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FROM GALÁPAGOS TO GLOBAL: LEVERAGING DEBT-FOR-NATURE SWAPS FOR DEBT RELIEF AND ENVIRONMENTAL PROTECTION

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I. INTRODUCTION

The convergence of climate risks and high debt burdens in low and middle-income economies (LMIEs) has created a dual crisis that demands innovative solutions. Increasingly, Global South nations struggle with high debt and vulnerability to climate change impacts. In fact, nearly 60 percent of low and middle-income countries facing significant climate risks are also at high risk of financial crises.[1] These countries are caught in a vicious cycle, spending an average of five times more on repaying their debts than addressing climate change or investing in mitigation efforts in 2021, a ratio projected to increase to seven times by 2025.[2] As extreme climate events intensify, the financial strain on these nations grows hindering their ability to invest in climate.

Climate change's intensifying impacts are exacerbating existing vulnerabilities and creating new economic pressures. Countries face the challenge of juggling immediate development needs, inequality, poverty, healthcare, infrastructure gaps, and climate vulnerability. At the same time, the burden of debt severely constrained fiscal space, limiting government spending across all sectors, including critical climate investments.[3] As a result, climate spending is not only competing with other domestic priorities but also being squeezed by debt obligations, leaving these countries with fewer resources to address the growing climate threats and their commitments to international climate pacts like the Paris Agreement's nationally determined contributions.

Debt-for-nature (DNS) swaps offer a potential pathway to alleviate this cycle for some countries.[4] By converting a portion of a country's debt into investments in environmental conservation, DNS can provide both debt relief and critical funding for climate spending; its potential remains largely untapped.[5] This paper examines the Galápagos 2022 DNS as a case study to explore how this approach can be replicated by other countries to open fiscal space while promoting climate action and in LMIEs.

II. THE CLIMATE DEBT TRAP

High debt service payments, the regular installments on a country's total debt, divert critical resources from climate action, creating a climate debt trap. The vicious cycle of prioritizing debt repayments over climate investments hampers resilience building. As climate change intensifies, causing fiscal strain and further debt, countries become

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[1] Kristalina Georgieva, Marcos Chamon, and Vimal Thakoor, "Swapping Debt for Climate or Nature Pledges Can Help Fund Resilience," International Monetary Fund Blog, December 14, 2022, https://www.imf.org/en/Blogs/Articles/2022/12/14/swapping-debt-for-climate-or-nature-pledges-can-help-fund-resilience.

[2] Tess Woolfenden and Sindra Sharma Khushal, "The debt and climate crises: Why climate justice must include debt justice," Debt Justice, October 2022, https://debtjustice.org.uk/wp-content/uploads/2022/10/Debt-and-the-Climate-Crisis-Briefing-October-2022-UPDATED.pdf.

[3] Oscar Cetrángolo, Juan Pablo Jiménez, and Ramiro Ruiz del Castillo, "Debt for Climate Swaps and the Case of the Caribbean," ECLAC, https://repositorio.cepal.org/server/api/core/bitstreams/2568f7e4-fe1e-485a-b1f0-a6cee73b4486/content.

[4] International Institute for Environment and Development, "Debt Swaps could release $100 Billion for Climate Action," International Institute for Environment and Development, April 15, 2024, https://www.iied.org/debt-swaps-could-release-100-billion-for-climate-action.

[5] Carola Mejía Silva, "Climate Crisis, Debt and Recovery in a Context of Multiple Crises," Latindadd, January 2023, https://www.latindadd.org/wp-content/uploads/2023/01/CLIMATE-CRISIS-DEBT-AND-RECOVERY-IN-A-CONTEXT-OF-MULTIPLE-CRISES_c.pdf.

increasingly trapped, limiting their ability to address climate challenges.[6] With limited fiscal space and competing demands on public resources, these governments struggle to allocate sufficient funds for climate action. Moreover, higher borrowing costs and downgraded credit ratings, often exacerbated by climate vulnerability, limit access to climate finance, perpetuating a vicious cycle.[7]

Historically, climate and debt challenges have been addressed in isolation. However, in recent years there has been a growing trend in the development of innovative financial instruments that tackle both debt and climate change simultaneously. Table 1 below shows some of these instruments.

