FDL Finance for Development Lab

Debt For What Swaps?

Guiding principles for the allocation of debt swap resources

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Introduction

Since their emergence as financial instruments, debates have revolved around whether debt swaps could represent a satisfactory solution to the intertwined crises of debt, development, and climate. Supporters have sometimes presented them as silver bullets that could be applied at scale, while detractors argue that swaps are not sufficient and may have detrimental consequences. Following a series of transactions in recent years, the debate has moved on. Debt swaps are now considered a tried and tested tool in the development finance toolkit, prompting us to explore how to optimize their use while being mindful that they may not universally fit every situation governments come to face.

This paper examines the financial flows resulting from debt swap arrangements as a tool for public finance. We argue that insufficient attention has been given to the unique characteristics of these flows, which stand out in the world of development finance for their long-term, regular, and predictable nature, often alleviating rather than increasing debt burdens. The distinctive structure of these flows and the legal obligations behind them warrant careful consideration to harness their unique potential for advancing development outcomes.

A shift in perspective leads us to a more sector-agnostic approach. Since the essence of swaps is to deliver long-term, predictable financing, projects and programs requiring such cash flow needs are optimal candidates for swaps. While nature conservation is a prominent example, other sectors can similarly take advantage of swap resources. We, therefore, focus on the types of outcomes and spending that would be optimally supported by debt swap resources. Specifically, by bridging the legal, economic, financial, and operational dimensions of debt swaps, we suggest three guiding principles to unlock their potential: (1) Define a long-term vision of what can be achieved through swap resources, (2) Target expenditures that particularly benefit from long-term financing, and (3) Establish mechanisms to ensure additionality with government spending.

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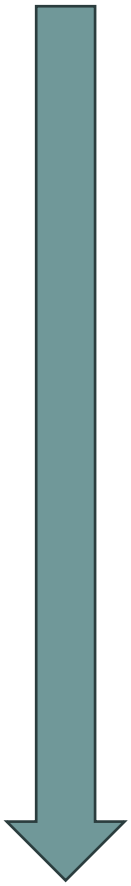
1. An Evolution From Bilateral To Trilateral Debt Swaps

Bilateral debt swaps represent the "classical" approach whereby a sovereign bilateral creditor agrees to provide debt relief to a sovereign debtor, with at least part of the resulting savings directed towards mutually agreed development or climate projects. Bilateral debt swaps represent a transfer of resources from a donor (the creditor) to a recipient (the debtor) and are, importantly, counted as official development aid by the OECD[1], as they rely on a donor's generosity.

Since 2021, the more recent trilateral debt swaps have involved the buyback and refinancing of privately held sovereign debt[2], backed by large, costed credit enhancement. This credit enhancement allows the refinancing operation to be executed at more favorable terms than market rates, resulting in significant savings for the government. These transactions have been intermediated by international non-governmental organizations (NGOs) that support the design, implementation, and monitoring of projects funded by the resources generated from the swaps.

A trilateral debt swap financial structure usually consists of four stages:



Stage 1: *Mobilization of funds*. A special purpose vehicle (SPV), specifically set up for this transaction, will issue a new bond at enhanced terms with the support of credit enhancement.

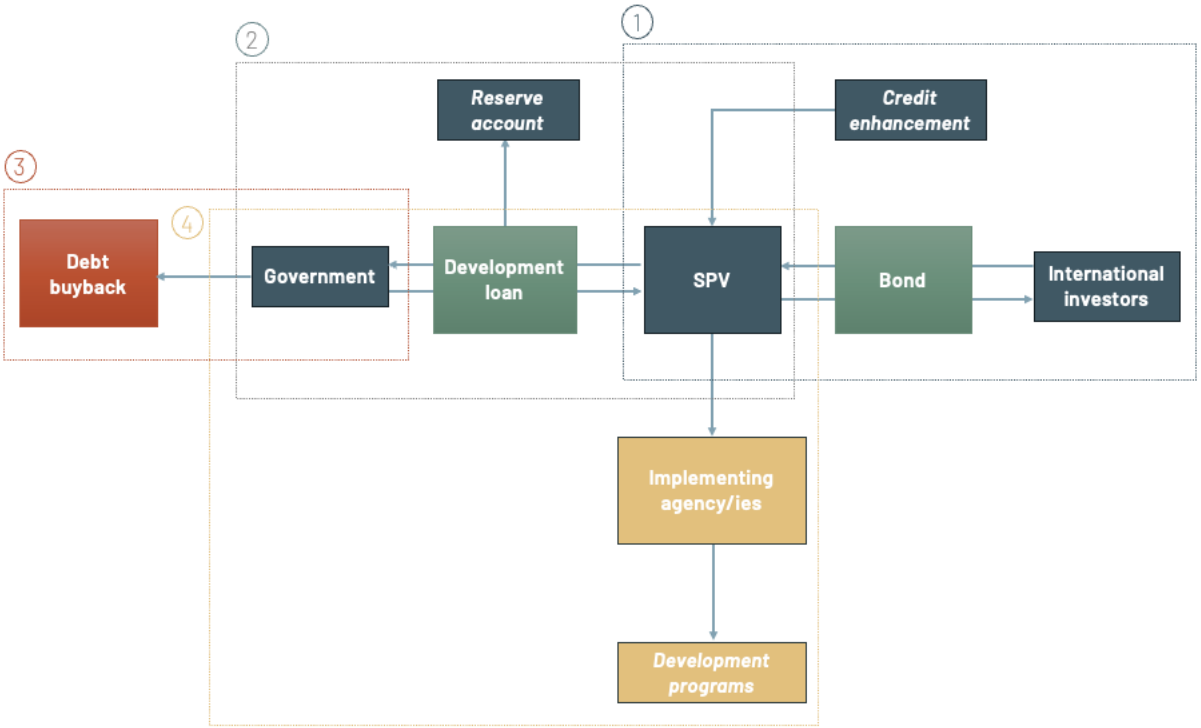
Stage 2: *Retrocession of funds*. The SPV on-lends the funds raised through a loan to the government. In parallel, a liquidity bridge is set up to cover bondholders' payments for the duration of the arbitration process – which could be achieved through a reserve account[1].

