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Prospects for Debt-for-Environment Swaps in ENI: A Background Paper

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What are Debt-for-Environment Swaps?

A debt-for-environment swap (or conversion) is the cancellation of a portion of a country's debt in exchange for the commitment to mobilize domestic resources for environment. The purpose of debt-for-environment swaps is not to reduce the external debt in any significant manner (the amounts are generally too small). Rather, the objective is to generate additional development resources. Debt swaps have been used for a variety of development goals around the world, often addressing sectors that had previously received inadequate attention from the debtor governments (e.g. health, education, and environment).

Experience using this mechanism in Central Europe has been quite positive, supplying millions of dollars to finance environmental projects. In Poland, ten percent of the debt owed to the United States was "swapped" for Poland's commitment to use the money for priority environmental projects. EcoFund (a Polish non-profit Environmental Fund) received the proceeds, reviewed applications for environmental grants and loans, and disbursed resources to qualified projects. Switzerland, France and Sweden later followed the US example, granting additional debt swap resources to EcoFund. Similarly, Switzerland forgave 20 percent of Bulgaria's debt and established the National Trust EcoFund with support from the World Bank. Both the Polish and Bulgarian Funds have earned praise for their transparent and cost-effective utilization of resources for environmental goals. There are no known debt-for-environment swaps in NIS countries, although the World Wildlife Fund and State University of New York are currently assessing the feasibility of implementing swaps in Russia. Debt-for-environment swaps have been most widely used in Latin America and Asia; some of the best examples are in Bolivia, Costa Rica, Ecuador, and the Philippines.

Resources generated from a swap can be used in a variety of ways, and contingencies for the use of the swap proceeds can be negotiated. For example, one of EcoFund's tasks is to promote the use of environmental technologies from the donating countries, by providing financial assistance for purchasing equipment. In other parts of the world, swaps have been used to preserve rainforests. This decision will depend on existing capabilities within the debtor country, political will to support specific environmental goals and the amount of resources made available.

Making Use of the Resources

Environmental Funds

When the objective is to mobilize resources for an array of environmental concerns, swap proceeds can be used to capitalize an Environmental Fund. The so-called "EcoFunds" in Poland and Bulgaria are Environmental Funds that have been financed by debt-for-environment swaps. Other Environmental Funds in the region have been capitalized by internal sources, such as pollution penalties or environmental taxes. The basic function of an Environmental Fund is to provide soft financing (grants or low interest loans) for projects that support environmental goals. In most cases, commercial financing is not available for proposed environmental projects, either due to the inadequacy of capital markets or the lengthy payback period on the projects. Most Funds in the region are "revolving," meaning that repayments become available to future loan applicants. Debt swaps can jumpstart the process by providing the initial funding.

Both "green" (biodiversity/conservation) and "brown" (urban infrastructure/pollution prevention) projects can benefit from the availability of Fund resources. For example, the priority areas of the Bulgarian Ecofund include: clean-up of past pollution; reduction of air pollution; clean water protection; and the protection of biodiversity.

Project applicants may be industries or municipalities, and projects are generally funded on a transparent and competitive basis. Usually, priorities are based on the National Environmental Action Plans or Local Environmental Action Plans (which are developed with the participation of many facets of civil society).

In addition to directly dispersing funds for a variety of environmental projects, Funds have served as vehicles for the development of invaluable project preparation and evaluation skills. Such skills enable countries to apply (often successfully) for financing from the International Financing Institutions and donors.

In CEE countries, Funds can address critical project preparation skills and supply matching funds for the European Union's Instrument for Structural Policies for Pre-Accession (ISPA) facility.[1] Funds can also help finance projects that are too small to qualify for EU funding -- such as small wastewater treatment plants for municipalities or enterprise level pollution prevention equipment.

In contrast to most CEE Environmental Funds, NIS Funds have been handicapped by excessive centralization. This has led to Fund resources being re-channeled to the State budget and away from environmental needs. An Environmental Fund set up through a debt swap could avoid this pitfall by establishing contingencies to protect the funding. For example, an independent accounting structure could be a prerequisite for the swap. Such a model, if successful, could have a demonstration effect and improve the operations of the existing Environmental Funds.

Special Purpose Funds

While the experience in the ENI region has been focused on Environmental Funds, a more targeted approach could be taken. For example, an endowment could be established to promote projects that protect and preserve Lake Baikal (such as support to ecotourism ventures and biodiversity monitoring). There is room for creativity in selecting which issues can be addressed by debt swap proceeds.