Table 1: Climate Debt Instruments

CATEGORY	INSTRUMENT	PROCESS	BENEFITS	LIMITATIONS
Climate Action	Concessional Grants	Direct funding for climate projects	Highly efficient for climate action alone	Requires significant funding and political will. Many MICs do not qualify.
Climate Debt Burden	Debt for Nature Swaps (DNS)	Refinance debt in exchange for climate investments	Immediate debt relief while supporting environmental protection	Limited impact if not substantial.
	Blue Bonds	Proceeds go to marine projects	Funds specific marine-related climate projects	Requires strong regulatory frameworks and investor confidence. Requires a market for these bonds.
	Green Bonds	Proceeds go to climate projects	Funds a wide range of climate-related projects	
	Sustainability Linked Bonds	Linked to Key Performance Indicators with proceeds for general purposes	Opens fiscal space and frees up funds for climate action. Encourages improved sustainability performance.	
Debt Relief	General Debt Fiscal Relief	Restructure or reduce debt without specific conditions	Frees up fiscal space for various uses.	Requires negotiations and agreements with creditors.

Source: Author creation based on information from the African Development Bank and the IFC-Amundi Report.[8]

The climate debt burden instruments represent a new wave of financial strategies aimed at integrating debt relief with climate action. While DNS typically focus on conservation spending, they can serve as a catalyst for broader climate awareness and investment,

[6] Bastien Bedossa, "The Climate Financial Trap: An Empirical Approach to Detecting Situations of Double Vulnerability," Agence Francaise De Development, October 2023, https://www.afd.fr/en/ressources/climate-financial-trap-empirical-approach-detecting-situations-double-vulnerability#:~:text=It%20is%20defined%20as%20a,ratios%20in%20the%20short%20to.

[7] Bastien Bedossa, "The Climate Financial Trap: An Empirical Approach to Detecting Situations of Double Vulnerability," Agence Francaise De Development, October 2023, https://www.afd.fr/en/ressources/climate-financial-trap-empirical-approach-detecting-situations-double-vulnerability#:~:text=It%20is%20defined%20as%20a,ratios%20in%20the%20short%20to.

[8] Jose Abad, "Emerging Market Green Bonds Report 2023," International Finance Corporation, May 2024, https://www.ifc.org/content/dam/ifc/doc/2024/emerging-market-green-bonds-2023.pdf.

indirectly advancing climate mitigation efforts by encouraging governments to integrate climate considerations into spending portfolios.

III. WHAT COUNTRIES COULD BENEFIT FROM A DNS?

A 2022 IMF study found that DNS are most effective for countries facing unsustainable debt burdens.[9] This occurs when a country struggles to meet its financial obligations, a condition known as debt distress. The IMF's Debt Sustainability Analysis (DSA) provides a clear assessment of a country's financial vulnerability and debt sustainability. It evaluates three key debt ratios — Debt-to-GDP, Debt Service-to-Revenue, and External Debt-to-Exports — and assigns one of four risk ratings based on the country's fiscal health and capacity to manage debt.[10] Debt forgiveness programs, such as the G20's Debt Treatment beyond the Debt Service Suspension Initiative, the Poverty Reduction and Growth Trust, and the Heavily Indebted Poor Countries initiative, generally require countries to be at high risk of, or already in, debt distress, or classified as having unsustainable debt (persistent debt crises). The DSA, which underpins many of these programs, focuses primarily on low-income countries, excluding middle-income countries with high debt-to-revenue ratios and constrained fiscal space from accessing such relief.[11]

Figure 1 below shows the distribution of countries based on their debt service-to-revenue ratio in 2024, color-coded by this DSA IMF's risk assessment. This comparison of debt payments as a percentage of government revenue accounts for the interest rates, the revenue available to the government for debt servicing, and the outflow of payments from the country, and it provides a more comprehensive measure of debt burden by considering both financial capacity and the external nature of debt obligations.[12]

As shown in Figure 1, many countries have high debt to revenue ratios though are not yet in debt distress or high risk. This means they face debt-related fiscal constraint but not the explicit debt crisis required to qualify for large relief programs. Debt Justice research shows that debt-to-revenue ratios exceeding 15 percent lead to spending cuts which inherently limits their ability to invest in all sectors, including climate change action. As a result, countries with high debt-to-revenue ratios but without an unsustainable debt classification are left to manage these challenges independently — where debt-for-nature swaps (DNS) could offer a potential solution for easing their fiscal burdens.