Stage 3: *Debt buyback*. The government uses the loan proceeds to buy back a share or the entirety of its outstanding bonds, potentially at a discount, thereby reducing its level of indebtedness and/or extending maturity.

Stage 4: *Reimbursement of the development loan and financing of a development program*. The government repays the loan installment to the SPV, which then allocates a pre-agreed share of the debt service to fund a development program[1]. The remainder is used to repay investors and cover fees.

[1] DAC Working Party on Development Finance Statistics Converged Statistical Reporting Directives for the Creditor Reporting System (CRS) and the Annual DAC Questionnaire.
[2] Thus far, on the bonds secondary market, where debt can trade at a discount.

Financial structure of a debt swap:



This paper focuses on trilateral debt swaps rather than bilateral ones for several reasons:

- **They represent a more recent evolution in financial engineering**, and, as a result, they have been less investigated than bilateral debt swaps despite their inherent complexities. Their unique characteristics warrant a separate analysis.

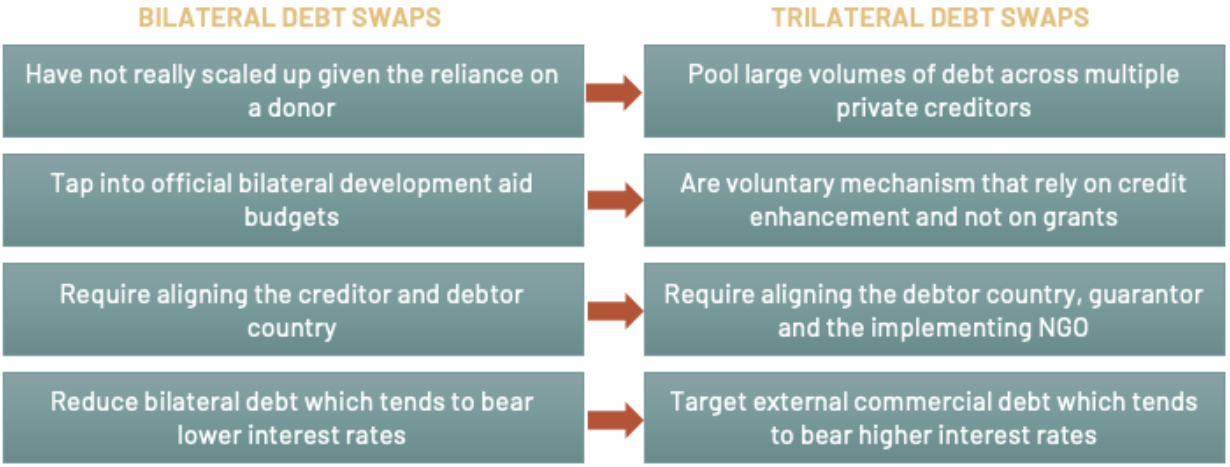
- **As a voluntary market mechanism, a trilateral debt swap is, by design, less subject to foreign political interference than bilateral debt swaps (not that they are immune to it).** This means that the debtor country could drive a significant part of the process and ensure it is optimally designed and aligned with their government priorities[1]. Nevertheless, trilateral debt swaps require more coordination in aligning the debtor country, the credit enhancer, and the implementing partner, which can be an NGO – all of which have a say.

- **Trilateral debt swaps should continue to account for significantly higher financial volumes compared to bilateral debt swaps on a transaction basis**. This is driven by several structural factors: (1) since they do not rely on mobilizing fresh donor funding, trilateral debt swaps do not face the same budget constraints as bilateral ones, (2) there are considerable fixed transaction costs involved in initiating a debt swap, which justifies aiming for scale, (3) they often aim to meaningfully reduce debt burdens and, sometimes, could entirely refinance targeted bond maturities.

- **Trilateral debt swaps are particularly relevant in the current macrofinancial context of higher interest rates and lower liquidity.** Given the increased refinancing risks for many low and middle-income countries (LMICs), governments are more and more looking at asset liability management operations, of which trilateral debt swaps could be an attractive option when conditions are favorable – at least from a financial standpoint.

Because of those idiosyncrasies, this paper will be focusing on trilateral debt swaps. For ease, we will be using "swaps" or "debt swaps" when referring to trilateral debt swaps in the remainder of this paper.

