
DEBT & DUGONGS
REALITIES OF PURSUING
NATURE FINANCE IN SRI LANKA
22ND NOVEMBER 2024 (FRIDAY)
FROM 4:00 PM - 6:00 PM
CLASSROOM 106
Bandaranaike Center for International Studies
Bauddhaloka Mawatha Colombo, 00700 Sri Lanka

CENTRE FOR A SMART FUTURE

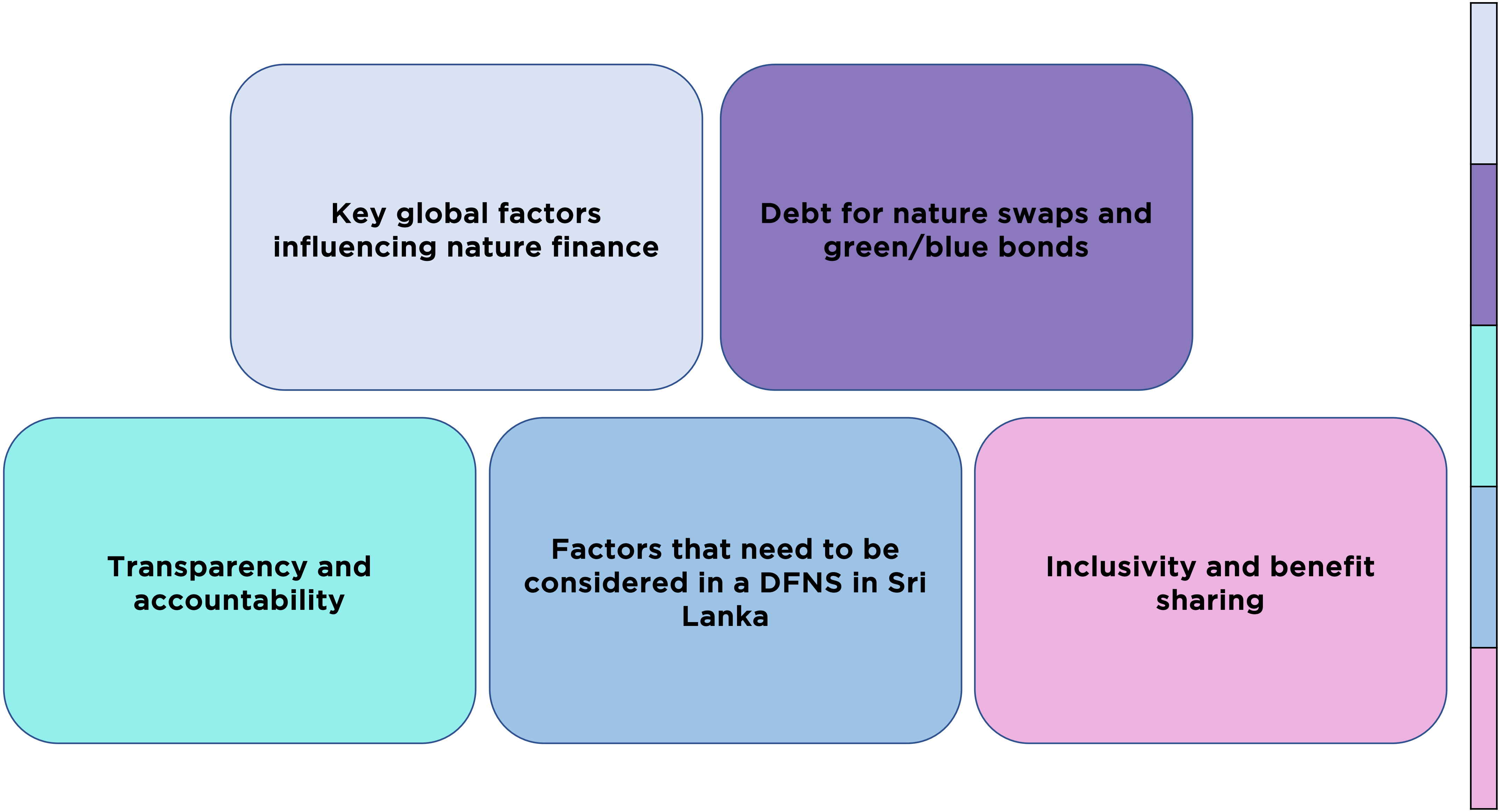
An interdisciplinary public policy think tank

Thematic pillars:

- Urbanization and Cities (Colombo Urban Lab)
- Trade and Competitiveness
- Inclusive Technology and Innovation
- Nature, Climate, Economy

Nature, Climate, Economy

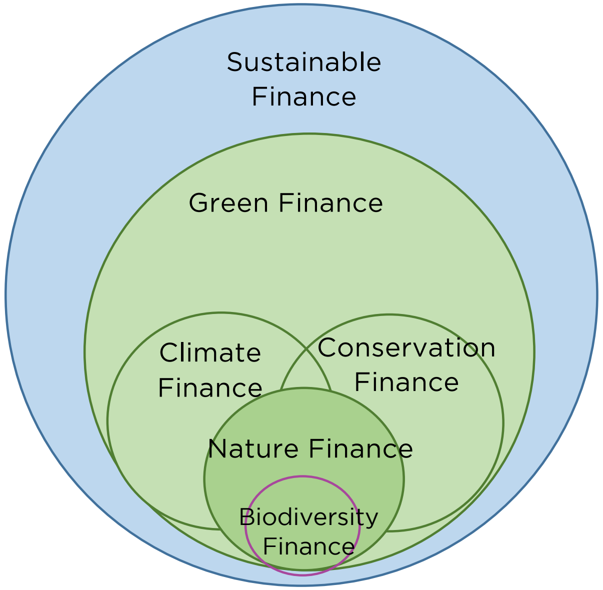
- Nature and Finance
  - Conservation Finance
  - Green Finance and FIs
- Nature-positive Economy
  - Nature x Tourism
  - Corporate Disclosures
- #BeyondGDP and Natural Capital Approaches

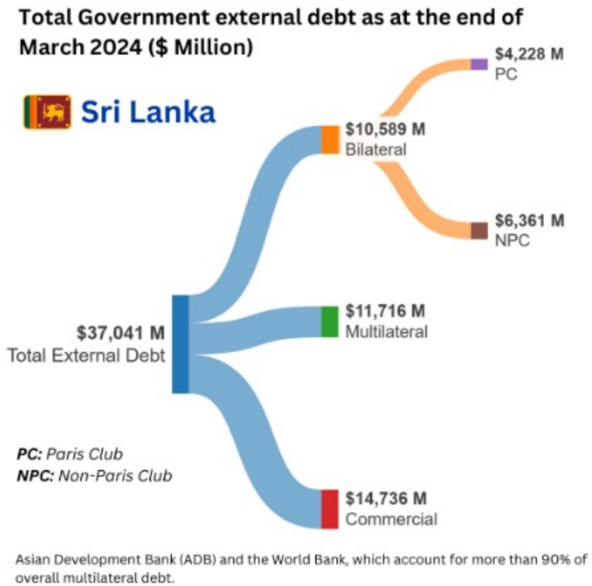

Key global factors influencing nature finance
Debt for nature swaps and green/blue bonds
Transparency and accountability
Factors that need to be considered in a DFNS in Sri Lanka
Inclusivity and benefit sharing

Terminology clarification before we commence

Nature finance encompasses financial flows and investments directed towards **maintaining and enhancing natural capital, including ecosystems, biodiversity, and the services they provide** (IUCN definition).

When we refer to debt, it is public debt held by the government i.e. **sovereign debt** [specifically external debt i.e. bilateral, multilateral and commercial/private creditors.]





Green (and blue) bonds

What is a bond?

- Bonds are debt instruments and represent loans made to the issuer
- Fixed-income instrument
- A **sovereign bond** is a debt instrument issued by a national government to raise funds **for public expenditure** e.g. International Sovereign Bonds (ISBs) and short term Treasury Bills (TBs).
- Governments commonly use bonds to borrow money to fund roads, schools or other infrastructure.

What is a thematic bond?

- Thematic bonds are debt securities that may be used to finance sustainability /green/blue/ social - focused activities or performance objectives.
- Fixed-income instrument
- A **sovereign green or blue bond** is a debt instrument issued by a national government to **raise capital specifically for funding environmentally sustainable projects.**

Understanding the global context

Understand some of the main global financial drivers influencing the discussion around nature finance

Urgency to meet 2030 targets

Protect 30% of the planet's land and ocean by 2030
Kunming-Montreal Global Biodiversity Framework (GBF)

1.5°C target - Requires global GHG emissions to decrease by 43% from 2019 levels by 2030.
Paris Agreement

Scientists estimate that global warming by 2°C threatens or drives to extinction about 25% of species (range: 15–40%)

The GBF and Paris Agreement both recognise the role of natural ecosystems as critical carbon sinks.

Time for your vote!

What is the global annual target for biodiversity finance?

A. $200 billion
B. $700 billion
C. $1 trillion

What is the global annual target for climate finance?

A. $300 billion
B. $500 billion
C. $1 trillion

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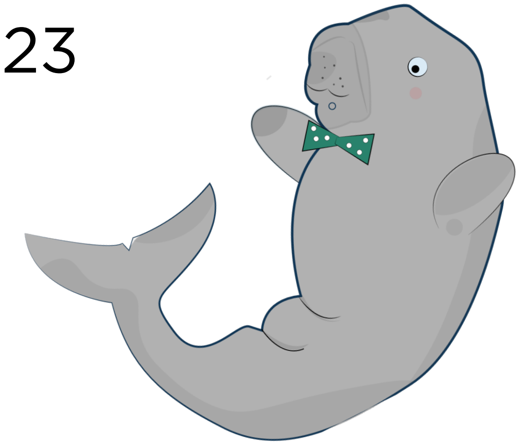

Did you know…

The value of subsidies that harm biodiversity is $500 billion?

That fossil fuel subsidies surged to $7 trillion in 2022!

Debt distress

Record high public debt – nations pay more in interest than is allocated toward climate investment!

Global public debt hits record $97 trillion in 2023, UN urges action

04 June 2024

The alarming surge in global debt burden calls for urgent reforms to the international financial systems to safeguard a prosperous future for both people and the planet.

Source: UN trade and developed

Sovereign defaults

FINANCIAL TIMES

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Expect more emerging market sovereign defaults, says S&P

Countries exiting restructurings have lower ratings than in the past and may struggle to access capital

"The warning comes as many countries trying to emerge from default battle to secure deals from an increasingly disparate groups of creditors, and to access enough relief to avoid another debt crisis."

