



September 2020

Recapitalising Sovereign Debt

Why Nature Performance Bonds are needed now

The Looming Debt Crisis

Seven of the ten nations with the highest number of COVID-19 infections to date are developing economies that were already facing debt distress before the pandemic struck. But the health crisis has radically altered the calculus: declines in local currencies have increased the cost of servicing hard-currency debt for many, while evaporating demand has robbed export-dependent nations of income.

At the same time, many countries have dramatically increased public spending to support their health systems and defend their economies and citizens' livelihoods. Emerging and developing countries have unveiled rescue packages worth 5.4% of their gross domestic product (GDP), according to the World Bank.ⁱ

This combination of factors has led to government budget deficits ballooning out of control. In Sub-Saharan Africa alone, deficits are projected by the International Monetary Fund (IMF) to reach a record 7.6% of GDP this year.ⁱⁱ This comes as governments in Africa and other developing countries are already facing an avalanche of sovereign debt repayments as a significant amount of post-2008, low-cost issuance comes due.

Efforts to ease the pain through debt standstills have helped. But standstills will not be enough. Zambia has hired bankers to advise on restructuring its US\$11 billion in foreign debts, which threatened to trigger Africa's first coronavirus-induced sovereign default. Many other countries are likely to follow suit in seeking debt-restructuring deals.

Few would doubt that a sovereign debt crisis is looming.

The Global Nature and Climate Crisis

An unprecedented number and ferocity of hurricanes, floods, melting ice sheets, infestations and forest fires are the most visible signs of the other global crisis: an unfolding environmental catastrophe triggered by climate change and nature degradation and destruction. Nature loss—such as deforestation, draining of wetlands, and species extinction—has reached alarming levels and is exacerbating the impacts of climate change. COVID-19 itself, and the prospects of more and worse pandemics to come, are further symptoms of this crisis, since by radically altering nature, we create the conditions in which diseases like COVID-19 emerge and thrive.

Climate change and damage to nature pose an enormous threat to human wellbeing. There is unambiguous evidence of the economic value at risk in this context, alongside the painfully visible human cost, from wildfires in California and Australia to Kenya's locust infestations and floods in Dhaka, the Bangladeshi capital.

Connected Crises

These looming debt and environmental crises are intertwined. Nature loss is eroding the capacity of many nations to underpin the economic prosperity needed to deliver livelihoods for their citizens and, in turn, their ability to service and repay sovereign debt.ⁱⁱⁱ

There is now a compelling body of research pointing to the critical role played by nature in driving economic productivity and growth, from such diverse authorities as the Paulson Institute, the London School of Economics, the World Economic Forum (WEF), and the Chinese government-hosted China Council on International Cooperation on Environment and Development. Recent estimates indicate that more than half of the world's GDP (US\$44 trillion) is highly or moderately dependent on nature, with the US\$2.5 trillion agricultural sector particularly dependent on the quality of soil, water and climate.^{iv}

The Task Force on Nature-related Financial Disclosures and the Dutch central bank's pioneering analysis of the systemic financial risks stemming from biodiversity loss point to the importance of nature to both financial capital and sovereign risk.^v Moreover, credit rating agencies have begun to incorporate climate and nature related risks into their assessment of sovereigns.^{vi}

Argentina is a case in point. In August, it struck a deal with creditors to restructure its US\$65 billion in debts, and relies heavily on agricultural production to generate its key exports of soybeans and wheat. But output of both crops has been falling as a result of drought and wildfires, a situation exacerbated by the expansion of cattle-ranching onto areas previously cultivated with soybeans.^{vii}

A Solution – Nature Performance Bonds

Just as climate risks are today being incorporated into investors' risk analysis, so will it be unthinkable in the future not to factor the state of a country's natural capital into its sovereign credit rating. We can already detect the early seeds of this development, building on decades of experimentation in debt-for-nature swaps. "Use of proceeds" green bonds are becoming part of the risk equation, and a first generation of Sustainable Development Goal (SDG)-linked performance bonds are explicitly linking the cost of capital to SDG outcomes.

Finance for Biodiversity (F4B) believes that these positive developments provide early signals of what needs to happen, at scale. There is now a compelling opportunity, and an urgent need, to deploy a sovereign debt instrument that links the cost of sovereign debt with success in protecting or enhancing a country's valued, productive natural capital.