Some key differences between bilateral and trilateral debt swaps:



By the end of 2024, nine debt swaps have been applied in seven countries (Belize, Barbados, Ecuador, Gabon, Bahamas, El Salvador, and Cote d'Ivoire), unlocking close to $1.7Bn of nominal financing over time. Five of these swaps have supported marine and coastal protection, in line with the global commitment to conserve and manage at least 30% of marine and coastal areas by 2030, and two have supported nature conservation. However, as we have seen at the end of 2024 with education and climate-focused debt swaps, there is nothing uniquely specific to marine or nature conservation that makes a debt swap a particularly good fit to further such ambitions. The Nature Conservancy (TNC), which has created the structure and has been involved in most of the operations thus far, is a trailblazer in leading such operations through its Nature Bonds program and, as such, has built a solid first-mover advantage. Other organizations, such as the World Bank, the World Food Program, the Global Partnership for Education, and the Global Fund, have also engaged in similar debt swap operations to support food security, education, and health projects.

Bilateral debt swaps have been applied to sectors as diverse as nutrition (Egypt, 2020), health (Debt2Health, ongoing), education (El Salvador, 2005), water and sanitation (Ghana, 2016), nature (Bolivia, 1987), climate (Seychelles, 2015) or even equity (Chile). Given the lack of obvious sectoral dominance for bilateral debt swaps, it is intriguing to observe how much marine and nature conservation has prevailed as the dominant sector for trilateral debt swaps. In the following section, we will break down what makes debt swap resources unique, and in the subsequent section, whether there is a rationale for sectoral dominance.

2. Debt Swaps Are Long-Term Predictable Financial and Legal Commitments Involving Multiple Stakeholders

Debt swap financial specifics can sometimes distract observers from their core nature. What makes such transactions unique, and what allows them to solve some problems, includes:

1. The **length of the financial commitment**, which goes well beyond the usual economic and political cycles;
2. An **institutional and legal framework** capable of withstanding shocks and system changes; and
3. A context involving an **alliance of multiple stakeholders.**

This section illustrates how debt swaps transactions differ from other typical government or development finance commitments.

a. A long-term commitment

While each swap can have distinctive features, trilateral debt swaps typically rely on three main pillars to further outcomes:

- Sectoral goals: similar to sustainability-linked bonds (SLBs) or World Bank results-based financing, the government commits to time-bound and measurable outcomes over the time of the new loan. For the four marine conservation-focused debt swaps, goals have been defined based on experts' engagement as well as stakeholder consultation – the latter, Eurodad (2023) argues, needs to be strengthened. As mentioned by the OECD (2023), conservation plans that stem out of this process are then translated into *"conservation implementation milestones that span 15 to 20 years. Conservation commitments have associated milestones"* that end up *"built into the financial transaction. Failure to meet those obligations is associated with financial penalties, which means that government agencies have a strong incentive to meet their commitments"*[1].

- Trust Fund: a dedicated fund is created to finance conservation projects. As per requirements from the US Development Finance Corporation (DFC)[1], and international best practices, the fund needs to be governed by a diverse board where the government represents a minority share, alongside international partners, the private sector, and, in some cases, civil society. The fund's role is to receive payments from the government, usually in local currency, and identify the projects it seeks to fund. An escrow account can also collect penalties if the government fails to meet conservation milestones, which it can hold and refund if the government ends up complying with the commitments.

- An Endowment Fund: the endowment will capitalize pre-funded investments and will ensure projects continue after the loan matures. In line with TNC (2022), we hypothesize in this paper that drawdowns from the endowment will replicate government's payments after yearly payments to the Trust Fund cease.

By virtue of their structuring, swaps unlock long-term, regular and predictable financial flows. From a financial standpoint, a debt swap tends to be initiated when the government is facing some debt service repayment challenges that would benefit from an asset liability management operation, extending maturities over time. The refinancing operation typically builds upon the issuance of a new bond with a longer maturity than the average one it replaces, matching the payment to the conservation trust fund – in part to enhance the nominal value of resources unlocked. Lastly, the flow of resources

needs to be structured to align with the country's absorptive capacity in the sector receiving the funding.

As a result, the four debt swaps closed by mid-2024 are expected to unlock more than 500M$ for marine conservation funding over less than 20 years - with Ecuador representing more than two-thirds of these resources. In contrast, the 48 traditional debt-for-nature swaps conducted between 1987 and 2008 led to the release of 150M$ of funds invested in projects, averaging about 3M$ per swap operation (Eurodad, 2023). In addition, at the end of the transaction, the duration of the project will be further extended by unlocking the endowment fund, which will then become available and extend the conservation trust's lifetime and ability to support projects for multiple years, with a total expected endowment of 334M$ for the four countries (with Ecuador representing 38% of that total amount).

Table 1: Conservation funding coming out of the four debt swaps (in $M)

Country	Yearly payments	Total flows	Endowment*	Total
Belize	4.2	84	94	178
Barbados	1.5	22.5	27.5	50
Ecuador	17.5	323	127	450
Gabon	5	75	88	163
***Estimated value at the end of the project**				

Assuming that yearly payments remain nominally constant after the endowment is unlocked[3], the lifetime of the marine conservation programs would be further extended by 22 years for Belize, 18 years for Barbados, 7 years for Ecuador, and 18 years for Gabon. Based on this hypothesis, the debt swap programs could run for as long as 33 years on average across the four debt swaps – an unusually long commitment timeline.