Debt justice

- Debt justice advocates are **calling for a cancellation of debt** for low income countries.
- Advocates argue instruments like DFNS are a distraction from tacking the root cause – unsustainable debt.
- Cancelling debt will free up the fiscal space to meet basic needs and implement much need climate and biodiversity interventions.

Dangerous distractions

Debt-for-climate and debt-for-nature swaps

Demands

Debt cancellation across all creditors for all countries that need it, so that countries are no longer forced to sacrifice basic needs to pay creditors

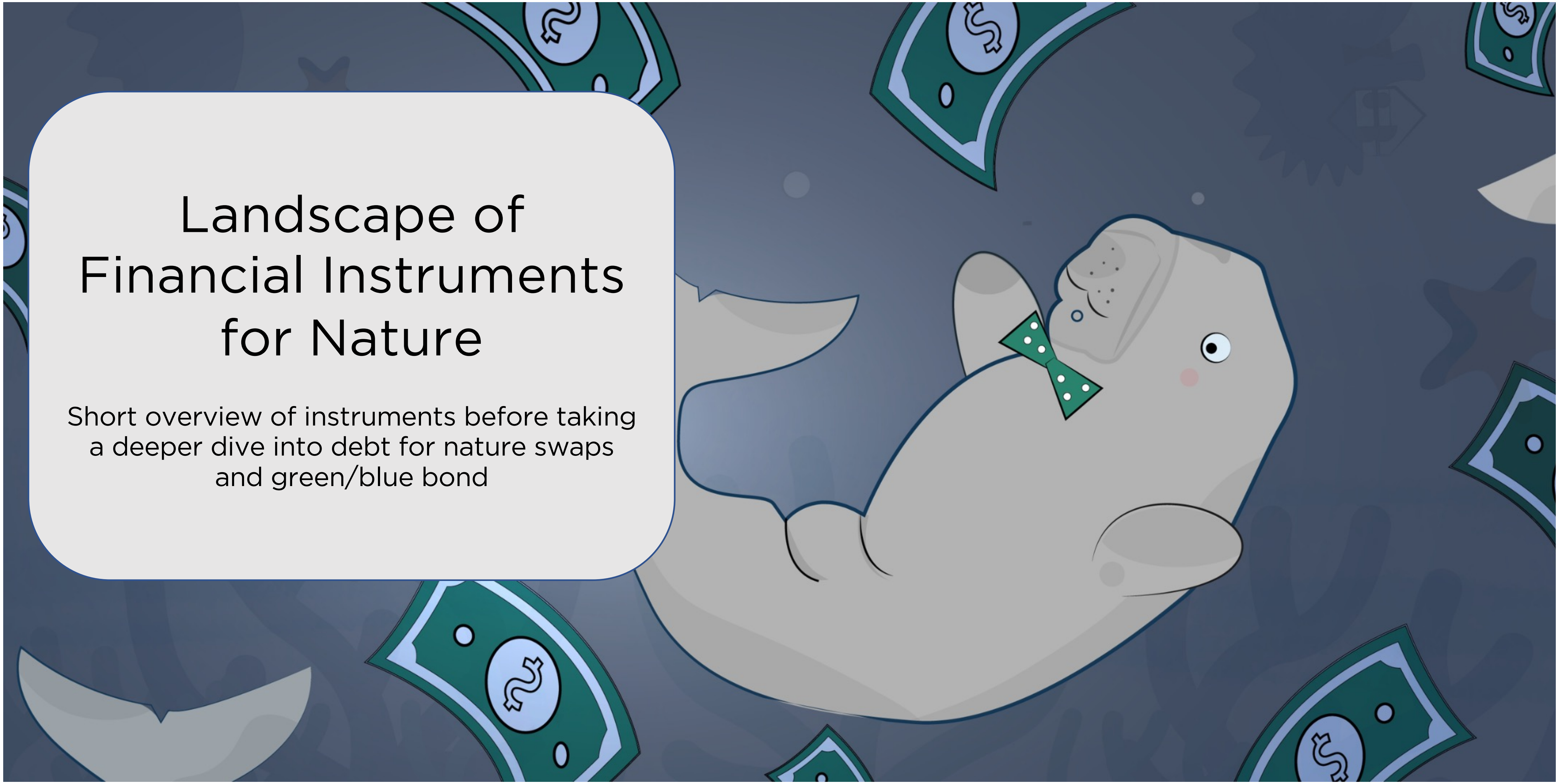
Key takeaways

- Debt stress is acting as a catalyst to restructure sovereign debt through new nature/climate instruments…
- …but also a push for reforming the global financial architecture

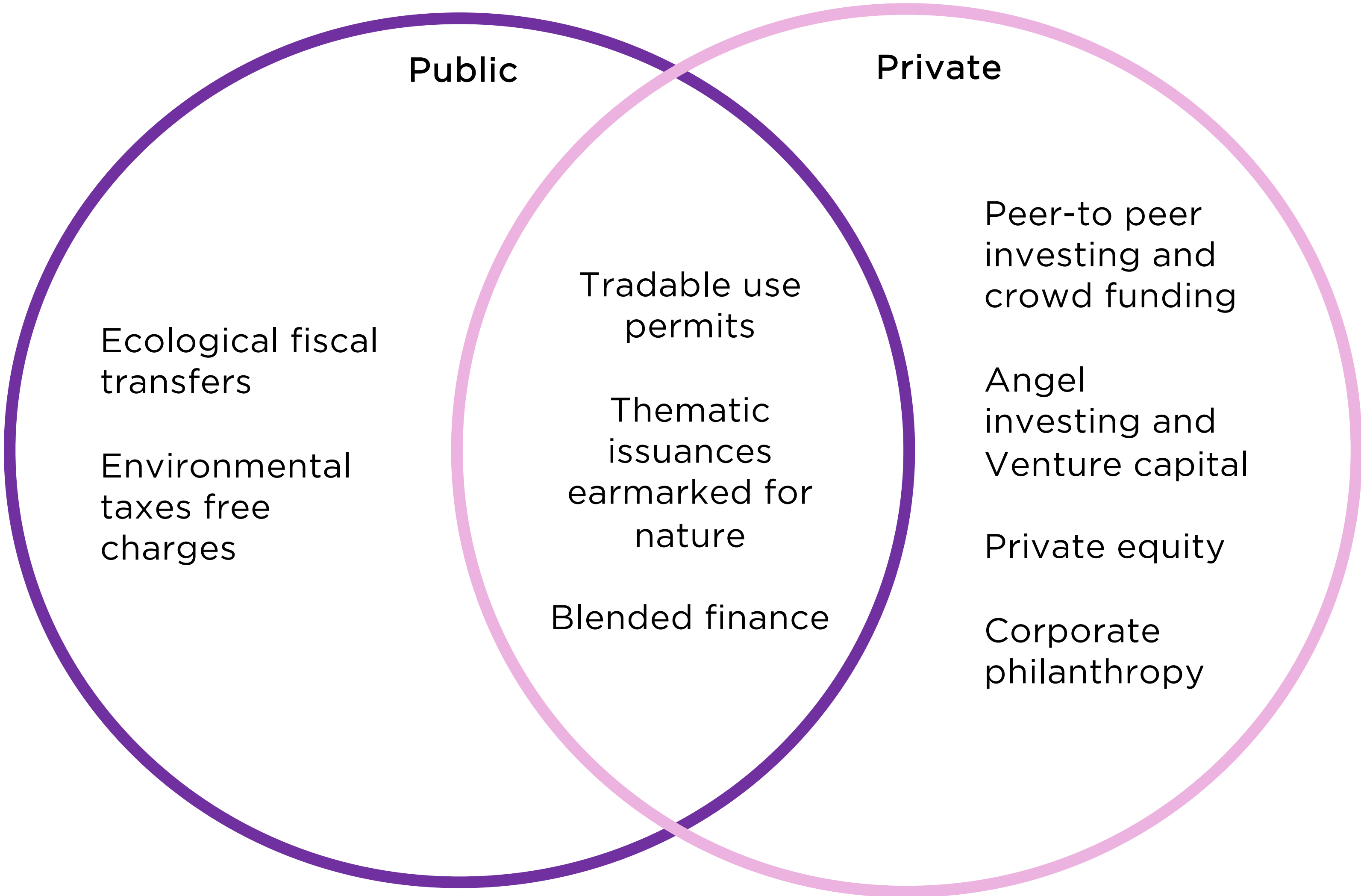
- For middle-income countries, the absence of a debt workout mechanism (that includes private creditors) is a key challenge

Landscape of Financial Instruments for Nature

Short overview of instruments before taking a deeper dive into debt for nature swaps and green/blue bond



Landscape of instruments and mechanisms



Four categories of instruments

1. Debt Instruments	2. Equity instruments	3. Credit enhancement /Guarantee mechanisms	4. Risk Transfer/risk sharing mechanisms
Supra-national and sovereign green/blue bonds	Islamic finance, including Sukuk	Full or partial credit guarantee (PCG)	First-loss capital
Sub-sovereign green/blue bonds (municipal bonds)	Public-Private Partnership	**Partial risk guarantee/Political risk guarantee**	Synthetic green capital notes or green securitization
General obligation green bond	Joint Venture	Partial risk swap guarantees	Loan loss reserves
Green revenue bond	**Private equity, venture capital and unlisted equity funds**	First-loss provisions	**Risk sharing facility(RSF)/Default swap**
Green structured finance	Mezzanine/subordinate debt and preferred stock (B-shares)	Contingent loans	*Carbon / Biodiversity / Coral Reef Credits (companies offset emissions – risk reduction)*
Green securitization Green tranches in ABS and MBS deals	Subsidiary/project financing vehicles/YieldCos	**Concessional loan**	Parametric insurance
Green convertible bond	**Investment Trusts**	Energy Service Companies (ESCOs)	Climate risk insurance
Green project bond	Infrastructure/property funds	Viability gap fund (VGF)	Ecosystem services insurance
Environmental impact bonds		A/B loans or grants	Blue carbon and ocean-based insurance
Private placement		Carbon / Biodiversity / Coral Reef Credits (issuer sells credits to meet emission targets)	Natural catastrophe insurance
Green loans, syndicate loans and credit lines			
Mezzanine and subordinate debt			
Sustainability-Linked Bonds (SLB)			
Transition Bonds (low carbon / RE)			

