



CLAUDE MONET, LES NYMPHÉAS

POLICY BRIEF

# Climate and Sovereign Debt Vulnerabilities: Some Practical Solutions

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# Executive Summary

**Key messages** based on Lazard's experience in advising governments dealing with debt problems:

- *The concomitance of elevated public debt levels and a far-reaching climate challenge is making the solution to both problems more difficult.*
- *This is especially true when countries face financial distress, as is generally the case for developing countries rated low single B and below. These are the focus of this Policy Brief.*
- *Yet, there is some whiff of hope that the wide mobilisation behind climate may make this complication less intractable than thought, and that one could at the same time address debt and climate unsustainability.*
- *Could climate change bring a good surprise to overly indebted countries? We do not think so. But that does not mean that well thought out financial solutions cannot help, in some cases meaningfully.*
- *High public debt levels make the financing of climate adaptation and mitigation by debt generally unadvisable: compounding a climate crisis with a financial crisis is not a solution. Happily, there are other alternatives, beyond indispensable and massive transfers from rich to poor countries in the form of grants:*
  1. *Climate shock absorbing features in debt instruments.*
  2. *Non-recourse financing solutions.*
  3. *Natural asset monetisation which may alleviate the tension between climate challenges and debt overhang.*
- *When public debt is unbearable, debt reduction is needed. Adding a climate element to the solution is tempting but likely to make already protracted negotiations intractable. Liability management operations, such as debt for nature swaps, which help progress the two objectives of climate and debt sustainability at once, can be usefully considered outside debt renegotiation processes. But barring an unlikely tax or regulation response in advanced economies, the mobilisation behind climate will not solve low-income countries' over-indebtedness.*

# Introduction

All countries must take costly measures to mitigate and adapt to climate change. For countries facing financial distress (which is generally the case for developing countries rated low single B and below) the confluence of excessive public debt and the need to finance climate adaptation and mitigation is making the solution to both problems more difficult.

The IMF estimates that the necessary climate mitigation investment by developing and emerging market economies to reach net-zero by 2050 may amount to USD 2 trillion per year by 2030. To dimension the issue, speculative grade countries' debt stock is USD 5.5 Trillion, of which USD 2.8 Trillion for single B and below rated countries. The ability of low-income countries to stretch their balance sheet in the face of massive investment needs is highly doubtful.

Yet, there is some whiff of hope that the mobilisation behind climate and the seniority which the cause could (should) get amongst competing objectives may make this complication less intractable than thought, and that one could at the same time address debt and climate unsustainability.

There are two key issues:

- i. Whether climate change adaptation and mitigation has necessarily to result in higher debt levels.
- ii. Whether climate-related financial solutions can decisively help address problems of debt unsustainability.

Based on our experience, we believe that:

- i. Climate change is a net negative for financially vulnerable countries, and financing adaptation and mitigation through debt is not advisable. That said, well structured financing instruments and carbon credits monetisation can to some extent alleviate the financial pressure.
- ii. The mobilisation behind climate objectives is unlikely to solve acute over-indebtedness problems, and adding climate considerations to already complex and protracted debt restructurings is bound to disappoint. That said, (improbable) changes in tax and regulatory policies in advanced countries may make a difference if they tilt the balance between fiduciary and social responsibility.

This note, based on Lazard's experience in financing and debt restructuring, offers some practical solutions to one of the key financial challenges of our time – how countries in or at high risk of distress can finance the urgently needed investments to adapt to and mitigate climate change, without exacerbating their debt problems.

## 1. Climate shock absorptive instruments – debt with equity-like features

One of the most promising ways to reduce the risk of concomitant debt and climate crises is to make debt repayments more sensitive to climate shocks. Thus, several countries, though principally small island states, have issued so-called “**climate resilient bonds**” that allow the country to suspend debt service payments in the event of a loss due to a natural disaster such as a hurricane or flooding.