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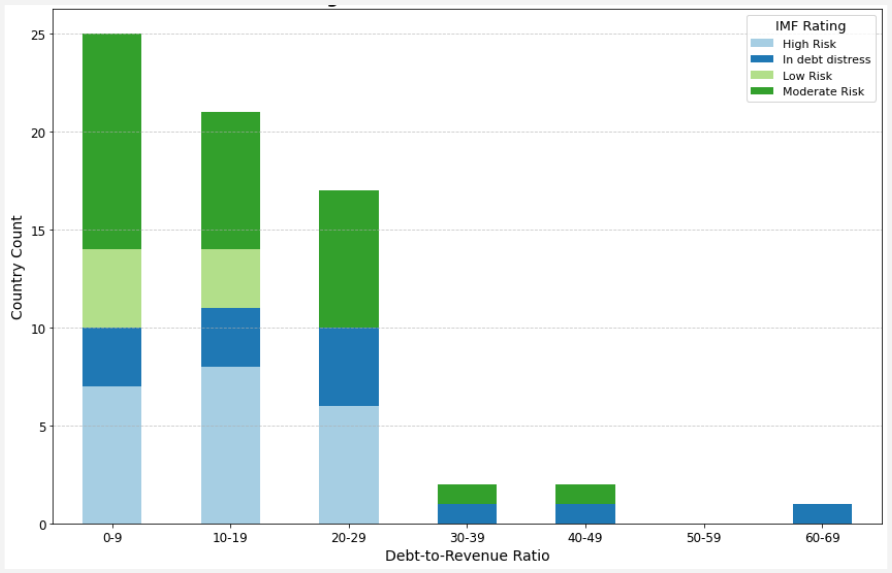
[9] Marcos d. Chamon, Erik Klok, Vimal V. Thakoor, and Jeromin Zettelmeyer, "Debt-for-Climate Swaps: Analysis, Design, and Implementation," International Monetary Fund Working Paper, August 12, 2022, https://www.imf.org/en/Publications/WP/Issues/2022/08/11/Debt-for-Climate-Swaps-Analysis-Design-and-Implementation-522184.

[10] International Monetary Fund, "Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-Income Countries," International Monetary Fund Policy Paper, February 14, 2018, https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf.

[11] International Monetary Fund, "Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative," accessed on October 2, 2024, https://www.imf.org/en/About/Factsheets/Sheets/2023/Debt-relief-under-the-heavily-indebted-poor-countries-initiative-HIPC; IMF, "Poverty Reduction and Growth Trust (PRGT)," accessed on October 2, 2024, https://www.imf.org/en/Topics/PRGT; Paris Club, "Common Framework for Debt Treatments beyond the DSSI," Paris Club, 2020, accessed on October 2, 2024, https://clubdeparis.org/sites/default/files/annex_common_framework_for_debt_treatments_beyond_the_dssi.pdf.

[12] Debt Justice, "Debt Data," Debt Justice, accessed on August 14, 2024, https://data.debtjustice.org.uk/.

Figure 1: IMF Risk Ratings across Debt-to-Revenue Ratios



Source: Author's representation of Debt Justice Debt Service score and IMF risk assessments.[13]

There are 31 LMIEs with 2024 ratios above 15 percent that are not being classified by the IMF as being in or at high risk of debt distress. Middle-income countries do not get a DSA IMF rating because the rating system focuses on low-income countries. For instance, Sri Lanka and Mongolia do not have a DSA rating and have rates exceeding 40 percent. A more comprehensive list of a subset of countries fitting this description is provided in Table 2 below.

Table 2: Countries That Could Implement Debt-for-Nature Swaps (2024)

REGION	COUNTRY	DEBT PAYMENTS TO REVENUE RATIO	IMF RATING
	Niger	10.4	Moderate
	Côte d'Ivoire	25	Moderate
	Angola	59.8	N/A
	Ghana	35.4	Moderate
Africa	Zambia	48.6	High
	Bolivia	9.9	N/A
	Colombia	18.2	N/A
	Belize	19.9	N/A
	Argentina	23.4	N/A
Latin America	Honduras	12.7	Low
	Myanmar	10.6	Low
	Bangladesh	15.5	Low
	Sri Lanka	43.5	N/A
Asia	Mongolia	48.1	N/A

Source: Author's representation of Debt Justice Debt Service score and IMF risk assessments.

[13] Debt Justice, "Debt Data," Debt Justice, accessed on August 14, 2024, https://data.debtjustice.org.uk/.

IV. DEBT FOR NATURE SWAPS MECHANISM

DNS are financial transactions where a portion of a developing country's foreign debt is transformed or forgiven in exchange for local conservation projects. This instrument initially appeared in 1987 as a response to the parallel crisis of increasing Global South debt burdens coupled with accelerating environmental degradation.[14] Since then, about 140 DNS agreements have been developed worldwide, with countries like Costa Rica, the Philippines, Belize, Ecuador, and Seychelles, among others participating.[15] DNS transactions usually involve three main parties – a debtor nation, a creditor, and a conservation organization. In these agreements, the creditor accepts to reduce or forgive a portion of the debtor's debt while the debtor commits to investing an agreed amount of the savings into specific conservation environmental projects.[16] There are three primary types of DNS agreements including bilateral, multilateral, and tripartite swaps as shown in Table 3 below.