Blended finance

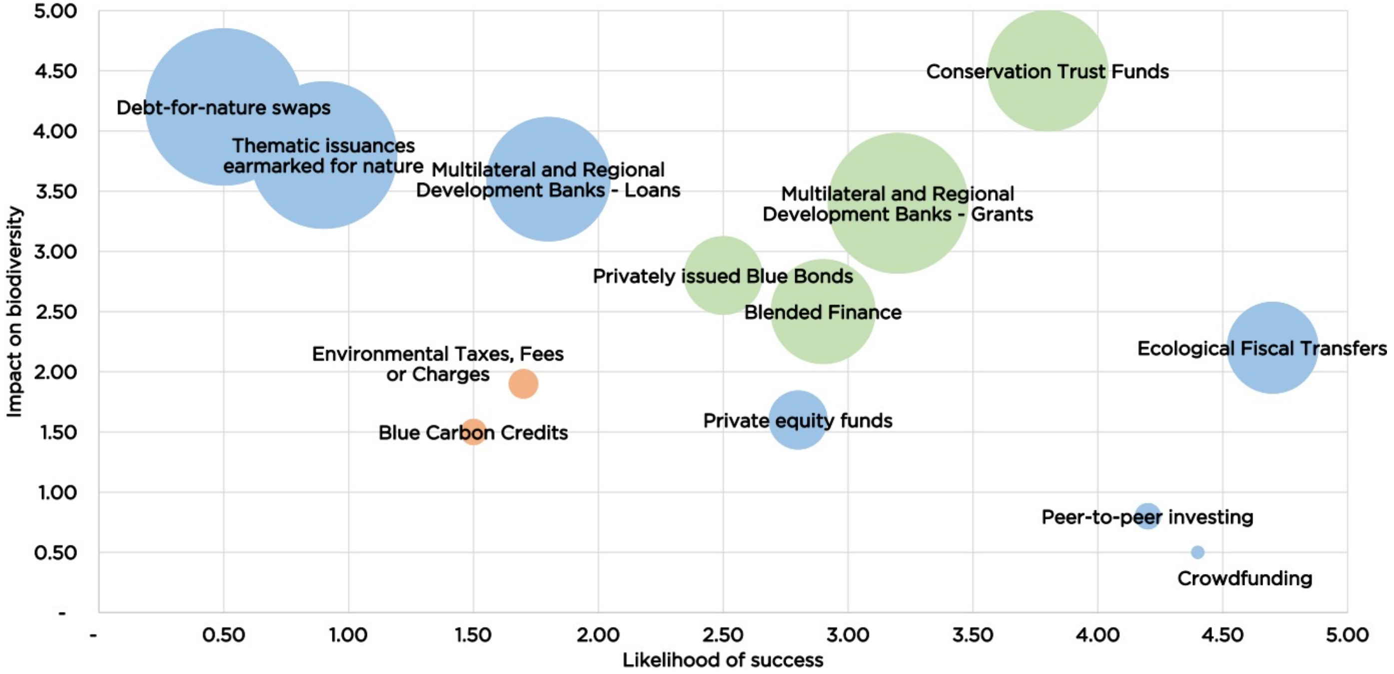
It is a term you will hear often in discussions on “unlocking” finance for nature.

- Approach that combines different financial instruments to raise funds from different sectors – government, private investors, MDBs, philanthropists.
- Instruments are use to de-risk a facility, helping to “unlock” much needed private finance to met global financial targets for climate and biodiversity.
- A debt for nature swap mechanism takes a blended finance approach.

CSF exercise

An application of selected debt, equity, credit enhancement and risk transfer instruments and mechanisms to marine conservation in Sri Lanka

Matrix

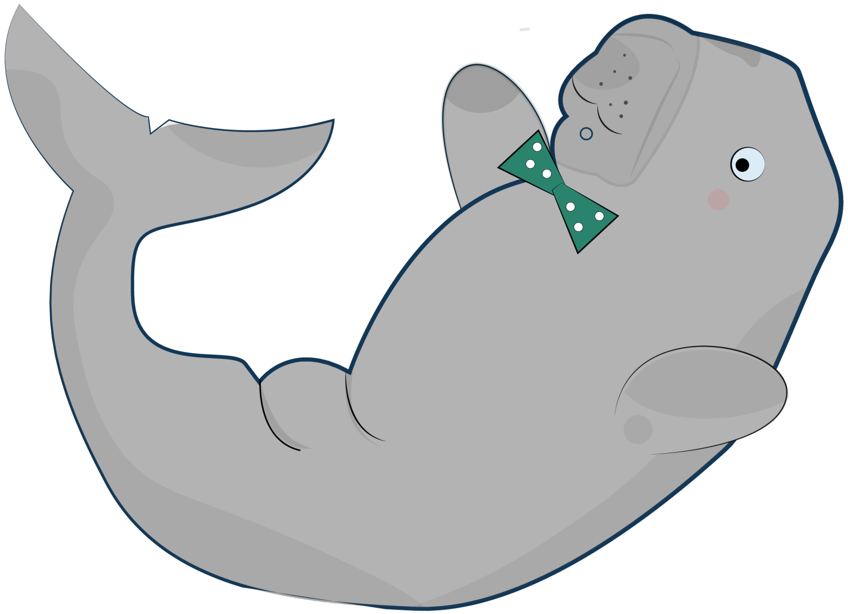


Key: Size of the bubble - Financial impact

JANUARY 12, 2024 | Nature, Climate, and the Economy

Applying Innovative Financial Instruments to Marine Conservation in Sri Lanka

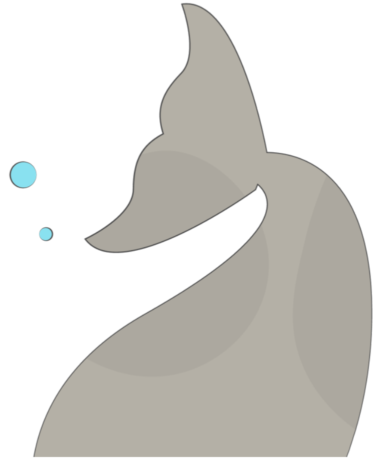
Any questions or thoughts so far?



Deep dive:

Debt for Nature Swaps

Understand why a country would consider a DFNS, what a DFNS structure looks like, why marine based DFNS are so popular and if a DNFS can actually have a significant impact (and worth the effort).



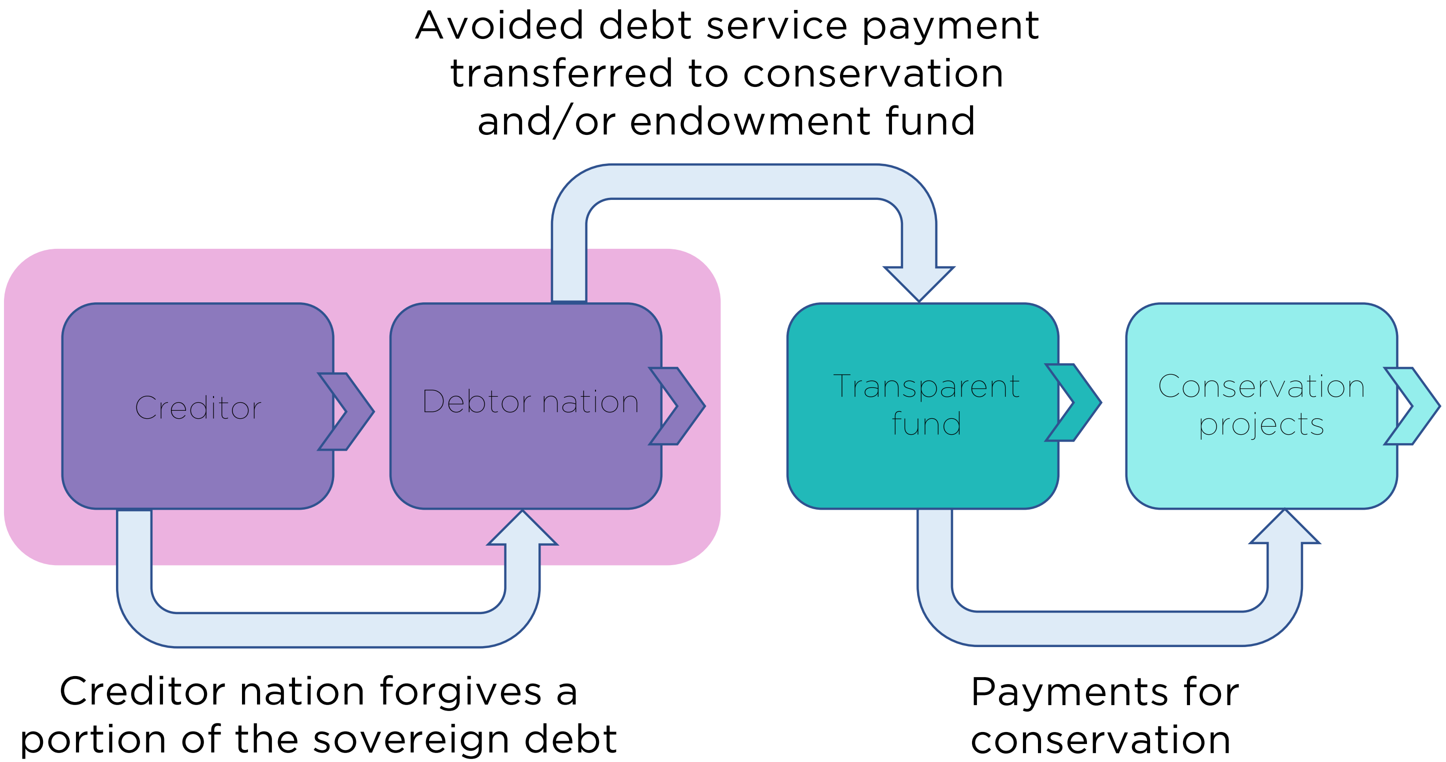
Why would a country consider a Debt for Nature Swap?