Table 2: Hypothetical length of the program (in years)

Country	Pre endowment duration	Extension after the endowment is unlocked*	Total length of the program*
Belize	20	22	42
Barbados	15	18	33
Ecuador	18.5	7	26
Gabon	15	18	33
***Assuming constant nominal payments flows**			

[3] Currently, endowments provide payments without a final term.

b. A uniquely robust legal and financial structure

A swap agreement is based on a long-term horizon with multiple players. However, governments frequently break promises or commitments when there is a change in policy priorities. How would swaps be different? After all, swaps are implemented over a long period of time (more than 20 years, and potentially over 40 in the case of Belize), and much can happen that can upend the existing equilibrium, from financial crises, drastic changes in the governing coalition, or major external shocks, which can be climate, health or conflict related.

The question of ensuring government commitment to sectoral spending is therefore a key dimension of the transaction. Without a strong commitment that would be at least *de facto* senior to the government's medium-term budget policy statements (which are routinely overridden), there is a strong chance that the swap agreement will not be implemented as initially conceived. More than that, and as is reflected by the IMF (2022), the *raison d'être* of debt swaps against conditional grants comes from the seniority of the underlying spending commitment vis-à-vis debt service. It would be unusual for a debt swap to yield superior outcomes than conditional grants in a scheme that does not rely on grant funding, which is currently scarce for LMICs and is trending downwards despite the needs (UNCTAD, 2023).

To answer this question, we will dive into the legal and financial agreements of the recent debt swap transactions, relying on the analysis made by Fontana-Raina and Grund (2024) of the Belize swap. In the case of Belize, conservation finance is based on two components:

- An upfront endowment of $23.5M which will only be accessible in 2041 when it is expected to grow to $94M (assuming 7% annual growth). This portion is, by design, secured.
- An agreement with the government to make local currency quarterly contributions amounting to $4.2M per year over 20 years.

In addition to those, Belize committed to eight conservation milestones, each of which has a deadline and requires the government to take measures to enhance ocean protection and further biodiversity. If the government does not comply with any of these milestones within a 6-month grace period, payments to the conservation fund would increase by $1.25M annually for the first missed milestone and then by an additional $250K for each additional missed milestone. Importantly, once all milestones are met, the additional payments go back to the government, and if milestones are never met, the funds remain within the conservation trust fund.

Table 3: Sectoral goals for the Belize debt swap[4]

Milestone	Due date
Expand Biodiversity Protection Zones to 20.5% of Belize's Ocean, from 16.5% prior to the project	5/4/2022
Designate Public Lands within the Belize Barrier Reef Reserve System as Mangrove Reserves	5/4/2022
Initiate the process of developing a Marine Spatial Planning (MSP) for Belize's Ocean	11/4/2022

[4] TNC, First Annual Impact Report, Belize Blue Bonds for ocean conservation (2023)

Expand Biodiversity Protection Zones to 25% of Belize's Ocean	11/4/2024
Approve, sign into law, and gazette the revised Coastal Zone Management Act and Integrated Coastal Zone Management Plan	11/4/2025
Expand Biodiversity Protection Zones up to 30% of Belize's Ocean; MSP completed, approved, signed into law, gazetted and implemented	11/4/2026
Apply to have at least 3 designated marine protected areas in Belize listed as IUCN Green List Areas	11/4/2027
Approve Management Plans for the Biodiversity Protection Zones	11/4/2029

Under this structure, payments to the conservation trust fund and the achievements of critical milestones are legally tied to the blue loan[5].

A cross-default clause could cause a failed payment to the conservation fund to trigger a default under the blue loan, which would then accelerate the entire unpaid principal amount of the loan, making it immediately payable. If Belize remains unable to make the payment, the DFC insurance would be triggered provided an arbitral award is granted. Similarly, failure to meet certain major sectoral milestones beyond a cut-off date may also trigger a loan default, resulting in the acceleration of the loan (TNC 2024). The activation of cross-default clauses in such instances remains a relatively unlikely scenario given the major consequences it would entail, but the potential for triggering them should exert a strong disciplining effect.

What this means in practice is that if the Belize government decides to stop making payments on the loan, or reneges on its commitment to achieving the milestones, the flow of funds that irrigate the whole transaction structure (cf. graph 1, financial structure of a debt swap) could cease. In that case, the DFC insurance would be triggered, and the US government would become, by far, Belize's largest creditor[6]. This might, in turn, undermine its relations with its principal trading partner – in addition to causing significant reputational damage given the high-profile nature of the transaction. An important addition is that the Belize government has fewer incentives to default on the conservation trust fund payments since these are in local currency and lead to spending that directly benefits the country with significant oversight from the government. These aspects suggest, in line with IMF (2022), that payments to the conservation trust fund would be considered *de facto* senior to other debt commitments given the reputational, political, and financial costs of defaulting.

The strength of the commitments underpinning a debt swap is striking when compared to other financial tools designed to bring private finance to support development and climate objectives.