Table 3: Types of DNS

TYPE OF DNS	DESCRIPTION	CASE STUDIES	LIMITATIONS
Bilateral DNS	Direct negotiations between the debtor country and a single creditor country.	Bolivia: Agreement with the United States to reduce debt in exchange for rainforest conservation.[17,18]	• Limited scope due to involvement of only two parties • Dependent on bilateral relations.
Multilateral DNS	Multiple creditor nations or financial institutions collaborating with the debtor nation.	Poland: Agreement involving multiple European countries and financial institutions for environmental projects.[19]	• Complexity in coordination among multiple creditors. • Higher administrative costs.
Tripartite DNS	Involves a third party, such as an NGO or environmental group, to facilitate and ensure project implementation.	Ecuador: Galápagos DNS facilitated by various stakeholders, including Credit Suisse, IDB, and US DFC, for marine conservation projects.	• Complexity in coordination among multiple creditors. • Requires effective third-party involvement. • Ensuring long-term commitment from all parties.

Source: Table created by the author utilizing classification from the African Development Bank Group and the Green Finance & Development Center.[20]

[14] Jocelyn Sims and Jessie Romero, "Latin American Debt Crisis," Federal Reserve History, November 13, 2013, https://www.federalreservehistory.org/essays/latin-american-debt-crisis.

[15] Mary Kate McCoy, "U.S., Peru trade debt for nature," Conservation International, September 7, 2023, https://www.conservation.org/blog/us-peru-trade-debt-for-nature#:~:text=In%201987%2C%20Conservation%20International%20brokered,heart%20of%20the%20Amazon%20Basin.

[16] Mengdi Yue and Christoph Nedopil Wang, "Debt-for-Nature Swaps in the Belt and Road Initiative (BRI)," Green Finance & Development Center February 1, 2021, https://greenfdc.org/debt-for-nature-swaps-in-the-belt-and-road-initiative-bri/.

[17] Chris Mooney, "Debt Relief for Nature: How Conservation is Becoming a Key Component in Global Financial Deals," *Foreign Policy*, June 25, 2024, https://foreignpolicy.com/2024/06/25/debt-relief-nature-swap-conservation-environment-climate-change/#:~:text=The%20inaugural%20nature%20swap%20occurred,of%20the%20Beni%20Biosphere%20Reserve.

[18] African Development Bank Group, "Debt-for-Nature Swaps: Feasibility and Policy Significance in Africa's Natural Resources Sector," African Development Bank Group, October 2022, https://www.greenpolicyplatform.org/sites/default/files/downloads/resource/debt-for-nature-swaps.pdf.

[19] Ibid.

[20] African Development Bank Group, "Debt-for-Nature Swaps: Feasibility and Policy Significance in Africa's Natural Resources Sector," African Development Bank Group, October 2022, https://www.greenpolicyplatform.org/sites/default/files/downloads/resource/debt-for-nature-swaps.pdf; Mengdi Yue and Christoph Nedopil Wang, "Debt-for-Nature Swaps in the Belt and Road Initiative (BRI)," Green Finance & Development Center February 1, 2021, https://greenfdc.org/debt-for-nature-swaps-in-the-belt-and-road-initiative-bri/.

Debt-for-nature swaps (DNS) have regained popularity as a tool to finance environmental conservation. After Ecuador's DNS swap in 2022, the largest one to date, many countries including Cabo Verde, Eswatini, Gambia, Kenya, Pakistan, and Sri Lanka, are contemplating debt-for-climate swaps to achieve debt relief.[21]

V. THE GALAPAGOS DNS

DNS Mechanism

The Galápagos DNS is a landmark deal that exemplifies the potential of the instrument in addressing both economic and environmental challenges. Finalized in 2022 and structured by Credit Suisse, this transaction is the largest DNS to date. The deal involved issuing an 18.5-year bond worth $656 million to refinance $1.6 billion of Ecuador's international bonds, effectively reducing Ecuador's debt stock by nearly $1 billion (approximately 1.51 percent of the total debt in 2022) and achieving a debt service cost reduction of $1.5 billion (around 2.26 percent of total debt service costs in 2022).[22]

Central to the swap's success was the issuance of a blue bond, an innovative financial instrument directly linked to marine conservation. By tendering bonds maturing between 2030 and 2040 at an average price of 40 percent, Ecuador secured a significant debt reduction of $656 million.[23] This blue bond attracted investors seeking both financial returns and environmental impact. The deal's design, incorporating an Inter-American Development Bank (IDB) guarantee and U.S. International Development Finance Corporation (DFC) political risk insurance, enhanced investor confidence and ensured the transaction's viability.