- Countries undertake a DFNS to help reduce their external debt.
- This can come in the form of a reduction to the principle (often referred to as a “haircut”) and/or reduction in interest rate and extension of the maturity period.
- Unlocks financing for conservation

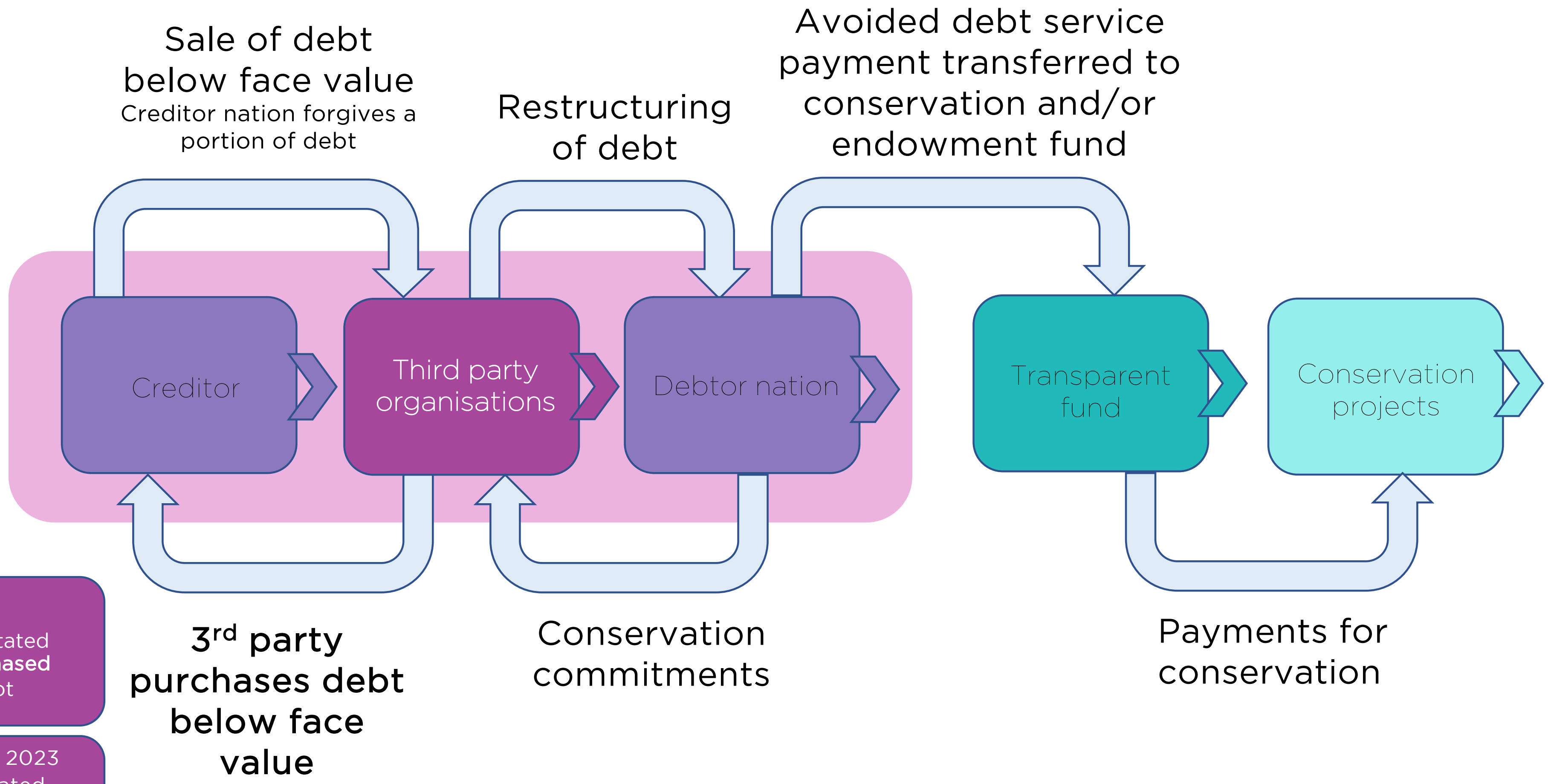
Why are marine protection based DFNS so popular these days?

- Many debt distressed countries are rich in marine biodiversity/resources. As such a marine based DFNS has more political and economic support.
- Ability to combine several environmental, climate and livelihood objectives through the protection of marine ecosystems
- Tangible conservation outcomes - meeting 30x30 GBF targets

The basic, bilateral swap



Increasing in complexity, trilateral/multipartite swaps

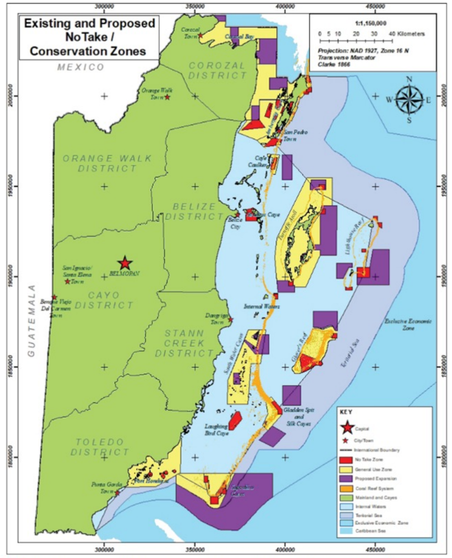


Belize 2021
***TNC** facilitated AND **purchased** the ISB debt

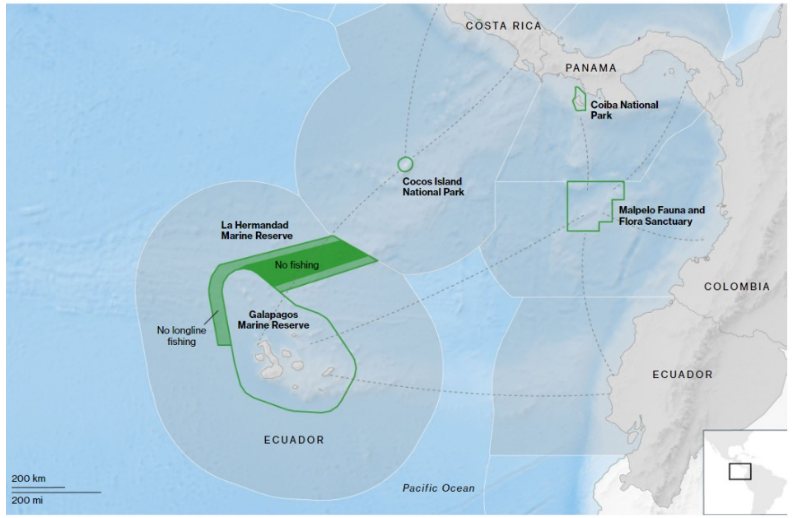
Galapagos 2023
TNC facilitated and **Credit Suisse purchased** ISB debt

Case study: Galapagos and Belize

- Was there a significant economic benefit to these two countries?
- What were the conservation benefits derived as a result of the DFNS for these two countries?



Marine reserves Exclusive Economic Zones Shark and turtle migration routes



Sources: Mission Blue, Protected Planet, Environment Ministry, Marine Regions, National Oceanic and Atmospheric Administration

Impacts on debt sustainability?

	Galapagos 2023		Belize 2021	
Population				
	2022	2023 & 2024	2020	2021 & 2022
GDP	$115 Bn	2023 - $118.8 Bn 2024 est - $121.8 Bn	$2.05 Bn	2021 - $2.42 Bn 2022 - $2.83 Bn
Debt to GDP ratio	56%	2023 - 54.67% 2024 - 55.4% June	133.1%.	2021 – 111.2% (due to DFNS) 2022 – 68.9%
Total Sovereign debt	$66.4 Bn	2023 - $65.78 Bn 2024 - $80.6 Bn June	$2.73 Bn	2021 - $2.69 Bn 2022 - $4.04 Bn
Blue Bond	$1.628 Bn Issued: 09/2023		$553 Mn (Superbond) Issues: 11/2021	
Haircut	-$972 Mn (59.7%)		- $189 Mn (45%)	
Blue Bond Issuance	= $656 Mn (Blue Bond)		= $364 Mn	
Savings from the swap as a proportion of debt and GDP	A reduction of $1 billion (approx.) in ISB debt = 10% of total ISBs. Total debt was $118.85 Bn in 2023. **This translates to a decrease of 0.8% in the debt-to-ratio.** **Considered a modest improvement.**		Decreased Belize's debt by approximately 12% of GDP. Total debt was $2.69 Bn in 2021 The debt-to-GDP ratio **declined from 133.1% in 2020 to 111.2% in 2021.** **Considered a significant improvement.**	

DFNS benefits derived for conservation

	Galapagos	Belize
EEZ	1,077,231 km^2	35,351 km^2
MPA target	expansion of the Galapagos MPA by 60,000km2 Total MPAs = 208,000 km^2 = 20%	**30% = 10,500 km2** **(from 15%)**
Haircut /saving	$972 mill	$189 mill
Blue bond	$656 mill [$640 mill to retire the $1.6 bill] [$24 mill for transaction costs] **[$16 mill for direct conservation]**	$364 mill [$301 mill to retire the $550 mill] [$39 mill for liquidity, transaction costs] **[$$24 mill endowment fund]**
Endowment fund	**$5.41 mill annual payment** Est. to grow to **$227 mill by 2041**	**$24 mill lumpsum** Est. to grow to **US$92 mill by 2041**
Immediate conservation	**$12.05 mill annual contribution** to 2041	**$4.2 mill annual contribution** to 2041

Point of reference

Sri Lanka
EEZ= 532,619 km^2

MPA = 401 km2
Bar Reef Marine Sanctuary, Hikkaduwa NP and Pigeon Island NP

30%? = Approx. 160,000km2

What benefits were derived from the funds raised and terms attached to the DFNS?

Belize – tripled budget allocation for marine conservation

Significant $$ for conservation

Attract additional $$

Galapagos – further $240M debt purchased for $90M. Add. $81M to be allocated to marine conservation

Large scale expansion of marine protected areas

Channel funds to Nature-based Solutions (NbS)

Ties in penalties for reneging on DFNS terms

Tie in policy and institutions reforms in DFNS terms

Belize – Payment will increase by US$1.25 mill per year for the first missed milestone and an additional US$250,000 for each additional missed milestone

Do all DFNS receive a haircut?

Given the context of debt distress discussed earlier, there may be an assumption that all developing countries DFNSs result in a reduction in principle.

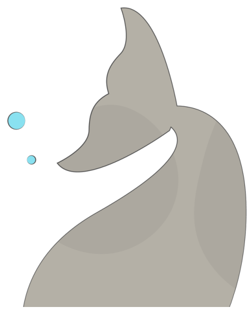
- Galapagos, Belize and Seychelles received a haircut.
- Barbados and Gabon did not.