The issuance of climate resilient bonds raises at least two issues: if the risk of debt service suspension reduces the value of the related bonds, the cost of debt at origin will be higher; and if only a small portion of a country’s debt includes climate resilient clauses, their inclusion will do little to protect the country against the financial burden of dealing with natural catastrophes.

Several Multilateral Development Banks have announced the introduction of climate resilient debt clauses into some of their development loans. But this only applies to a very limited subset of the portfolio – essentially new loans.

The Caribbean Development Bank (CDB), advised by Lazard, is working on an innovative solution: *all of the loans* it has extended to member countries exposed to the risk of periodic hurricanes would include a climate resilient debt suspension clause based on insurance models; the bank would cover its risk by issuing hybrid debt with parallel triggering conditions with the overall objective of protecting its credit rating.

Ultimately, the CDB is looking to offer a form of collective insurance to its member countries with the support of outside investors. The advantage that the CDB has in doing so is that, like all other Multilateral Development Banks (MDBs), it does not have to provide its shareholders with a return on equity.

Of course, if the CDB is the only MDB to offer this benefit to its clients, the impact will be limited. Although it intends to include this feature in all its existing and new loans, the fact is that most of its members borrow from several other sources as well. So, the real benefit from this project will only be achieved once the other MDBs offer similar protection to their borrowers, that is covering the stock (the outstanding loan) and not only the flow (the new loan).

It may then reach another level of materiality if low-income countries’ governments were assisted in the issuance of bonds (or other forms of debt) with similar clauses. Obviously, the cost may be prohibitive, at least at the beginning: bondholders will have difficulties pricing it and will be conservative; and some fixed income funds will simply balk at investing in instruments with deferral options outside their control. Still, with some well-structured guarantees from AAA countries, this type of debt may get traction over time if the attraction for bespoke clauses is resisted.

## 2. Non-recourse financing

Non-recourse financing, where the lender looks only to a dedicated payment stream for payment and has no claim (recourse) against the borrower itself, is an exception to the caution against borrowing by over-indebted countries. It is also a form of monetisation of assets, in this case a financial asset. As such, it is discussed in the following Section.

## 3. Monetisation of natural assets

Asset sales are a source of funds for both public and private sector actors, but it would be a mistake to believe that they are inherently a better choice for a heavily indebted country. To the extent that the asset sold is a right to receive future payments (which is typical of non-recourse financing), the sale effectively accelerates the receipt of those payments in the form of the purchase price of the asset sold. But the sale also eliminates the right to receive future payments that could otherwise have been used to service debt. So, although debt does not increase, the *capacity to service debt* decreases.

The analysis is different in the case of an asset that does not generate a future payment stream (new or existing) and, in particular, in the case of an asset the acquisition or creation of which directly contributes to climate change mitigation.

As it happens, a significant number of distressed countries are fortunate to have a large – and in some cases massive – store of onshore and offshore assets (natural carbon sinks and renewable energy sources, for example) the protection or development of which can make a significant contribution to efforts to combat climate change and can readily be monetised in the process. Here, **as the assets generally do not generate a future payment stream, monetisation does not impair the capacity to service debt and, if well done, can in fact facilitate the reduction of debt.**

Several developing countries have abundant assets in the form of natural resources whose value in the hands of advanced economies lies not in their potential exploitation but in their preservation. Thus, the value of carbon sinks (or offsets) can be embodied in carbon credits, which are a prototypical example of such an asset. Although most of these countries lack the technical capacity to create and market credible carbon credits, there are a number of private firms that are offering their services to do so to these developing countries, although at a hefty price.

The big problem today is that there is at best only a nascent market, with trading done on a bespoke basis, and it is difficult to find buyers willing to offer a “fair” price, assuming one can figure out what that is. Absolute GHG sequestration – the main benefit of a carbon sink – is also not adequately valued under current carbon credit standards which rather tend to reward GHG reduction outcomes compared to a do-nothing baseline.