The transaction was supported by various stakeholders, including environmental, social, and governance (ESG) investors like IDB, DFC, and private insurers, who helped raise funds. Oceans Finance Company (OFC), a portfolio company of Climate Investor Two (CI2) managed by Climate Fund Managers, played a crucial advisory role, providing early-stage development capital and ongoing project management throughout the transaction's lifespan. The DNS also committed Ecuador to making 74 quarterly conservation payments over 18.5 years, ensuring sustained investment in conservation efforts. Figure 2 provides a detailed flowchart of the DNS process.

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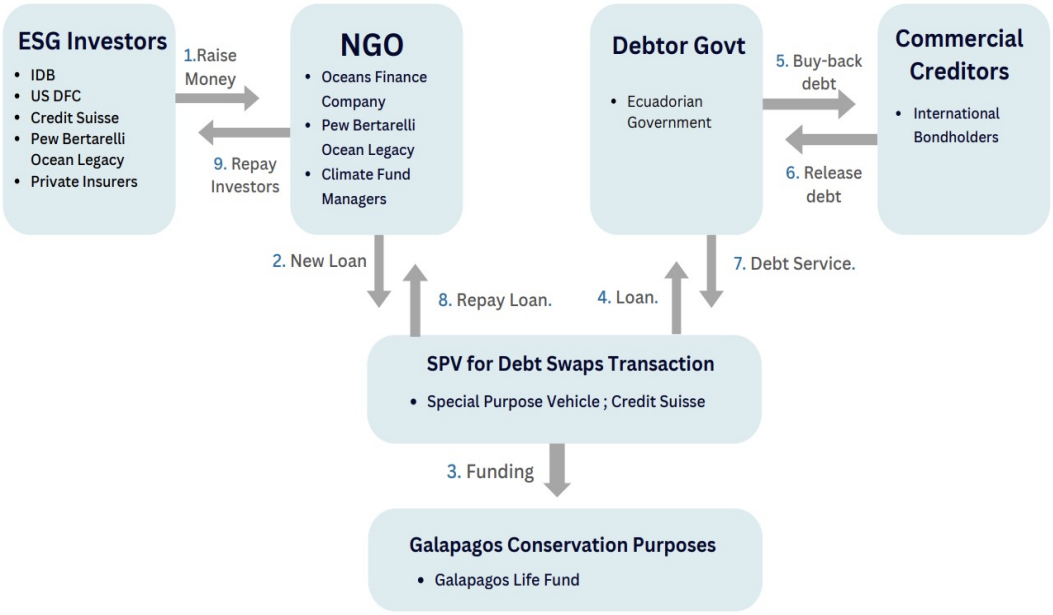
[21] Gautam Jain, Luisa Palacios, and Harry Verhoeven, "Can Debt-for-Climate Swaps Help Heavily Indebted Developing Countries Address Climate Priorities? ," Columbia University Center on Global Energy Policy, September 1, 2023, https://www.energypolicy.columbia.edu/wp-content/uploads/2023/09/DebtClimateSwaps-Commentary_CGEP_090123.pdf.

[22] Environmental Finance, "Impact project/investment of the year - oceans and coastal zones; Impact initiative of the year, global: Debt conversion for marine conservation in the Galapagos Islands," Environmental Finance, 2023, https://www.environmental-finance.com/content/awards/impact-awards-2023/winners/impact-project/investment-of-the-year-oceans-and-coastal-zones-impact-initiative-of-the-year-global-debt-conversion-for-marine-conservation-in-the-galapagos-islands.html.

[23] Environmental Finance, "Impact project/investment of the year - oceans and coastal zones; Impact initiative of the year, global: Debt conversion for marine conservation in the Galapagos Islands," Environmental Finance, 2023, https://www.environmental-finance.com/content/awards/impact-awards-2023/winners/impact-project/investment-of-the-year-oceans-and-coastal-zones-impact-initiative-of-the-year-global-debt-conversion-for-marine-conservation-in-the-galapagos-islands.html.

Figure 2: The DNS Process Flowchart



Source: Author's representation of IMF flowchart.[24]

Before the swap, Ecuador faced a total debt service obligation of $2.725 billion, comprising $1.629 billion in capital and $1.096 billion in interest. After the DNS, the debt service obligation was reduced to $1.599 billion, resulting in net savings of $1.126 billion. These savings were allocated as $624 million towards capital reduction and $502 million towards interest savings. Additionally, the DNS facilitated a $333 million donation to the Galápagos Life Fund (GLF), which, combined with the savings, contributed to a total financial benefit of $1.459 billion. Figure 3 illustrates the financial transformation resulting from the DNS.

