of debt swaps for developing countries

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.

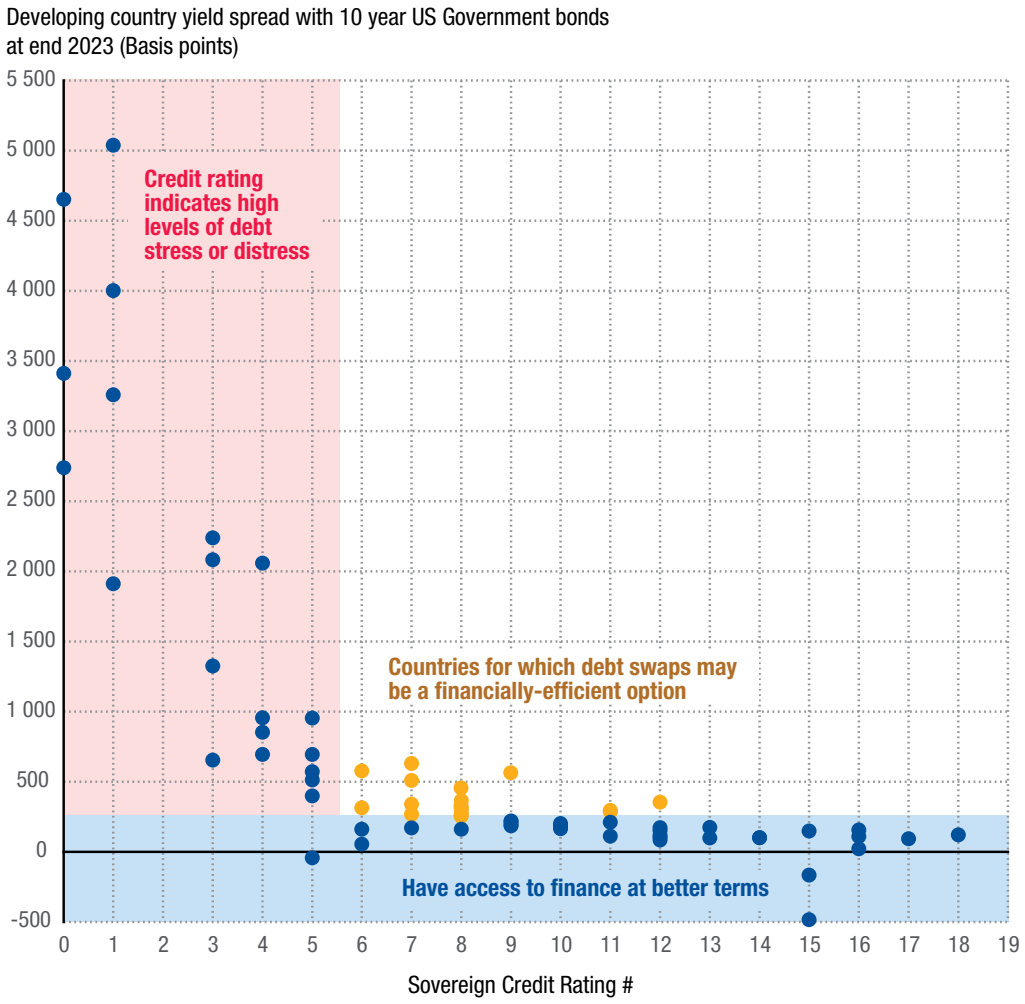
Figure 5 reflects the application of this approach to the 14 debt swaps conducted since 2020, in which 11 of these swaps are represented[26]. Four of these swaps (coloured in red) fall within the scope of countries that would – with prevailing assumptions of transaction costs and default risk – have 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.

[25] 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.