The issue of "greenwashing" regarding use of proceeds bonds (e.g. green or social bonds) is well known (Baker McKenzie, 2019). Following the ICMA guidelines, these bonds lack any enforceable mechanisms for ensuring the green or social aspects are upheld. In addition, the issuing government has full latitude in determining which expenditure would be considered in line with the green or social commitments. Curtis et al. (2023) have investigated over 1000 green bonds and found that climate commitments were

[5] The Blue loan is the loan issued by the SPV (which, in the case of Belize, is the Belize Blue Investment Company), the proceeds of which were then lent to the government of Belize.
[6] By end 2023, Belize's external debt represents 41.8% of GDP, about 1,276M$. With a total DFC political risk insurance of 610M$, if Belize was to trigger the entirety of the insurance, the US would hold close to 48% of Belize's external debt.

vague and that failure to comply would not trigger any penalties. The only remaining commitment mechanism is the reputational risk of not abiding by the commitments set out. SLBs, thus far only issued by Chile and Uruguay in 2022, take the commitment one step further by including a coupon step-up for missed targets and a step-down for exceeding targets. Importantly, in the case of an SLB, penalties are directed towards creditors, whereas in the case of swaps, they are allocated to sectoral priorities. However, beyond these interest rate penalties, missed targets would not represent an event of default, and bondholders cannot ensure compliance.

In contrast, the Belize swap creates an array of interlinked legal and financial commitments that strongly incentivize compliance with both the trust fund payment and the sectoral targets. Emerging best practices (TNC, 2024) suggest that missing major sectoral milestones beyond a cut-off date would trigger a loan default, resulting in the acceleration of the loan. This puts tripartite debt swaps at the most robust end of the spectrum, elevating the strength of the underlying climate or social commitment. Overall, Fontana-Raina and Grund (2024) argue that "the credible climate conservation commitments made by Belize represent an important evolution in the legal structure of green sovereign finance".

While we have not reviewed the legal and financial agreements of other swap deals, the broader point here is that it is possible to structure those in a way that development spending is de facto senior to debt service over a long-term horizon, which is a remarkable feature, especially in the context of LMICs.

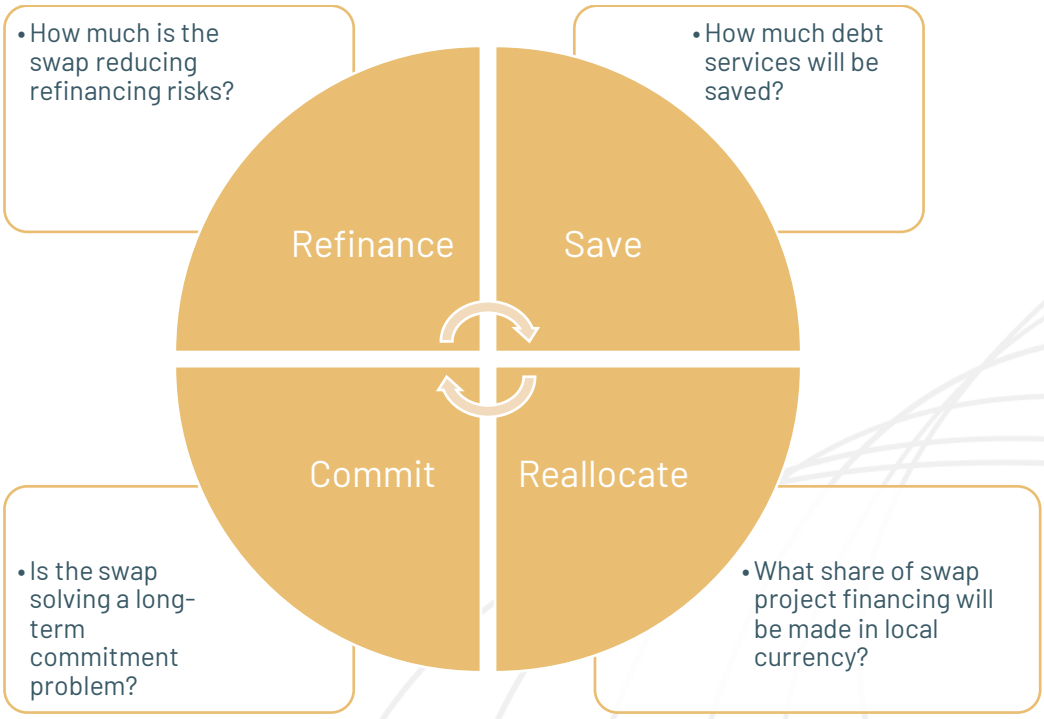
c. The involvement of multiple stakeholders

Programs underpinning debt swaps have, so far, been implemented by international NGOs. This is explained by several factors:

- **Swap transactions are led by a "project facilitator and advisor**" that has dedicated resources and capacity to structure them and coordinate the multiple stakeholders needed for them to happen – investors, credit rating agencies, international NGOs, local groups, banks…
- **The credit enhancement providers are likely to favor NGOs with a strong reputation and local expertise** to oversee and implement the programs as a "technical partner". That role entails co-designing the project commitments and conducting the necessary planning – which includes engaging with the local communities – providing technical advisory, and overseeing the trust fund grants and commitments.
- **Despite being led by an NGO, trust fund board representation tends to be relatively diversified**, and the leading NGO holds a clear minority stake[1].
- **Crucially, the government has a veto power during the transaction structuring** to make sure programs and approaches align with long-term development priorities and that selected NGOs are trusted partners.

3. The Domestic Public Finance Problems Debt Swaps Can Solve

World Bank and IMF (2024) propose a framework to evaluate the financial opportunity for engaging in a debt swap. Albinet, Chekir and Kessler (2024) provide a comprehensive framework analyzing the economics and costs associated with swaps. Here, we highlight the main reasons why a developing country's government would engage in a debt swap from a domestic public finance perspective – assuming its economics, impact, and governance make sense. We use a straightforward framework to examine the domestic finance benefits from refinancing, saving, reallocation, and commitment perspective – all four of which, we argue, are advantageous for the government and attainable through swaps.