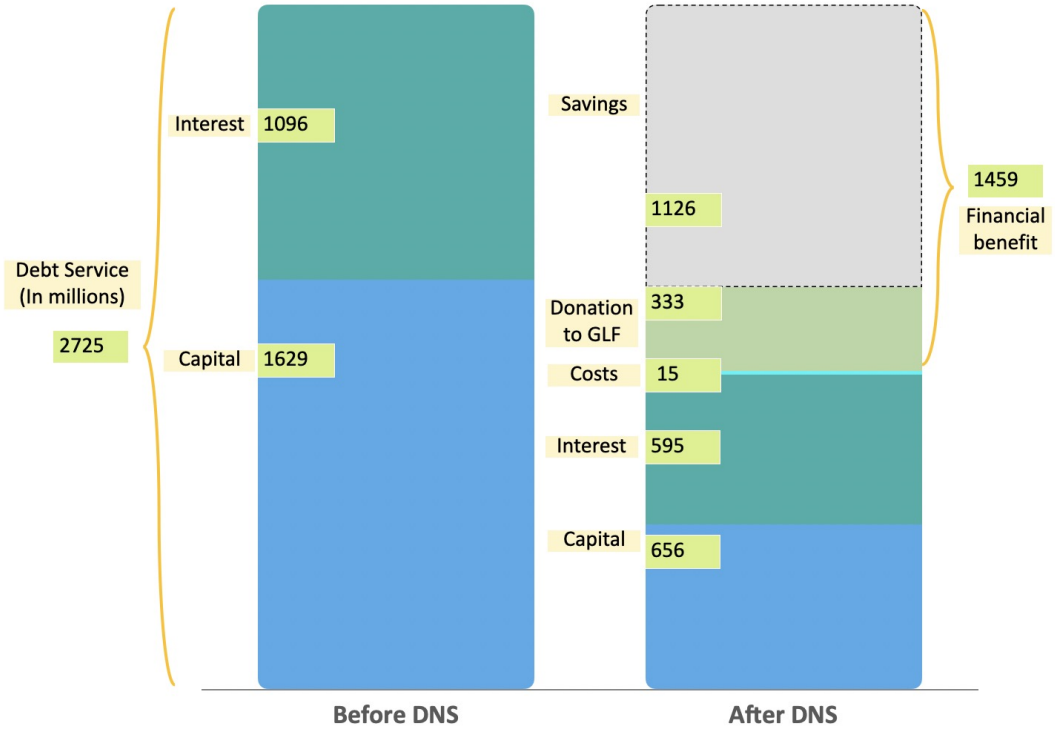
The comprehensive benefits of the DNS include a net savings of $1.126 billion in debt service costs for Ecuador with $624 million allocated to capital reduction and $502 million to interest payments. Additionally, the $333 million donation from GPS Blue to the GLF will finance grants and capitalize the endowment, resulting in a total benefit of $1.459 billion to Ecuador.[25] Without this deal, these funds would have left the country. Instead, they are reinvested in Ecuador, securing lasting environmental and economic benefits and setting a precedent for future debt management and conservation efforts.

In total, the DNS allocated $450 million to conservation efforts in the GLF, including the previously mentioned $333 million from GPS Blue. Of this amount, $223 million

[24] International Monetary Fund, "Debt-for-Climate Swaps: Analysis, Design, and Implementation," International Monetary Fund Working Paper, August 11, 2022, https://www.imf.org/en/Publications/WP/Issues/2022/08/11/Debt-for-Climate-Swaps-Analysis-Design-and-Implementation-522184; Justin Villamil, "Ecuador's Blue Bond Deal Won't Save the Galapagos," *Jacobin*, June 2023, https://jacobin.com/2023/06/ecuador-blue-bond-deal-galapagos-debt-sustainability-conservation.

[25] IDB News, "Ecuador Completes World's Largest Debt-for-Nature Conversion with IDB and DFC Support," Inter-American Development Bank, May 9, 2023, https://www.iadb.org/en/news/ecuador-completes-worlds-largest-debt-nature-conversion-idb-and-dfc-support.

Figure 3: Ecuador Debt Service Before and After DNS



Source: Author's representation of debt transformation by Galapagos Life Fund and IDB reports.[26]

will be used during the life of the agreement with an additional $227 million endowed at its conclusion. Furthermore, $100 million was invested in a fund that is projected to grow to $227 million, generating an ongoing annual income of approximately $15.9 million in perpetuity starting from year 18.5 onward.[27]

This transaction not only eases Ecuador's financial burdens but also secures long-term investment in the Galápagos, fostering both economic stability and environmental sustainability and setting precedence for prioritizing environmental spending.