- All 5 nations received a lower interest rate on remaining debt and extended maturity.

What is the difference between Debt-for-Nature Swap vs Green/Blue Bond Issuance?

DFNS includes bond issuance as part of the mechanism to *refinance existing* debt.

A government can, however, seek to raise $$ directly by issuing a green or blue bond. This will be *new* debt.



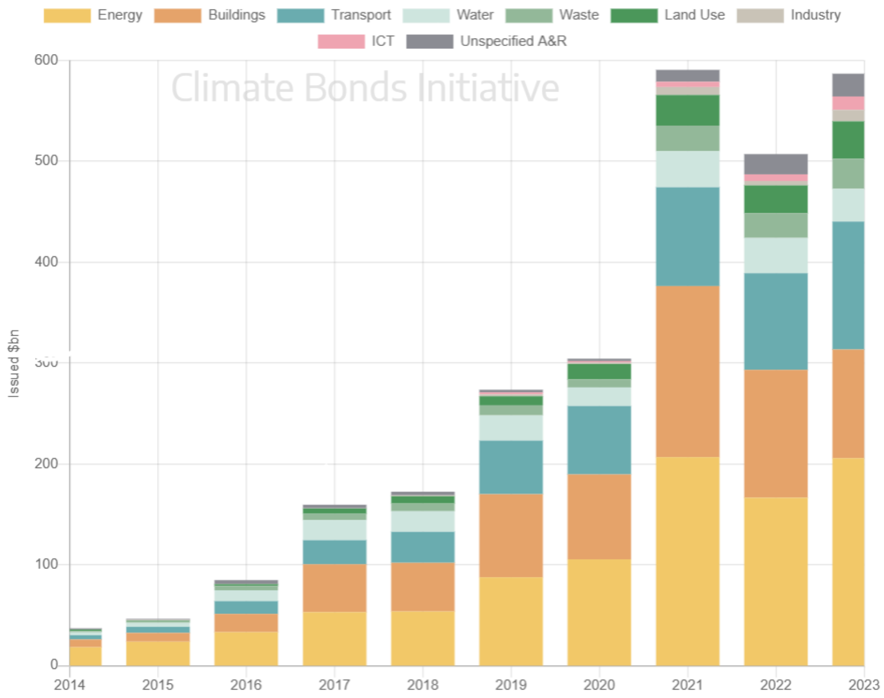
Why do countries issue green or blue bonds?

- Raise finance to fund green or blue investments – typically these are for projects that are attractive to private investors (e.g., renewable energy, sustainable fisheries and aquaculture)

- Doing so, a country can allocate limited public finance for projects/interventions that do not easily attract private capital

How are green/blue bond proceeds being invested internationally?

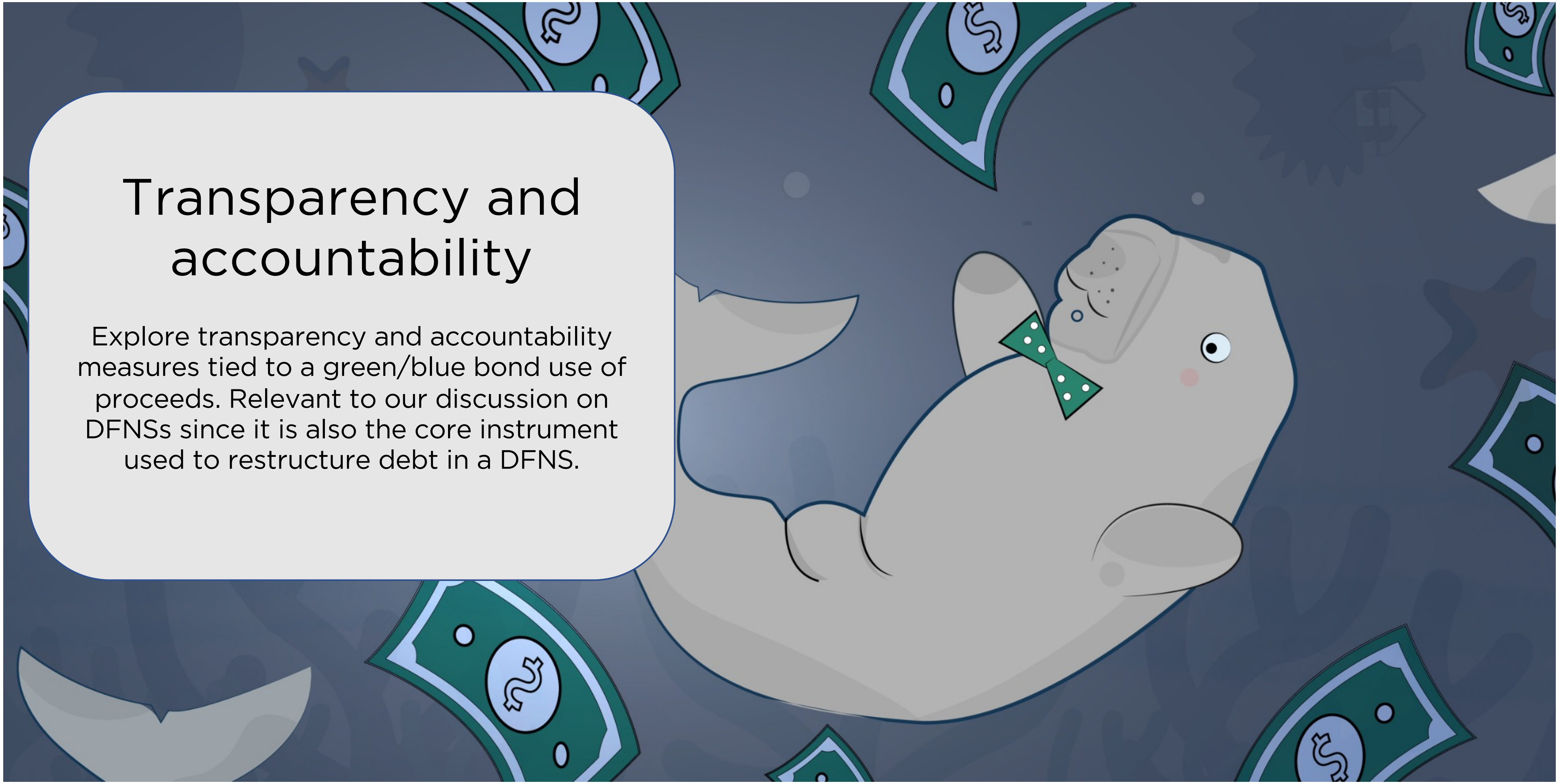
- In 2023, approximately **$1 trillion** in green, social, sustainability and sustainability-linked bonds were issued (**sovereign and commercial**).
- Green bonds represent the lions share.
- Renewable energy, buildings and transport represent 75% of the market.
- Global climate finance: Mitigation finance accounts for 92%, while Adaptation only 8% (CPI, 2024)



Green Bonds by Sector (CBI, 2023)

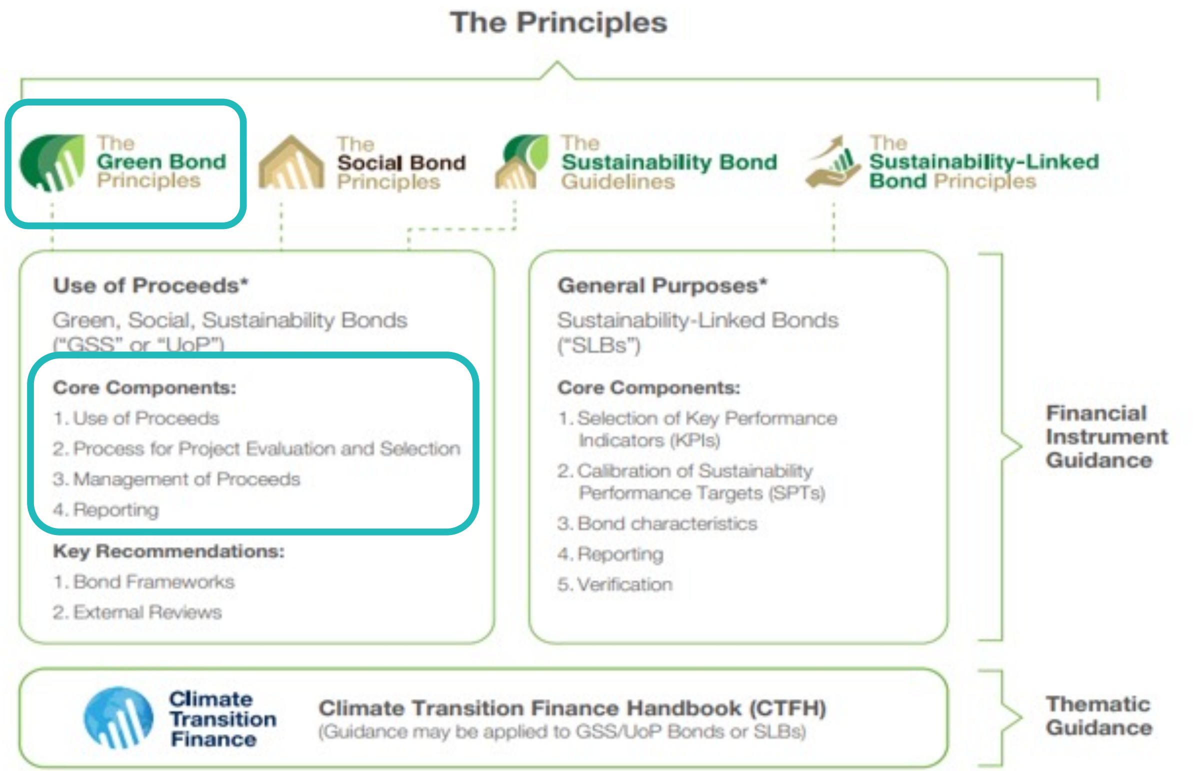
Challenges that Sri Lanka may need to consider when issuing sovereign green or blue bonds

- Country **sovereign rating**, timing of an issuance (alongside debt restructuring), risk appetite on Sri Lanka
- Credible **green project pipeline** (amidst perceptions of these as **riskier** investments)
- **Low liquidity** in secondary markets
- **High transaction cost vs '*greenium*' gained**
  - Impedes issuers with smaller transactions (obtaining consultant review, verification, certification, and ratings from qualified third parties)
- Issuer **lacks deep understanding** of green bonds, and the different stakeholders needed (not only MoF/CBSL)


Transparency and accountability
Explore transparency and accountability measures tied to a green/blue bond use of proceeds. Relevant to our discussion on DFNSs since it is also the core instrument used to restructure debt in a DFNS.