“Nature Performance Bonds” (NPBs) are a sovereign debt instrument that can meet this challenge. They could provide a catalytic and practical pathway for introducing natural capital into the response to today’s sovereign debt crisis, and in embedding it systemically into tomorrow’s global financial system. They would incentivise performance outcomes that lead to both direct financial and nature returns—NPBs would underpin a virtuous cycle of:

- reduced debt repayments;
- improved nature and climate outcomes;
- strengthened country resilience and productivity;
- lowered risk profile and improved access to cheaper capital; and
- increased attractiveness of a country as a long-term investment destination.

Our thinking behind NPBs is laid out in detail in a separate Technical Paper, which explains how and why NPBs build on previous efforts to address sovereign debt and natural capital linkages. Success to date in debt-for-nature swaps, for example, has been limited by a lack of standardisation, constraining scaling across multiple actors and markets. The Technical Paper makes the case that standardisation should be a key component in any offering if effective debt instruments are to be attractive to private sector creditors. NPBs would build on this asset class evolution by ensuring that they are not only scalable, but standardised in line with existing asset classes, evolving the natural capital financial ecosystem beyond the project-specific nature of much green finance so far.

To support our work further, F4B has built a unique database of the debt sustainability and biodiversity status of countries to understand the nexus at which debt distress and biodiversity priorities coincide.

How NPBs Would Work

NPBs would link delivery of agreed, verifiable “nature performance outcomes” to more favourable coupon (interest) and principal debt payments.

The design of nature performance targets would be country- and deal-specific, reflecting the country’s biodiversity profile, the costs of achieving outcomes and the ease of demonstrating success, as well as the interests of the creditor. For example:

- Climate outcomes, such as reduced emissions and improved resilience, could be an integral element of the bond's performance offering, especially if such outcomes could be monetised through, for example, carbon credits.
- Social and economic objectives might also be part of the performance targets dashboard—for example, if the debtor wanted to secure enterprise and livelihood opportunities as part of addressing nature outcomes.

NPBs could accommodate diverse ways to value and pay for nature outcomes:

- Sovereign creditors may be open to paying directly for nature outcomes as part of their policy interests and international commitments.
- Private creditors would be interested where they are impact investors, where nature performance outcomes impact the productivity of economic assets that they are invested in, and when accepting nature-related performance outcomes as part of a “best bad option” in the context of a broader debt-restructuring deal.
- Both sovereign and private creditors would be interested if the nature performance outcomes are material to solvency risks reflected in sovereign credit ratings.

Initial interest in NPBs would most likely come from sovereign creditors with a policy interest in nature outcomes, although in the context of the looming debt crisis there may be interest in hybrid solutions involving sovereign and private creditors.

Nature Performance Bonds: the benefits

For sovereign debtors:

- The proceeds would help countries fund their environmental objectives—including those on biodiversity and climate change—as well as critical economic and social goals, over the short, medium and long term.
- NPBs offer a pathway through which debtor countries can win some debt (principal and repayment) relief.
- NPBs would support short-term economic recovery, with most of the funds released available for general purpose use.
- Developing nations would benefit from NPBs financially because the terms of their debt will improve as they achieve agreed performance milestones, while over time a strengthened, more productive natural capital balance sheet will bring new economic opportunities and resilience.
- The bonds would help achieve improved nature and climate outcomes, such as restoration of degraded forest and other landscapes, wetland management, and species conservation and recovery. This in turn would increase the country's nature-based resilience, enhance productivity and generate new market opportunities.

For creditors:

- Lenders—whether public or private—would have a new way to build into their portfolios alleviation of financial risks stemming from biodiversity loss and ecosystem degradation.
- NPBs would support delivery of existing and future international commitments to outcomes such as climate change adaptation and mitigation, job creation, health and other social goals, as well as biodiversity protection itself, thereby enabling investors to demonstrate the broader social benefit of their activities.
- Governments, international financial institutions and private creditors that recognise the economic and wider value of protecting and restoring nature would have the opportunity to embrace a new, pay-for-performance approach that would simultaneously secure both nature and climate objectives and strengthen a developing nation's solvency and prosperity.

What Needs to Happen Now

2020 was to be a “super year” for global environmental action, given the multiple commitments to halt biodiversity loss and climate change. There is now an opportunity to do even better in 2021.

With a looming sovereign debt crunch, and an accelerating set of climate initiatives in the run-up to the United Nations Convention on Biological Diversity (COP-15) meeting in Kunming, China, in May 2021, and the UN Framework Convention on Climate Change (UNFCCC) COP26 climate conference in Glasgow, Scotland, scheduled for November 2021, the time to grasp the debt and nature opportunity is now.