The Guarantees: Financial De-Risking

To ensure the success of the transaction and mitigate risks, the deal was backed by a $656 million political risk insurance policy from the DFC and an $85 million guarantee from the IDB to cover the first six quarterly interest coupons in case of default.[28] The political risk coverage protects against breaches of arbitration awards and denial of recourse, ensuring that stakeholders are safeguarded against non-payment from Ecuador. These measures enabled the Galápagos Bonds to receive a better credit rating than Ecuador's bond rating.[29] Table 4 summarizes the key measures and their impacts.

[26] "Internal Report on Debt for Nature Swap Galápagos Life Fund, unpublished document; IDB News, "Ecuador Completes World's Largest Debt-for-Nature Conversion with IDB and DFC Support," Inter-American Development Bank, May 9, 2023, https://www.iadb.org/en/news/ecuador-completes-worlds-largest-debt-nature-conversion-idb-and-dfc-support.

[27] "Internal Report on Debt for Nature Swap Galápagos Life Fund," unpublished document

[28] Coface, "Debt-against-Nature: Coface Provides Reinsurance in Largest Deal in History," Coface, June 30, 2023, https://www.coface.com/news-economy-and-insights/debt-against-nature-coface-provides-reinsurance-in-largest-deal-in-history.

[29] Moody's Ratings, "Debt-for-Nature Swap," Moody's Ratings, May 5, 2023, https://ratings.moodys.com/ratings-news/402314.

Table 4: De-Risking Measures

MEASURE	IMPACT
Political risk insurance by DFC	Enhanced creditworthiness
IDB's $85 million unfunded guarantee	Supported liquidity reserves
CREDIT RATING	**RESULT**
Ecuador's original rating	Caa3 (Moody's)
Galápagos Bonds rating	Aa2 (Moody's)
Upgrade	16-notch improvement

Source: Author's representation based on Moody's credit rating and IDB details on DNS.[30]

The Environmental Impact

The swap supports Ecuador's goals for biodiversity and sustainability, aligning with the Global Biodiversity Framework from COP 15.[31] The Galápagos Marine Reserve, covering 13 large islands over 40 nautical miles, is home to over 3,500 species, including many endemic marine organisms and mammals. These reserves are crucial for Ecuador's tourism and artisanal fishing sectors, highlighting the significant economic and environmental benefits of the Galápagos DNS.

As part of the DNS, the GLF was created to ensure that the environmental commitments of the deal are fully realized. The GLF focuses on key areas such as monitoring, enforcement, sustainable fisheries management, and environmental education. Funded through blue bonds expected to generate over $12 million annually, the GLF provides sustained financial support for conservation efforts in the Galápagos[32].

The success of the Galápagos DNS provides a valuable blueprint for future DNS structures. By effectively combining debt reduction with substantial conservation funding, risk mitigation, and investor engagement, this case sets a precedent for innovative financial mechanisms that address both fiscal and environmental challenges. The GLF's ability to provide grants and sustain an endowment for perpetual conservation funding further exemplifies the potential for DNS to create long-term positive impact.

[30] Moody's Ratings, "Debt-for-Nature Swap," Moody's Ratings, May 5, 2023, https://ratings.moodys.com/ratings-news/402314; "Ecuador Completes World's Largest Debt-for-Nature Conversion with IDB and DFC Support," Inter-American Development Bank, accessed on August 14, 2024, https://www.iadb.org/en/news/ecuador-completes-worlds-largest-debt-nature-conversion-idb-and-dfc-support.

[31] IDB News "Ecuador Completes World's Largest Debt-for-Nature Conversion with IDB and DFC Support," Inter-American Development Bank, May 9, 2023, https://www.iadb.org/en/news/ecuador-completes-worlds-largest-debt-nature-conversion-idb-and-dfc-support.

[32] Environmental Finance, "Investment of the Year: Oceans and Coastal Zones Impact Initiative of the Year—Global Debt Conversion for Marine Conservation in the Galápagos Islands," Environmental Finance, 2023, https://www.environmental-finance.com/content/awards/impact-awards-2023/winners/impact-project/investment-of-the-year-oceans-and-coastal-zones-impact-initiative-of-the-year-global-debt-conversion-for-marine-conservation-in-the-galapagos-islands.html.