Swaps can help refinance maturities at a time when asset liability management operations are particularly challenging. In the case of Gabon, Ecuador, Barbados, and Belize, the average maturity extensions of Eurobonds were respectively 3.9, 2.1, 0.2, and 3.7 years – pushing refinancing needs further out at a time when global interest rates remain relatively high. Typically, there is a trade-off between generating nominal fiscal savings and refinancing the shorter-term maturities[7] – which is why, with the exception of Belize, the swaps have involved more than one bond issuance.

Swaps can generate significant savings over time, which are allocated between the government and the trust fund. These savings can be split between fiscal space and trust fund financing. The split will be defined by the credit enhancement provider, who might set a minimal project funding requirement threshold; the technical partner, which seeks to implement ambitious projects; and the government,

[7] Usually, longer-term debt trades at a deeper discount which can unlock more project funding. In the case of Gabon, the swap was unable to make a sizable dent into refinancing the 2025 bond maturities – which were the main short-term challenge.

which might be looking for additional fiscal space. The share of total savings allocated to project funding has fluctuated in the four debt swaps, ranging from 29% in the case of Ecuador to 100% in the case of Gabon.

Swaps can help alleviate foreign reserve tensions. Debt swaps can convert scheduled foreign debt service repayment into hard currencies to savings, which contributes to building foreign reserves[8]. When it comes to trust fund allocation, TNC (2024) highlights that *"countries have options to make conservation payments in local currencies", to be "invested in the local economy"*. This can be a significant advantage for countries that are facing challenges in maintaining adequate foreign reserves[9].

A significant yet often overlooked public finance benefit of swaps is a government's commitment to long-term objectives – especially when long-term finance can be a binding constraint.

Long-term funding is critical to finance sustained investments. Compared to advanced economies, LMIC governments tend to issue more debt with shorter maturities (Songwe and Awiti (2021)) and struggle to access long-term financing IMF (2017). Most policies that would enable governments to mobilize long-term financing require extensive reforms that would only yield results after years if implemented effectively[10]. In the short-term, the most reliable option for governments is to mobilize financing from donors and IFIs, but this approach has limits in terms of volumes. It is in this context that debt swaps, by funding projects over decades, contribute to alleviating the constraint of long-term funding while possibly attracting further financing from development finance institutions by creating a pipeline of projects.

Debt swap flows are remarkable not only for their long-term nature but also for their predictability – which is particularly relevant given how much volatility and vulnerability to shocks is an increasingly defining feature of LMICs economies (CGD, 2009) – for example, when countries confront natural disasters or when commodity prices display high volatility[11]. This occurs in a context where LMICs already have fiscal policies that exacerbate volatility: in contrast with advanced economies, fiscal policy in developing economies tends to be procyclical, affecting both primary expenditures and budget balance (Arroyo Marioli et al. (2024), Talvi et al. (2005)). This volatility, in turn, translates into unreliable budgets that hinder the fulfillment of government commitments[12], off-budget spending, and payment arrears, all of which directly impact service delivery and can derail projects, causing them to halt mid-way or be implemented with significant delays. Furthermore, the management of debt swap funds is, by design, shielded from direct government control, which means that they should not be severely impacted by swings in expenditure prioritization and political change. Reflecting a requirement from the US DFC, the Belize conservation funding agreement stipulates that *"the Conservation Fund will at all times be an independent legal entity…with a majority non-government representation".*

[8] Apart from the Barbados debt swap, all other swaps analyzed have targeted external debt held in foreign currency.
[9] In Sub-Saharan Africa, the IMF shows that, one third of countries hold reserves smaller than three months of imports – which is typically the minimum expected amount to provide adequate buffers against future shocks.
[10] E.g. improving creditworthiness with rating agencies, building robust legal and regulatory frameworks…
[11] There have been multiple attempts at introducing contingency features in financial instruments to help manage external shocks (Cohen et al., 2023). However, the cost of the contingency features and the high discount rate in LMICs have made those a hard-sell for many LMICs that end up dependent on an increasingly uncertain global solidarity in case of a crisis (or outright repayment default).
[12] The International Budget Partnership (2022) has shown that repeated deviations from approved budgets erode confidence in the government's ability to make realistic plans.

Long-term, ringfenced, regular debt swap financial flows help alleviate the long-term funding and commitment issues faced by governments that are traditionally prone to shifting priorities and, consequently, often struggle to stay the course when long-term investment is needed. This is particularly the case in countries with weak governance indicators. A Trust Fund structure with a minority government stake might appear to contradict the Aid Effectiveness agenda. However, it helps to keep in mind that funding derived from the four debt swaps analyzed here has represented between 0.04% and 0.57% of annual government spending. It is our view that tying the hands of the government to a cause it decided to tackle over the long run is a beneficial aspect of the debt swap – especially when funding flows represent a minor portion of the government's annual budget. The more targeted the objective of the swap, the more likely it is to effectively address the underlying challenge – given the resources mobilized.