International Capital Market Association (ICMA) Bond Framework

- The ICMA Green Bond Principles is a voluntary framework adopted globally
- Countries and corporations align their Green Bond Frameworks to ICMA
- Blue bonds are issued under a ICMA Green Bond Principle compliant framework.



* Under the GBP, SBP and SBG, an amount equal to the net bond proceeds is dedicated to financing eligible projects (Use of Proceeds Bonds) while under the SLBP, proceeds are primarily for the general purposes of an issuer in pursuit of identified KPIs and SPTs (Sustainability-Linked Bonds). A bond that combines SLB and Use of Proceeds features should apply guidance for both types of bonds.

Sri Lanka's Green Bond Framework?

- Received cabinet approval on 22 May 2023
- Process of undergoing Second Opinion assessment before it can formally be adopted
  - UNESCAP and Global Green Growth Institute (GGGI) supporting the cost of Second Party review (i.e., ICMA compliance verification)

Cabinet Decisions 22.05.2023:

"Funds gained from such bond issues can be used for renewable energy, energy efficiency, green buildings, clean transportation, sustainable water & waste water management, pollution prevention, governance and circular economy, adaptation to climate change, conservation of biodiversity and sustainable management of natural conservation of biodiversity and sustainable management of natural resources and land use."

Establishing transparency and accountability

ICMA Green Bond Framework's 4 Green Bond Principles (GBP)
Commonly referred to as "Use of Proceeds".

Use of Proceeds

A process and criteria to identify projects that provide clear environmental benefits

Project evaluation and selection

A robust process to identify eligible green/blue projects

Management of Proceeds

Transparent mechanism to track and allocate proceeds to eligible projects

Reporting

Issuers provide regular updates on how proceeds are used and the environmental impact achieved

Eligible green projects e.g. Taxonomies and exclusion lists

Institutional arrangements e.g. Steering committees, selection procedures

Segregation of proceeds e.g. creation of dedicated accounts within Treasury

Allocation and impact reporting e.g. digital tracking of proceeds and report generation

Use of Proceeds – Green Taxonomy

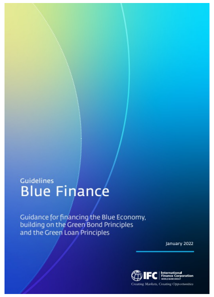
A Green Taxonomy is **classification system** that provides clear criteria and standards for determining **which economic activities qualify as environmentally sustainable**.

Why are green taxonomies so important?

- **For issuers**, a taxonomy provides a **blueprint for developing eligible projects** and reducing uncertainty about what qualifies as "green" or "blue".
- **Confidence to investors** that green/blue bonds meet specific environmental criteria in the selection of projects
- Enable more **consistent data collection and reporting** on environmental impacts

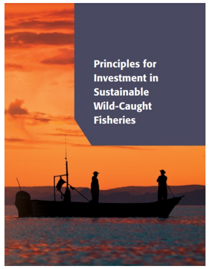
Additional "Blue" Guidance

If a country's Green Taxonomy or supporting policy documents do not provide enough detail eligible blue activities, there is plenty of international principles and detailed guidelines available.



- The **UNEP FI Blue Finance Principles** 2018
- The **UNEP Finance Initiative sector-level guidance** on the application of the Blue Finance Principles, Turning the Tide: How to Finance a Sustainable Ocean Recovery 2021

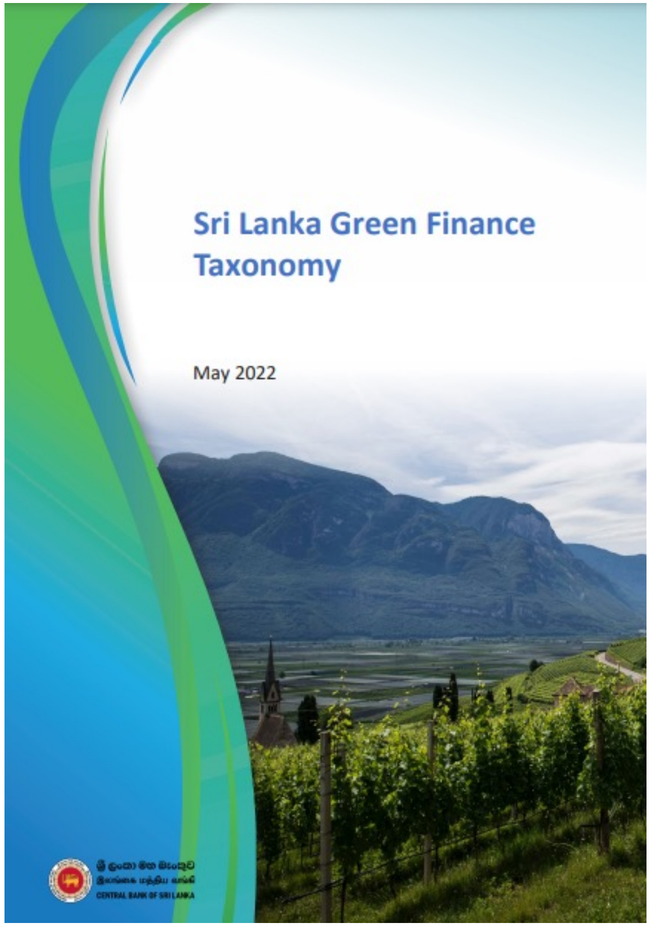
- WB **IFC Blue Finance Guidelines** 2022 – Guidance for Financing the Blue Economy, building on the Green Bond Principles and the Green Loan Principles.
- EDF **Principles for Investment in Sustainable Wild-Caught Fisheries** 2018



Sri Lanka's Green Taxonomy

- Sri Lanka's green taxonomy is based on international taxonomies (EU, China, Colombia, WB-IFC) and alignment to domestic policies (NDC, NAP).
- Alignment with IFC Guidelines for Blue Finance.

"The Sri Lanka Green Finance Taxonomy is applicable to all domestic and foreign market participants offering financial products such as bank lending, debt instruments, portfolio management, and investment funds."
(Official Government News Portal – news.lk)



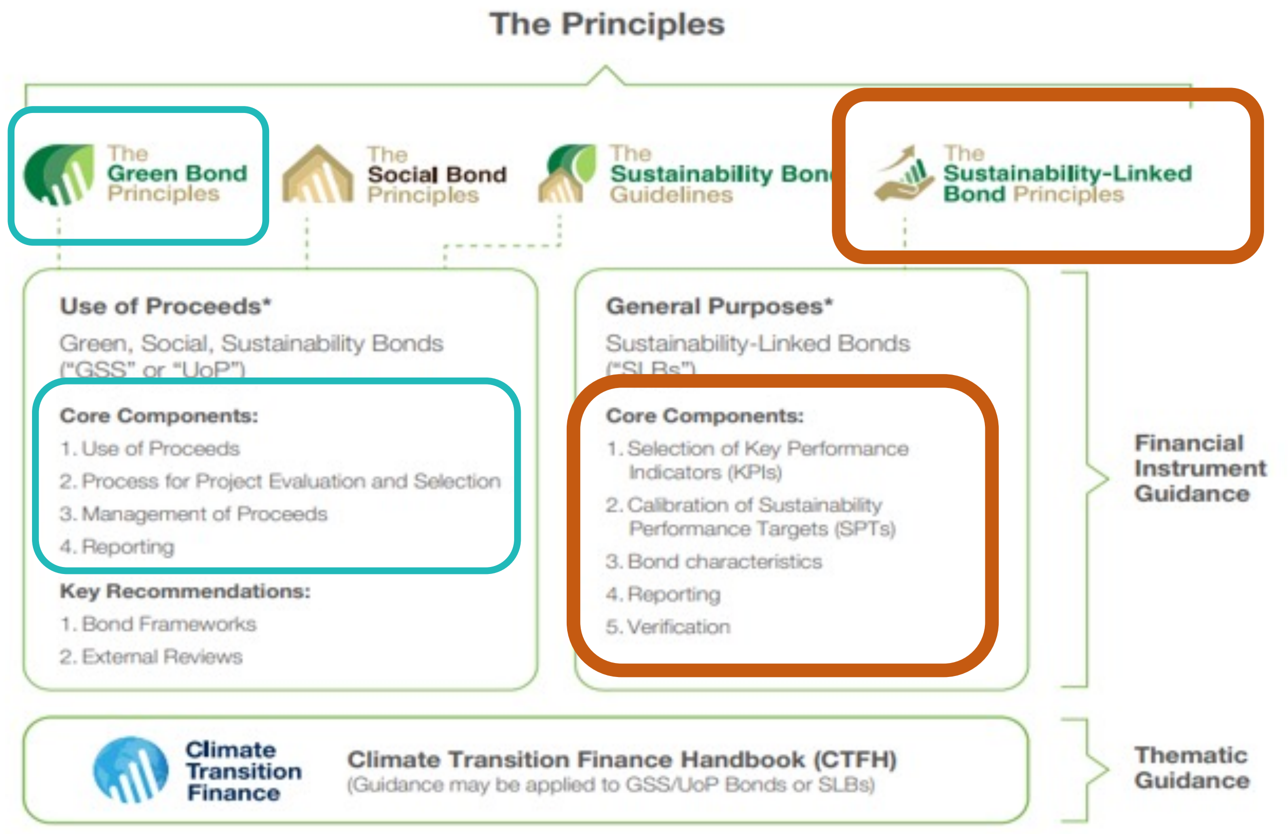
What about sustainability-linked bonds?

Aren’t they **linked to outcomes** and not to specific eligible green/blue activities?

Sustainability-Linked Bonds (SLBs) are designed to support broader sustainability goals **without tying proceeds to specific green or sustainable projects**, as green/blue bonds do

- Some fund managers have shown preference for sustainability-linked bonds since it is linked to performance and an overall target. **Failure to meet the target can be penalised by a higher coupon rate.**

- **However, there are loop-holes used by some issuers to watch out for** to stop greenwashing such: keeping penalties low and calling a bond i.e redeem it before maturity to avoid or minimize the penalty.