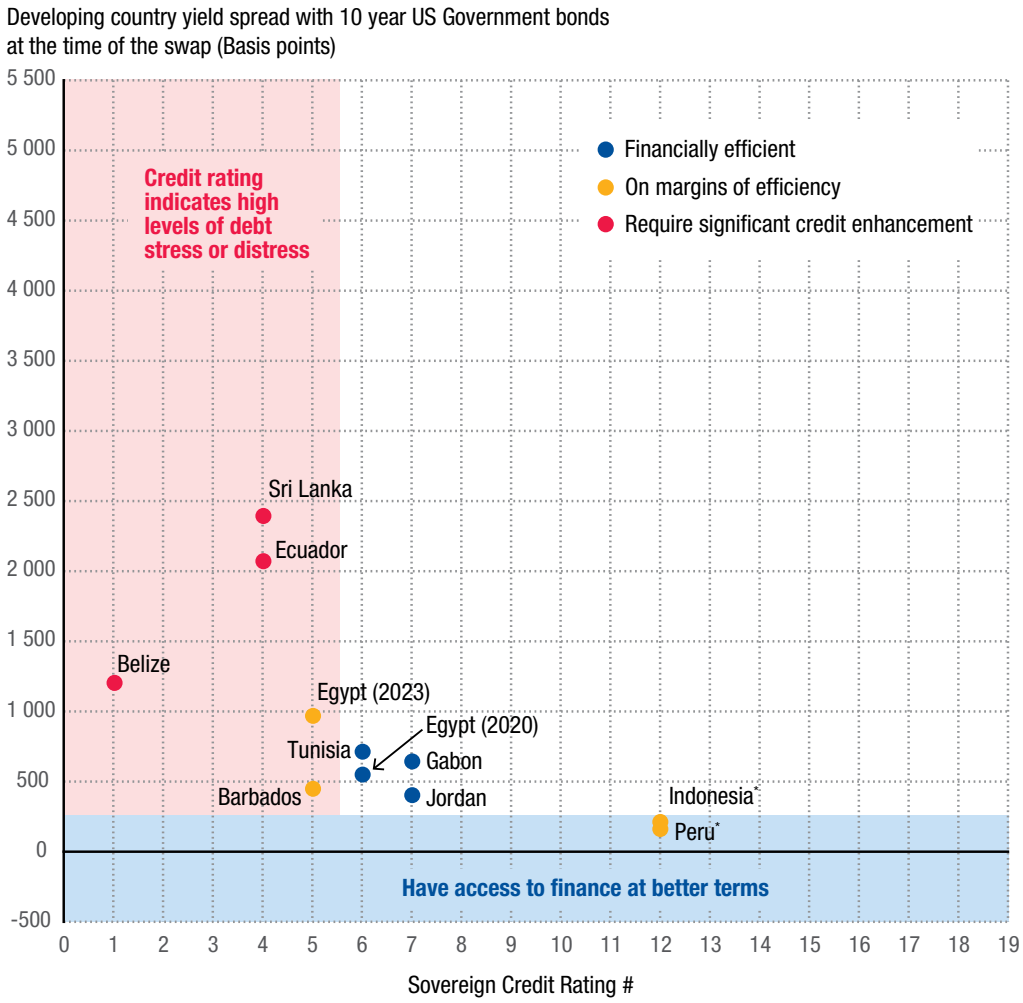
[26] The remaining three swaps could not be included in this analysis because the countries either did not have access to secondary capital markets (and hence did not have an indicative yield spread) or did not have a sovereign credit rating.

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



Source: 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

Figure 5
Indicative financial efficiency of debt swaps concluded since 2020



Source: 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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4.
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.

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

> Expanding debt swaps requires lowering transaction costs, especially for first-time or long-inactive participating countries