[1] ISPA is a grant program that will provide 1 billion Euros per year for the next seven years to support accession candidate countries with environmental and transportation projects. Project eligibility requires that the beneficiary (for the most part, local governments), provide a 25% matching contribution.

Types of Debt Swaps

The major variables in structuring debt swaps are as follows:

- What type of debt is being purchased (bilateral or commercial)
- Who negotiates the transaction (an NGO or USG officials)
- How the proceeds are used.

There are two ways in which this mechanism can be applied in SEED Act countries: via the purchase of commercial debt and via the purchase of bilateral debt. *Note: ENI/GC found no authority under FSA to conduct bilateral swaps in the NIS countries.*

Commercial Debt Swaps
Money owed by a government to private banks can be extinguished through commercial debt swaps. In this type of swap, USAID provides a grant to *an NGO* (legally, it must be an NGO) to buy the debt at a discounted value. The NGO uses the grant to purchase the debt on the secondary market (assuming it is trading for significantly less than face value). The initial grant funds are leveraged by negotiating with the debtor government to reimburse the NGO for an amount greater than the discounted purchase price. For example, in 1993, USAID provided $13 million to the World Wildlife Fund[2], which purchased $19 million in commercial debt owed by the Government of the Philippines (representing a purchase price of 68% of the face value). In exchange for the cancellation of the debt, the Government of the Philippines agreed to pay Philippine pesos and peso notes valued at the equivalent of US$17 million (or a redemption price of 90% of the face value). An initial grant of $13 million yielded $17 million of funding for the environment, which was transferred to a conservation endowment. A much smaller amount would be needed to start a revolving Environmental Fund.

Bilateral Debt Swaps
The type of debt purchased in a bilateral debt swap is debt owed to the US government (Treasury). Although USAID does not have the authority to orchestrate this transaction, the Executive Branch can facilitate the sale of debt via an NGO or private company provided that the debt is exchanged for "local currency, policy commitments or other assets needed for development or other economic activities." USAID would need to work closely with State and Treasury to negotiate with the debtor government, with USAID playing a role in the overseeing the eventual use of those funds.

Pros and Cons of the Swap Options

Both types of swaps result in funds to be used for environmental purposes. The commercial swap involves fewer political players on the US side, but also requires that USAID supply the initial grant resources. Since USAID resources are limited, the proceeds resulting from the swap would be significantly less that what might be obtained

[2] World Wildlife Fund is one of only a handful of NGOs that have the demonstrated experience and capacity for setting up these kinds of Funds.

through a bilateral swap. At least $1 million should be provided in grant money, in order to buy enough debt to make it worth everyone's effort.

Since a bilateral swap forgives official debt, this has two implications: 1) an appropriation is required; and 2) State and Treasury would need to negotiate the transaction. Although it seems daunting, strong political support on both sides can push through a bilateral swap.

First Steps: Feasibility Study/Inquiry to Ambassadors

Certain questions would need to be answered before making the decision to proceed with funding and/or negotiating a debt-for-environment swap. The availability of debt and its market value are key factors (i.e. is it trading at a significant discount). The cost of commercial debt fluctuates on the secondary market and should be researched. In considering commercial debt, it is necessary to "source" the debt -- determine which private sector entities own the government's debt. This is a labor-intensive process and should be a component of a feasibility study. The value of bilateral debt owed to the US Government is calculated by the Treasury Department.

Political will is another essential ingredient to be explored in a feasibility study. Does the government value environmental goals enough to dedicate government resources for a debt-for-environment swap? Based upon the government's interests and needs, what are the specific environmental objectives that should be supported from resources made available through this mechanism (e.g., pollution abatement, prevention activities, conservation, etc.)? A feasibility study could address these and other questions, providing a basis upon which to proceed.

If the bilateral swap is pursued, representatives from Treasury and State could most likely address these issues without the use of outside consultants. USAID programs could support these efforts by providing technical support for the recipients of the proceeds. The first step in this case would be to inquire whether the State Department is interested in pursuing the use of the debt swap mechanism.

Incorporating Debt Swaps into USAID Environment Programs

It is critical to ensure that the local organization receiving the proceeds is able to use the funds effectively and as intended. In particular, training in environmental project preparation should be provided if this expertise does not already exist.

Debt swaps can leverage USAID resources and programs, by building on past technical assistance efforts or funding newly created organizations. Although complicated, debt swaps may be highly effective in countries where debt has been significantly discounted or there is strong political support for an environmental agenda.