Table 4: The domestic public finance benefits of debt swaps

	Belize (2021)	Barbados (2022)	Ecuador (2023)	Gabon (2023)
Average maturity extension	+3.7 years	+0.2 years	+2.1 years	+3.9 years
Debt service reduction ($Mn)	200	40	1100	0
Total expected financing ($Mn)	176	49.5	450	163
Share of savings allocated to project financing	47%	55%	29%	100%
Total savings as a share of foreign reserves*	90%	6%	35%	14%
Total expected financing as a share of 2023 government expenditure	24.00%	2.71%	0.94%	3.66%
Total expected financing as a share of yearly government expenditure over the swap time horizon**	0.57%	0.08%	0.04%	0.11%

At bond issuance year. Estimates for Gabon foreign reserves

****Assuming constant government expenditure from 2023 and considering the average swap flow over the lifetime of the program***

4. Three Guiding Principles For Debt Swap Resources Allocation

Instead of arguing that one sector, due to its intrinsic needs, is a better fit for a debt swap (as might have been said about nature conservation or climate), we suggest that any sector can be suitable for a debt swap. What matters most is not the sectors themselves but the objectives that the swap's financial flows aim to achieve and how. In this regard, we argue that three interrelated principles that can guide debt swap resources allocation. Importantly, these principles rely on the idea that such resources, while meaningful, represent only a minor portion of yearly government budgets and, as a result, could be used in a different and complementary manner.

a. Define a long-term vision of what can be achieved through swap resources.

Since debt swaps align sectoral goals with funding over a long period of time[13], it is important for the government to define a vision for what the funds will ultimately support, serving as a guiding north star that aligns with long-term plans. This approach would also help prevent funds from being diverted to recurrent needs down the line, which would de facto blur the lines between the swap and government budget. The vision could be intersectoral, especially considering the significant intersections between climate and development that can be harnessed to achieve a common objective. For instance, there are transformative interventions that can advance both climate and health objectives, such as the solar electrification of health facilities, placing them on a low-carbon pathway whilst providing critical refrigeration for vaccines and electrified labor wards in remote areas (Gates Foundation, 2023). The vision could also be narrowly defined within one sector, such as disease elimination, that requires significant sustained effort but could generate a long-term payoff as the government won't need resources to contain the disease once eliminated.

Consultations, that are key to defining the long-term vision for the swap, can be led at two levels:

- **At the top level**, during the design stage of the swap, consultations should help ensure that swap resources support a project backed by society – which would establish its relevance over a long implementation period. In the case of Ecuador, the conservation and expansion of the Galapagos Islands marine reserves was set as the vision to be achieved. A key point is to ensure the vision is sufficiently defined with respect to the financing involved, but also ambitious enough to achieve significant results over time. Given the market sensitivity of debt swap transactions, it has been challenging to consistently involve civil society at this critical stage.
- **At the operational level**, the Trust Fund board plays a critical role in approving projects and monitoring the implementation of the program. A diverse board with no intrinsic bias will ensure that the Trust Fund stays true to its long-term vision over time. Board diversity and its consideration of civil society views is also critical to the legitimacy of the mechanism.

Transparency and accountability are key in tracking progress towards accomplishing that vision (Eurodad, 2023) and should be promoted by the swap mechanism – given that unlocked funding represents public resources, akin to national budgets. Clear result metrics alongside outcome-based spending commitments could enhance the readability and flexibility of the mechanism (World Bank and

[13] Beyond the terms of the transaction (upwards of 15 years), given the endowment fund portion.

IMF, 2024) – while acknowledging the need to exert discretion prior to the financial close of the transaction. In addition, Lazard (2024) argued that civil society involvement *"has had significantly positive impact on the implementation of the instrument"* in previous cases of debt swaps, a learning that governments should keep in mind.

Table 5: Belize Fund for a sustainable future board composition

Government members	Non governments	Objectives
Ministry of Blue Economy and Civil Aviation	TNC	• To provide grant funding and other forms of support for conservation and sustainable use of ocean resources in Belize. • To support the achievement of Belize's conservation commitment under the Blue Loan Agreement (Blue Bond). • To contribute to the stewardship of a sustainable future for the people and environment of Belize. • To ensure fiduciary responsibility and integrity in the administration of the Belize Fund's finances.
Ministry of Finance, Economic Development and Investment	Belize Tourism Industry Association	
Ministry of Sustainable Development, Climate Change & Disaster Risk Reduction	University of Belize	
Bipartisan representative	Belize Fisheries Council	
	Belize Network of Non-Governmental Organizations	

b. Target expenditures that particularly benefit from long-term financing

As mentioned above, debt swaps unlock long-term, regular, and predictable financial flows. As such, an optimized use for these resources would leverage these rather distinct characteristics. This means allocating financing to expenditures that involve substantial and ongoing investments, typically in areas with consistent and predictable costs over extended periods. This feature is particularly important given the reluctance of many development partners to support an initiative over an extended period (e.g. recurrent expenditures). Some principles could drive the identification of expenditures that are a better fit for debt swap resources:

- Lumpy investments that benefit most from upfront large financing are not particularly adapted to debt swaps - for instance, public infrastructure or housing.
- Investments that require and benefit from regular financing over time are a good fit. This could include infrastructure maintenance and upgrades, which is a known pain point for many LMIC budgets. This could also include vaccine financing, which requires regular campaigns, or investment in the training of schoolteachers.
- Investments that deliver significant returns over a long period of time require the type of patient capital a swap provides. This could include environmental protection, such as conservation projects, pollution control, and climate-resilient infrastructure. This could also include human capital spending (health, education, nutrition), which, according to the Mathew & Weil (2020) or The Lancet (2013), has one of the highest long-term returns on investment.
- Debt swap resources do not need to be invested in the productive capacity of the economy that exhibits a short-term return on investment since they could rely on private capital mobilization. That would mean, for example, that support for financial services, real estate, or energy facilities is not necessarily the most pertinent for a swap.