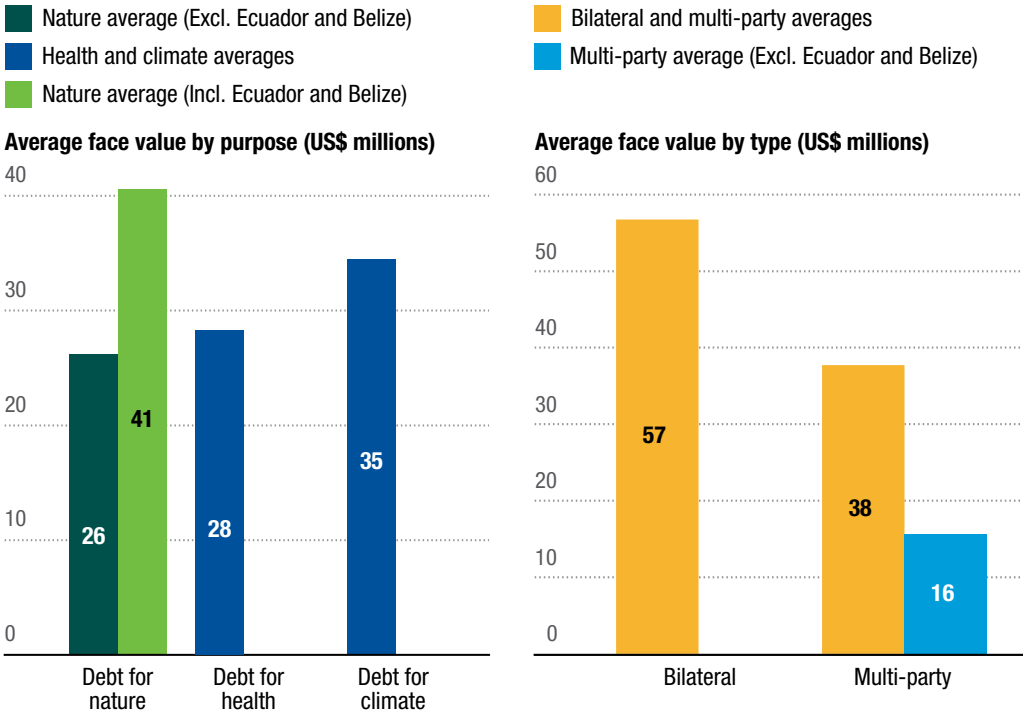
had not previously undertaken swaps. Madagascar engaged in a series of 13 debt swaps between 1989 and 1996 and a further 4 swaps between 2003 and 2012. Mexico engaged in 16 debt swaps during the 1990s, but nothing since then, and Indonesia undertook 10 swaps between 2002 and 2011 and then concluded additional 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 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.

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 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 6
Average face value of debt swaps by purpose (left) and type (right)



Source: UNCTAD 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.

5. 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 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.

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 of the external PPG debt of participating debtor countries 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 overseas 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,

> Bilateral swaps suit ongoing projects needing steady funding, like climate adaptation, rather than large-capital infrastructure or climate mitigation efforts

suggesting a bilateral debt swap potential of around US$6 billion per year if all bilateral debt service costs were included.

The debt-for-Foreign Direct Investment (FDI) swap between Egypt and the United Arab Emirates (UAE) announced in February 2024, amid rising sovereign debt and declining foreign exchange reserves, shows that bilateral debt swaps could also be a vehicle to increase foreign direct investments[27]. The agreement involves a $35 billion investment to develop the Ras El-Hekma region on Egypt's Mediterranean coast. It aims to transform it into a tourist, residential, and financial hub, alongside additional projects across the country. [28] Development rights for Ras El-Hekma were acquired by Abu Dhabi's sovereign investment fund, but the Egyptian government retains a 35 per cent equity stake in the project.

Providing guarantees to reduce political and default risks will help increase the value of debt-for-development swaps

The investment will be financed through a combination of fresh disbursements and a debt-for- FDI swap. Out of the $35 billion, $24 billion will consist of new inflows, while $11 billion will be converted into Egyptian pounds from existing UAE dollar deposits at the Central Bank of Egypt. This debt-for-FDI swap represents one of the largest bilateral debt swap agreements of its kind, significantly reducing Egypt's external debt burden. In addition, the deal hopes to eventually attract an additional $150 billion in foreign direct investments. Combined with an ongoing IMF program, the deal is expected to inject much-needed liquidity into the Egyptian economy, bolstering foreign reserves and alleviating financing pressures.[29]

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.