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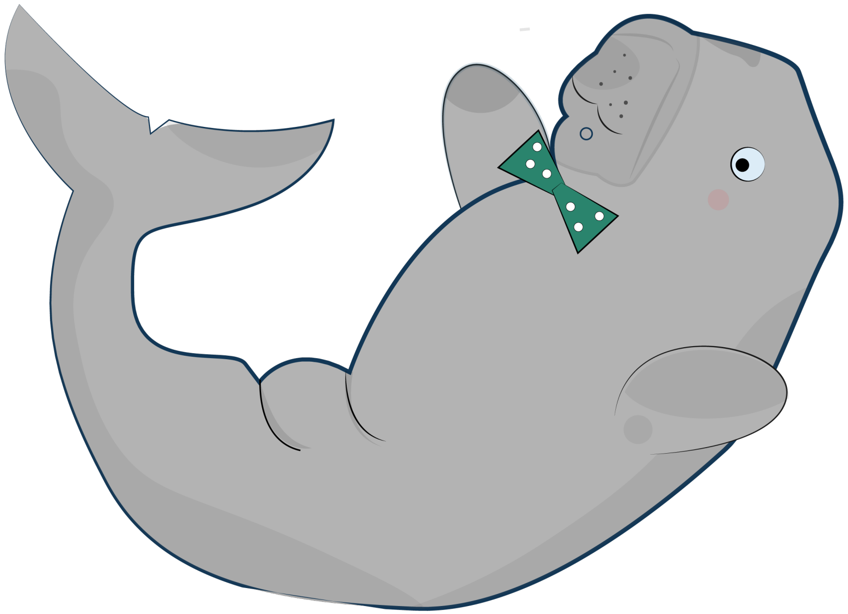

Time for your vote!

Do you think Sri Lanka is ready for a debt-for-nature swap or a green/blue bond?

Scan the QR code

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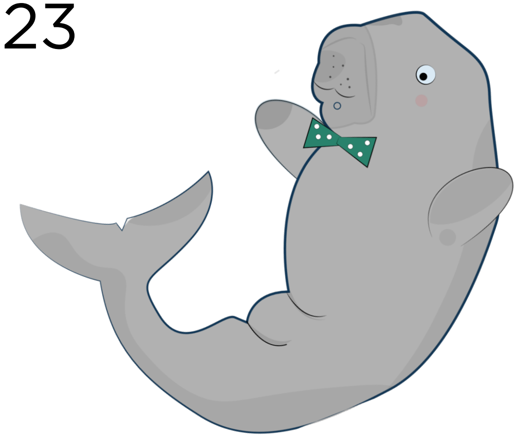
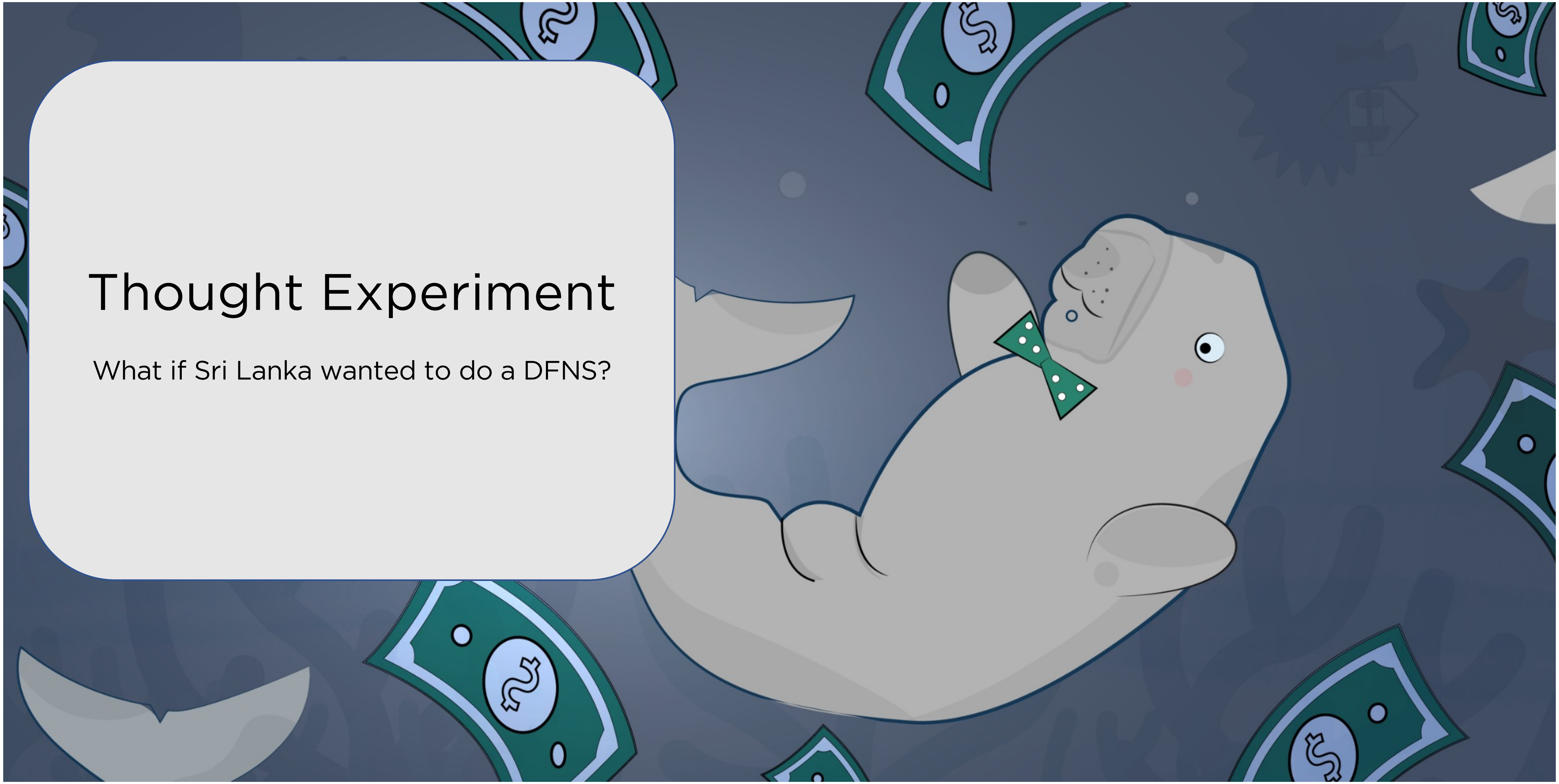
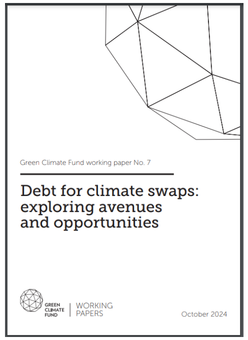




Thought Experiment

What if Sri Lanka wanted to do a DFNS?

Assessment of country's vulnerability and readiness for a Debt for Climate Swap by GCF



Sri Lanka was ranked 6 out of 50 nations

Methodology is based on 3 parameters (weighting%):

i. Environment Pillar (35%) **[0.65]**
ii. Debt & Macroeconomic Pillar (45%)
iii. Institutional Pillar (20%)

"The Environment Pillar specifically identifies countries where environmental challenges may significantly affect their socioeconomic conditions and by extension their debt sustainability"

Rank	Country	Global score	Environmental Score	Debt Score	Institutional Score
1	Ghana	0.56	0.56	0.58	0.50
2	Lao P.D.R.	0.54	0.66	0.52	0.35
3	Rwanda	0.51	0.64	0.39	0.57
4	Kenya	0.50	0.61	0.44	0.45
5	Vietnam	0.50	0.85	0.23	0.50
6	Sri Lanka	0.50	0.65	0.42	0.41
7	Zambia	0.50	0.45	0.58	0.39
8	Philippines	0.48	0.66	0.31	0.54
9	India	0.48	0.69	0.27	0.56
10	Maldives	0.47	0.35	0.58	0.44
11	Argentina	0.47	0.50	0.46	0.42
12	Mozambique	0.46	0.57	0.42	0.37
13	Mongolia	0.46	0.53	0.41	0.45
14	Bolivia	0.46	0.50	0.48	0.33
15	Colombia	0.46	0.48	0.40	0.54

Green Climate Fund, September 2024

What experts think…

1. DFNS are feasible in a post-debt restructuring scenario

2. Must build our financial and institutional framework to be multi-disciplinary, integrated and inclusive

3. Take a disciplined but flexible approach to the use and management of proceeds

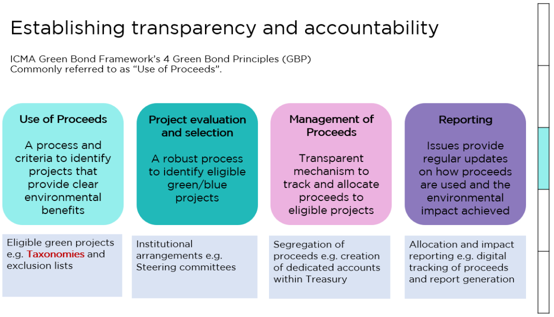
CSF led panel discussion : Deshal De Mel (Economic Advisor, MoF), Ranga Pallawala (Climate Policy Expert, EU SWITCH) and Lucy Emerton (Environmental Economist)

Elements in place and what do we still need to established to be more DFNS ready

What we have in place or underway

- Sri Lanka Bond Framework (Second opinion certification underway)
- Green Taxonomy
- Budget tagging (developed but not applied)
- Introduction of more transparent public finance accountability mechanisms

Recall the ICMA GBP accountability interventions…



What we still need to do (not an exhaustive list)

- New institutional arrangements – Public Debt Management Office and an independent Central Bank.
- New laws for fiscal discipline - Public Financial Management Act 2024
- Establishing dedicated accounts, proceeds register and internal & external auditing processes
- Establishing a digital proceeds tracking and reporting system

Basic steps to issue a DFNS

Successful DFNSs have taken between 2 to 4 years to negotiate.
Sri Lanka has some advantage having built capacity due to the debt restructuring process.

1.Preliminary Feasibility Assessment

1. Assess existing debt arrangement
2. Review conservation priorities
3. Domestic stakeholder engagement

A component of the PFA – **Risk Assessment and Mitigation Plan** - important for securing a guarantee facility.