One solution would be for **MDBs to offer technical assistance in the form of assisting countries in the production of carbon credits** and supervising, or indeed providing, the certification as to their validity needed to make these credits marketable. The World Bank has started to go in that direction, at least partly.

**Ideally, these MDBs would take one step further and agree to accept carbon credits in repayment of their loans to borrowing countries.** Thus, for example, if the African Development Bank assisted one of its borrowers in the creation of carbon credits, it would accept these credits as currency to repay loans made by it to that country. In doing so, it would stand behind the validity of the credit and rely on its institutional and market expertise to monetise it.

Although not itself a game changer, this could be an important expansion of the role of MDBs and a step the right direction of increasing their relevance in today's complex environment, without expanding their balance sheet.

#### **4. Addressing debt distress and climate needs at the same time**

As noted above, the confluence of debt distress and the urgent need to invest in adaptation to and mitigation of climate change has spurred proposals to kill two birds with one stone: use the occasion of a needed restructuring of public debt to design the new debt that will be issued in such a way as to give the issuer incentives to pursue measures to address climate change.

For example, issue the new debt in the form of sustainability linked bonds (SLBs), where the issuer's debt servicing costs are reduced if it meets certain defined climate-related objectives.

**Our experience as advisors to the governments of nearly all countries that have had to restructure their public debt over the last years suggests that adding climate-related objectives to an already complicated negotiation risks prolonging the successful conclusion of the restructuring, at significant cost to both the debtor and its creditors.**

In a restructuring two issues are paramount: the level of debt relief (or from the creditors' perspective the level of impairment of their claims) and comparability of treatment of different creditor classes. The first is the issue on which the parties are focused. They, and particularly the creditors with fiduciary duties to those whose money they manage, are not interested in balancing the objectives of minimizing losses and proactively addressing climate change. And if comparability of treatment means that all creditor groups, official and commercial, bondholders and other private creditors must in some measure contribute to a climate agenda (not as farfetched as it may seem), the added complexity will be unwelcome to all, to put it mildly.

That said, there is a class of investors, not necessarily those whose debt is being restructured, that are natural investors in SLBs and other bonds designed to promote climate-related objectives. Accordingly, including in the new debt to be issued in a restructuring, one or more tranches of SLBs or other climate-related debt available to those creditors who wish to acquire it could at the margin facilitate a restructuring, but we should not anticipate the effect on climate issues to be large.

**In summary, the possibilities of achieving synergies that will further important goals to achieve both debt sustainability and climate-related objectives are, as a general rule, limited.**

**There are, however, two cases – one available today outside the context of a debt restructuring and a second embedded in a restructuring, but dependent on government or regulatory action – in which debt reduction and action to address adaptation to climate change can be achieved in a single transaction.**

The first case is a class of transactions familiarly known as **debt for nature swaps**.

In these transactions, expensive debt, typically trading at a substantial discount, is exchanged for debt with external credit support and a substantially lower interest rate (and typically lower aggregate principal amount) than the debt surrendered in exchange. The debtor country in turn agrees to invest the savings in debt service cost to further climate objectives.

A recent example is the debt swap carried out by Ecuador with the advice of Lazard, where the savings were dedicated to the protection of the Galapagos Islands. This transaction was carried out after a debt restructuring, but other debt for nature swaps have been done before a debt restructuring, in which case the amount of debt to be restructured will have been reduced by the amount of debt previously exchanged in the swap. Debt for nature swaps involve multiple parties, are complex and take considerable time from start to finish.

It is not clear to what extent these transactions can be scaled up. The Ecuadorean swap involved the exchange of \$1.6 billion face amount of bonds that were trading at approximately 40 cents and resulted in a savings of \$1.1 billion in debt service costs over 17 years. The discount on the bond was exceptionally high. If one took all the bonds from frontier economies that today trade with a significant discount (higher than 30%), we come to less than 5% of the total debt stock<sup>1</sup>.