F4B invites creditors, debtors and other interested partners to engage to help shape its NPB proposition, so as to:

1. Further develop and refine this approach to sovereign debt based on nature-related performance, including a common approach across multiple initiatives, identifying proven pathways for standardisation and scale.
2. Develop country-specific deal packages, including short-to-medium-term reductions in the cost of capital and interest to debtors, linked to delivery of measurable biodiversity/climate, social and economic outcomes.
3. Build consensus among policymakers, international organisations and the private sector ahead of forthcoming meetings of the IMF, World Bank, G7 and G20, with the aim of establishing NPBs as a key element of international sovereign debt architecture.

Key Resources

Climate & Nature Sovereign Index: Introducing a framework for a clear assessment of environmental risk. WWF and Ninety-One. July 2020.

[https://www.wwf.org.uk/sites/default/files/2020-07/Climate %26 Nature Sovereign White Paper.pdf](https://www.wwf.org.uk/sites/default/files/2020-07/Climate%26%20Nature%20Sovereign%20White%20Paper.pdf)

The Sovereign Transition to Sustainability: Understanding the dependence of sovereign debt on nature. Alexandra Pinzón and Nick Robins with Matthew McLuckie and Gabriel Thoumi. London School of Economics and Grantham Research Institute. February 2020.

<https://www.lse.ac.uk/granthaminstitute/publication/the-sovereign-transition-to-sustainability-understanding-the-dependence-of-sovereign-debt-on-nature/>

Sustainability-Linked Bond Principles Voluntary Process Guidelines. International Capital Market Association. June 2020.

<https://www.icmagroup.org/green-social-and-sustainability-bonds/sustainability-linked-bond-principles-slbp/>

Emerging market debt crisis: biodiversity as a lever for building back better. Finance for Biodiversity Initiative. June 2020

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Green Bonds Global State of the Market 2019. Climate Bonds Initiative. July 2020.

<https://www.climatebonds.net/resources/reports/green-bonds-global-state-market-2019>

Blue Bonds: An Audacious Plan to Save the World's Oceans. The Nature Conservancy. April 2019.

<https://www.nature.org/en-us/what-we-do/our-insights/perspectives/an-audacious-plan-to-save-the-worlds-oceans/>

Moving Mountains: Unlocking Private Capital for Biodiversity and Ecosystems. UNDP

<https://www.biodiversityfinance.net/sites/default/files/content/publications/BIOFIN%20-%20Moving%20Mountains%20-%20Unlocking%20private%20capital%20for%20biodiversity%20and%20ecosystems%20%28Web%20Version%29.pdf>

Sovereign Environmental, Social and Governance Data. Data, tools and guidance. World Bank Group. October 2019

<https://datatopics.worldbank.org/esg/>

Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy. The World Economic Forum. January 2020.

http://www3.weforum.org/docs/WEF_New_Nature_Economy_Report_2020.pdf

About Finance for Biodiversity

Finance for Biodiversity's mission is to increase the materiality of biodiversity, or nature, in financial decision-making. In so doing, it seeks to better align financial flows with the needs of biodiversity conservation and restoration.

For further information: <https://www.f4b-initiative.net/>

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ⁱ <https://www.worldbank.org/en/publication/global-economic-prospects>

ⁱⁱ <https://www.imf.org/en/News/Articles/2020/06/27/pr20249-sub-saharan-africa-a-cautious-reopening>

ⁱⁱⁱ https://www.lse.ac.uk/GranthamInstitute/wp-content/uploads/2020/02/The-sovereign-transition-to-sustainability_Understanding-the-dependence-of-sovereign-debt-on-nature.pdf

^{iv} http://www3.weforum.org/docs/WEF_New_Nature_Economy_Report_2020.pdf

^v <https://medium.com/@WWF/harnessing-sovereign-debt-investment-in-the-fight-for-climate-and-nature-eb7b3465ce9>

^{vi} https://www.moodys.com/sites/products/ProductAttachments/Climate_trends_infographic_moodys.pdf and <https://www.fitchratings.com/research/sovereigns/climate-change-risks-facing-sovereigns-to-rise-01-06-2020>

^{vii} <https://planet-tracker.org/hall-of-flame-argentinas-debt-restructuring-negotiators-advised-to-factor-escalating-drought-and-wildfire-costs/>