2.Engage Creditors, International Conservation Partners and Legal & Financial Advisors

1. Initial creditor Terms - the portion of debt they are willing to forgive
2. Partner with conservation organisation to act as intermediaries
3. Engage legal and financial advisors to represent GoSL interests

3.Define conservation goals and Project Objectives

Build on the work carried in the by domestic parties in the PFA

1. Prioritise projects with significant measurable outcomes
2. Develop a monitoring framework to track progress

4.Assess Financial and Legal Structures (e.g. SPVs and CTFs)

1. Evaluate debt mechanisms
2. Compliance with national debt policies and international regulations

5.Negotiate terms with creditors on specific terms and conservation program

1. Detailed creditor terms
2. Design the Conservation Program and Fund Management Structure
3. Multilateral and domestic stakeholder engagement

6.Finalise and Implement the DFNS Agreement

1. Follow required bond issuance process
2. On rescript of funds, disperse funds to SPV and/or CTF and any other domestic mechanism
3. Undertake continuous monitoring and evaluation

Time for your vote!

When do you think it's the right time for Sri Lanka to undertake a DFNS?

- Start preparing now and aim to complete a successful DFNS
- Start preparing now – by getting our policies, institutions and regulations in place – we can decide later if we want to undertake a DFNS
- Should **not** consider a DFNS – but consider other ways to raise finance for conservation
- Only access international grants - developed nations should provide significantly sized grants for conservation until they cancel our debt

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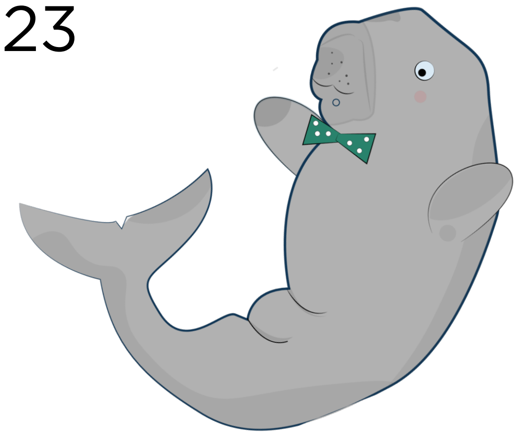

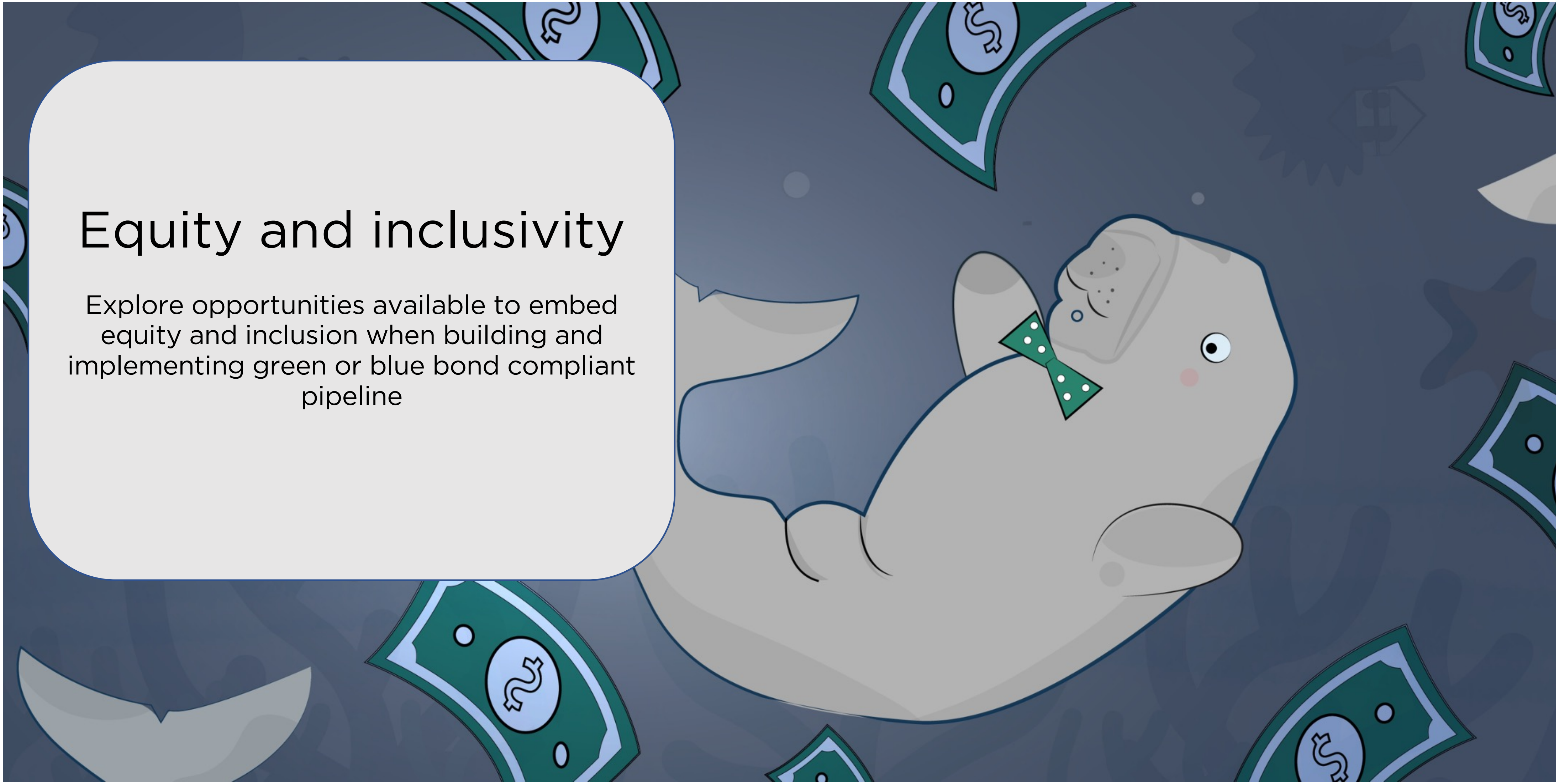

Equity and inclusivity

Explore opportunities available to embed equity and inclusion when building and implementing green or blue bond compliant pipeline

Embedding equity and inclusivity

It's important to ensure that nature finance trickles down to the vulnerable and ground level actors.

Ensuring **representation** when designing a mechanism, selecting conservation priorities, as well as during the project selection process and implementation is very important.

Design of the financial mechanism

- National level consultation with broad range of stakeholder
- Equitable financing models for the grass roots e.g. grants, Fintec
- Blended finance model - guarantees to reduce cost of capital for marginalized groups
- Benefit/revenue sharing mechanism (carbon credits)

Project selection and implementation

- Participatory project design
- Social and gender safeguards
- Community ownership / stewardship models
- Institutional support for CSOs, MSMEs to access nature finance
- Technical assistance for MSMEs and community members
- Community feedback and grievance mechanisms

Reuters

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Record Galapagos debt-for-nature swap scrutinized over transparency irregularities claims

By **Marc Jones**

September 27, 2024 11:23 PM GMT+5:30 · Updated 2 months ago

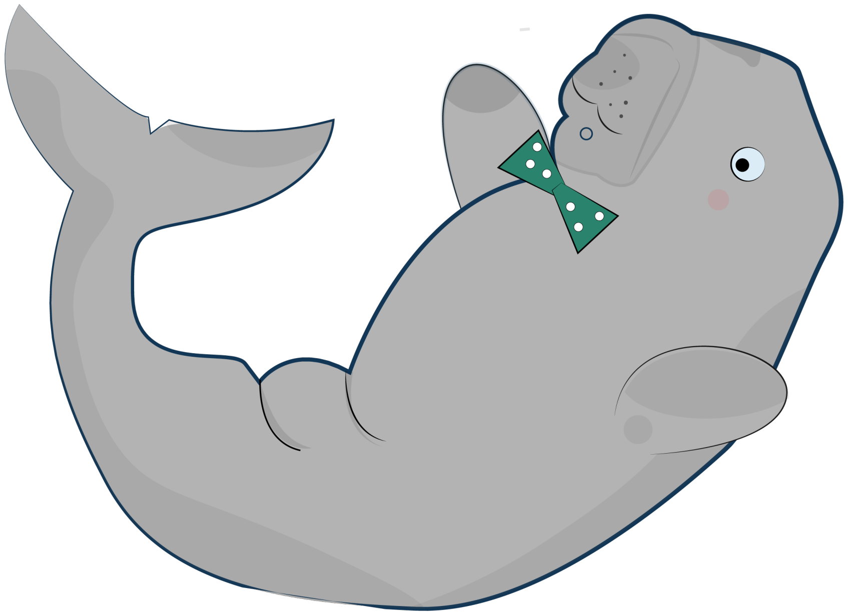
Aa

"24 groups involved in the complaint are frustrated about their lack of involvement in decisions and that conservation money is yet to arrive."

The Independent Consultation and Investigation Mechanism (MICI) is an accountability office for the Inter-American Development Bank Group.

MICI's investigations are limited to potential breaches of the IDB Group's "environmental and social policies and standards", but concerns about how projects, including disbursements, are managed, and public disclosure, fall under that umbrella.

Any questions or thoughts so far?



Concluding reflections

Regardless of the instruments or how a mechanism is structured…

- Must have a benefit on debt sustainability…
- But also, should have benefits beyond debt sustainability (e.g., conservation financing, green jobs, etc.)

Vital considerations…

- Investors are consulted and an instrument or mechanism is market-tested to understand
- Ensure transparency, inclusivity and accountability + good oversight mechanisms
- Strong understanding of risks and limitations
- Benefits are shared fairly among all stakeholders
- A feasible pipeline is developed with a high level of buy in

We would love your feedback on this session – only two short questions ☺

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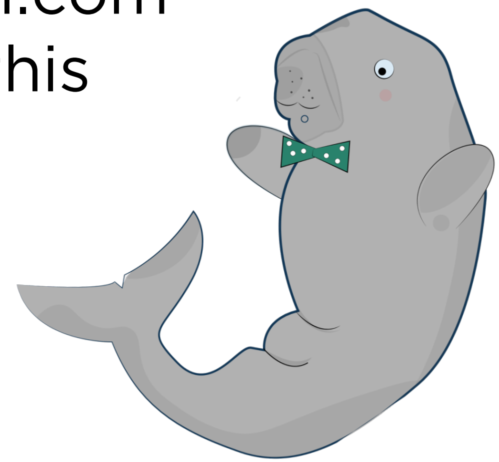

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