**The second case would require prior action by governments regulating or taxing bondholders.**

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<sup>1</sup> Outstanding of relevant discounted bonded debt divided by total debt for countries rated B1 or below by Moody's.

The question is the extent to which advanced economies' governments can help facilitate sovereign debt restructuring negotiations through some sort of 'green' nudging of the international creditors. Fund managers – the creditors – are mostly based in advanced economies and thus responsive to regulatory or tax policies.

There is precedent in the United States and elsewhere for governments to provide favourable tax or regulatory treatment to debt that is deemed to promote policies favoured by the government. Thus, interest on bonds issued by municipalities in the United States as well as on so-called Industrial Revenue Bonds is exempt from Federal income tax, and several other countries have provided favourable regulatory treatment to certain categories of debt from time to time. In the same vein, but working in the other direction, the European Union is introducing a Carbon Border Adjustment Mechanism (CEBAM), which is a tax targeting 'carbon leakage' in the context of the import of carbon intensive goods. The whole point is that tax and regulation have a role to play in shaping incentives as part of the climate agenda.

The underlying issue is that fund managers will inevitably give priority to their fiduciary responsibility over social/climate responsibility. Therefore, tax or policy incentives may change the balance.

Considering the support, including subsidies, that advanced countries currently give to climate-related measures, one possibility to expand that support would be to grant for instance favourable tax (or regulatory) treatment to interest received on bonds issued, in the context of a debt restructuring, to promote or fund climate-related goals.

This would be a way for advanced economies to help unlock some debt restructuring negotiations, especially when there is a gridlock: the debtor country would for instance offer to exchange its defaulted bonds against climate-linked bonds with a lower value; but such bonds would benefit from tax or regulatory benefits in advanced economies, helping find a compromise where debt is reduced to ensure sustainability for the debtor but the effort made by the lenders is reduced by the tax benefits enjoyed by the new climate-related bonds.

## Conclusion

Climate adaptation and mitigation is a net cost for all countries, and primarily for those whose finances are already stretched. The first solution is a large transfer from rich to low-income countries. It may not be realistic as the pledges so far have generally not been followed by action.

Funding the climate response by conventional debt is a recipe for more problems. Climate shock absorptive debt instruments are much more promising, to the extent they can reach sufficient scale.



Helping financially poor but natural resources rich (in terms of biodiversity) countries repay their debt with carbon assets is a solution that in our view deserves to be explored more thoroughly.

Last, while adding green features to debt restructuring negotiations is tempting, it should be kept in mind that the primary objective of these negotiations is to provide timely and sufficient debt relief to countries facing financial distress. Our experience shows that adding additional constraints or variables to the negotiation is likely to prolong the process further. That said, significant changes in tax or regulation in advanced economies in favour of climate-related assets may change the equation and facilitate debt restructurings as the value of such bonds, in the eyes of investors, would be partly disconnected from the cost, for the debtor, of carrying them.

# Contact Information

Lazard's Sovereign Advisory Group is committed to serving its clients: governments and public institutions looking for solutions to their complex financial problems.

The sheer scope and importance of these matters also compels us to share our decades of experience for the broad public interest.

Contact persons:

- Pierre Cailleteau – [pierre.cailleteau@lazard.fr](mailto:pierre.cailleteau@lazard.fr)
- Thomas Lambert – [thomas.lambert@lazard.fr](mailto:thomas.lambert@lazard.fr)
- Mark Walker – [mark.walker@lazard.com](mailto:mark.walker@lazard.com)
- Jérôme Alexis – [jerome.alexis@lazard.com](mailto:jerome.alexis@lazard.com)
- Thomas Moatti – [thomas.moatti@lazard.com](mailto:thomas.moatti@lazard.com)
- Leonardo Pupperto – [leonardo.pupperto@lazard.com](mailto:leonardo.pupperto@lazard.com)
- Raphaël Hecht – [raphael.hecht@lazard.fr](mailto:raphael.hecht@lazard.fr)

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