Ultimately, most sectors would have expenditures or areas that would be a strong fit for debt swap resources. Hence, the responsibility to ensure optimal expenditure targeting lies with the trust fund board directors, which reviews and approves projects over time.

c. Establish mechanisms to ensure additionality with government spending

As argued above, a debt swap would be a lost opportunity if it merely serves as an extension of government budgets, given the unique nature of swap flows. Elected governments seldom have the ability to promote long-term objectives beyond the electoral cycle, and there is strong evidence of political budget cycles, especially in newer democracies (Brender and Drazen, 2005). A debt swap thus offers a unique opportunity to tie a government's hands over the long-term to a set of objectives it devised when the operation was initially conceived of. Therefore, additionality against government action becomes an important principle. By this, we mean spending that would not have been incurred by the government but would still generate a real increase in social value that is aligned with the government's objectives at the time the debt swap is approved. Abiding by the additionality principle while focusing on a long-term societal vision would ensure that debt swap resources address a governance failure – that the government would be challenged to tackle, considering its historical fiscal policy choices (World Bank and IMF, 2024).

Additionality is one of the key principles for development assistance. However, it is notoriously hard, if not impossible, to measure, given the need to rely on an unobservable counterfactual. That said, a couple of measures could help ensure a higher likelihood of additionality:

- **Additionality with national budgets can be fostered by having the government maintain a minority rather than a majority seat on the trust fund board – a practice that has been applied for most debt swaps.** This would prevent the funds from becoming an extension of the government's budget, especially during times of fiscal crunch, which would defeat the purpose of the mechanism altogether. While the government is still likely to remain the largest shareholder in the Trust Fund, its lack of veto power over decisions will require it to coordinate with civil society.
- **The Trust Fund should seek to fund programs that would be challenging for the government administration to support, thereby expanding the range of possibilities.** This could include, for instance:
    - Smaller initiatives that respond to newly identified or emerging needs while furthering the long-term vision of the swap. This means the Fund should ensure it is also able to mobilize and release funds over a short period of time, but also potentially assess projects that fall outside of the call for proposals window.
    - Conversely, initiatives that require long-term sustained financing which the government may find challenging to reliably fund. This can be due to economic factors (domestic and global economic cycles, tax base volatility or deficit-reduction policy) or political factors (policy reversals, short-termism or changing citizens' expectations).
    - Riskier initiatives that have the potential for significant impact. Governments often face challenges in financing innovation, as the failures of riskier initiatives can be used against them by political opponents. Typically, a government tends to back larger players that have already demonstrated progress rather than seeding innovators.
- **Encourage a more diverse set of players to benefit from trust fund support.** For instance, the involvement of a diverse board, that can bring together academia and reputable players, is likely to broaden the scope of initiatives. Intentional outreach campaigns towards organizations can also help nurture a fertile pipeline of projects.
- **Engage in sectors or areas that are structurally underfunded by the government, as the larger the funding gap, the more likely it is that new funding will be additional.** The government should assess the prospects of domestic and external sector funding to identify where it is likely to face a financing constraint over time.

These three principles are interrelated and overlap in many ways. For instance, having a long-term vision should help anchor additionality, ensure funds are not used to supplement government budget shortfalls, and bring a focus on long-term expenditures. It is too early to assess the extent to which the four debt swaps analyzed in this paper align with these principles, but that is definitely something to monitor.

Conclusion

This paper goes beyond the usual debate "in favor of" or "against" swaps, which has dominated the discussion until recently. It argues that swaps can be done well and with a more diverse sectoral approach: what matters is how objectives are leveraging the unique cash flow structure that swaps deliver.

There are several factors that governments need to weigh carefully before engaging in such an operation. This notably includes debt sustainability prospects, the debt structure, the capacity of the government to carry out such a complex transaction, and a comprehensive cost-benefit analysis of the transaction[14]. Debt swaps are transaction-intensive, and governments need to ensure that the use of proceeds is in line with their long-term developmental objectives. Under no circumstances should a debt swap be a substitute for broader debt treatments when debt is unsustainable or for ODA or climate finance commitments – both of which remain the lifelines for many countries. However, we argue that debt swaps can be valuable tools under the right circumstances, recognizing that first-best solutions are not always available. Debt swaps are no more a silver bullet than other development finance tools, and they need to be well-structured and tailored to specific objectives and pain points to really have an impact.

While much has been written about their financial structuring and policy relevance at the macroeconomic level, there has been significantly less emphasis on the sectoral allocations of debt swap resources, which will ultimately determine whether the operation was successful. Similar to the labeled bonds market, which began with green bonds, we expect debt swaps to continue their early-stage expansion into "social" sectors such as health, education, or nutrition – a movement that is now underway.

This paper is an attempt at framing the debate around guiding principles for the sectoral allocation of debt swap resources at a time when more of these operations are expected to be led by a wider variety of implementing NGOs across different sectors.

[14] Trilateral debt swaps can include significant transaction costs, for instance, the Belize swap deal included more than $10M in closing costs (Bloomberg, 2023).

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