LESSONS FROM THE GALAPAGOS SWAP

The Galapagos debt-for-nature swap offers valuable insights into the potential of debt-for-nature swaps (DNS) as a tool for conservation finance. Leveraging a blue bond and a strong public-private partnership, demonstrated the ability to mobilize significant financial resources for environmental protection. By reducing debt service costs and providing dedicated funding for marine conservation, the swap displayed the potential for achieving both fiscal and environmental objectives. The financial de-risking mechanism was a crucial component of the Galapagos debt-for-nature swap, enhancing its profitability and that could be replicated for future DNS.

Challenges in Implementation

Despite its successes, the Galápagos DNS has faced challenges. The complex negotiations involving multiple stakeholders and the need for extensive risk insurance highlighted the difficulties in structuring such deals. Moreover, the structure of the GLF, while innovative, raises questions about governance and potential conflicts of interest. With a majority of the board composed of external stakeholders, concerns emerged regarding Ecuador's control over the allocation and utilization of these funds. Critics argue that this arrangement could potentially limit the fund's ability to achieve specific objectives, raising concerns about the alignment of priorities between the fund's governance and Ecuador's national interests.

Challenges in Replication

While the Galapagos Islands' global appeal facilitated investor interest in the debt-for-nature swap, other regions may face challenges in attracting similar levels of investment. Effective marketing and a strong commitment to environmental goals are essential to overcome these hurdles. By showcasing the unique features of conservation projects and aligning them with national priorities, countries can enhance their appeal to potential investors.

Diversifying the types of environmental projects eligible for DNS can also expand the reach of this innovative financing mechanism. Initiatives related to energy development, climate mitigation, or reforestation can be particularly attractive to investors seeking both environmental and economic returns. Aligning these projects with nationally determined contributions (NDCs) can further strengthen their appeal and contribute to global efforts to combat climate change.

By addressing these challenges and seizing these opportunities, countries can broaden the applicability of debt-for-nature swaps and unlock their full potential as a tool for sustainable development and environmental conservation.

Key Lessons from the Galápagos DNS

1. **Scale Matters:** The Galápagos DNS highlights the importance of scale in maximizing the impact of debt-for-nature swaps. By raising significant loan capital directly from capital markets, the transaction demonstrated that scaling up DNS initiatives can amplify both debt relief and environmental outcomes. Replicating this model with larger transactions will allow countries to make greater strides in conservation

while addressing fiscal pressures. Future DNS efforts should aim to attract larger investor pools and tap into global financial markets for more substantial funding.

2. **Innovative Financial Instruments:** A key element of the Galápagos DNS was the integration of blue bonds which appealed to investors seeking both financial returns and environmental outcomes. This innovative approach is crucial, as it not only directed funds to marine conservation but also demonstrated the potential for similar instruments — such as green bonds or impact investment funds — to be deployed in other contexts. The success of blue bonds in the Galápagos underscores the need for continuous evolution in financial tools that support environmental goals, particularly in regions where ecosystems are vulnerable.

3. **Financial De-Risking:** The incorporation of political risk insurance and credit guarantees in the Galápagos transaction was essential for reducing investor risk and making the bonds more attractive. This de-risking strategy, which helped mitigate concerns over sovereign risk, is a critical component of DNS transactions in countries with perceived higher political or financial instability. By providing these assurances, future DNS deals can enhance investor confidence and ensure greater participation in conservation financing, particularly in LMIEs.

4. **Evolving Financial Instruments for LMIEs:** The Galápagos swap exemplifies the evolving nature of financial instruments in conservation finance. It serves as a call to action for LMIEs to creatively adapt and modify these tools to address their unique debt challenges. As these countries seek to manage their debt sustainably, there is an opportunity to tailor DNS mechanisms, incorporating elements like impact bonds or sustainability-linked loans. This flexibility allows LMIEs to customize financial instruments to their specific environmental and fiscal needs, maximizing the benefits of debt relief and conservation efforts

CONCLUSION

The Galápagos debt-for-nature swap stands as a powerful example of how innovative financial mechanisms can simultaneously address debt and environmental issues. By combining fiscal relief with targeted conservation efforts, it paves the way for future DNS initiatives to mitigate the financial strain of indebted countries. The key to expanding the success of DNS lies in scaling up these efforts, ensuring robust financial de-risking, and adapting instruments like blue and green bonds to diverse regional contexts. For low- and middle-income economies, the creative application of DNS presents an opportunity to reshape their debt burdens while advancing sustainable development goals.

While the current use of DNS as discussed in this paper does not directly secure funds for climate mitigation or adaptation to address the growing threats of climate change, it initiates critical conversations about climate finance. By fostering international partnerships and validating conservation and climate projects as legitimate areas for investment, DNS helps to strengthen the global framework for climate action. In the future, DNS could also expand to target climate mitigation and adaptation efforts by further broadening the scope of its projects.

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