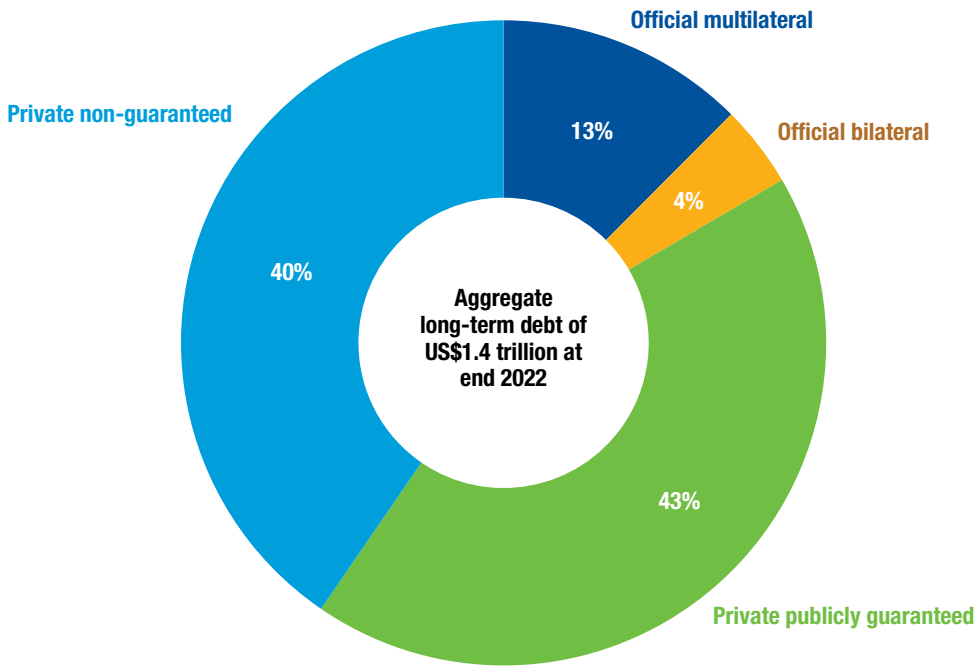
This represents less than 0.15 per cent of the total external PPG debt of the participating debtor countries. If this was scaled up to 1 per cent, it would result in an increase of over US$24 billion in the aggregate value of this type of debt swap.

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.

[27] https://www.reuters.com/business/egypt-announces-multi-billion-uae-investment-boost-forex-2024-02-23/
[28] https://www.adq.ae/newsroom/adq-led-consortium-to-invest-usd-35-billion-in-egypt/
[29] https://findevlab.org/the-impact-of-the-surprise-mega-deal-impact-on-egypts-financial-prospects/

Figure 6
Composition of the long-term debt of countries for which debt swaps may have been a financially efficient option as at end 2022



Source: World Bank, International Debt Statistics, 2023

Caveats related to scaling up swaps

Evaluating the financial benefits of small debt swaps sometimes leads to the conclusion that they could lead to 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 positive 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.

A large debt swap may attract attention, potentially seen as a distressed exchange or sign of debt distress

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.

6.
Extracting better development outcomes from debt swaps

Extracting 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.

> Debt swaps historically favored third parties; to avoid this, they must align with the debtor country's development plans

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7. 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 by providing 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 a South-South 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 platform or 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 providing 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 reduce risk for creditors by providing insurance for the debt instruments being swapped and can increase creditor participation in debt swap programmes when concern for creditworthiness 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 benefit competition, potentially reduce transaction costs, and enhance 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 increase countries' fiscal space for development priorities, making it easier to scale up financing for targeted development initiatives.

> Programs aligned with national objectives yield better outcomes, but many developing countries lack the capacity to implement them effectively

8. Final remarks

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 channel to attract FDI – as in the recent debt-for-FDI swap between Egypt and the UEA, negotiating with creditors and constructing debt swap agreements. Debt swaps could be further facilitated by improving reporting and standardisation of practices to allow countries to make informed decisions and lower transaction costs. Lastly, it is vital that the 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.

> Repeated swaps help spread transaction costs and build local capacity, while complex multi-party swaps require higher values but may limit capacity building

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